United States General Accounting Office

GAO

Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

For Release on Delivery
Expected at 10 a.m. EST
Tuesday, March 5, 2002

PROTECTING THE PUBLIC INTEREST

Selected Governance, Regulatory Oversight, Auditing, Accounting, and Financial Reporting Issues

Statement of David M. Walker
Comptroller General of the United States

GAO
Accountability ★ Integrity ★ Reliability

GAO-02-483T

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to discuss with the committee my perspectives on some of the issues that are now receiving extensive national interest following the rapid and unexpected decline of Enron Corporation (Enron) and the resulting huge losses suffered by Enron's shareholders and employees. The rapid failure and bankruptcy of Enron has led to severe criticism of virtually all areas of the nation's financial reporting and auditing systems, which are fundamental to maintaining investor confidence in our capital markets. At last count, 12 congressional committees, the Department of Justice, the Securities and Exchange Commission (SEC), and the Department of Labor's Pension and Welfare Administration all have ongoing investigations of Enron. The individuals responsible for the Enron debacle should be held accountable for any misdeeds. At GAO, accountability is one of our core values and must be a critical component of any system in order for it to function effectively.

The facts regarding Enron's failure are still being gathered to determine the underlying problems and whether any civil and/or criminal laws have been violated. Therefore, I will not comment on the specifics of the Enron situation and who is at fault. At the same time, the Enron situation raises a number of systemic issues for congressional consideration to better protect the public interest. It is fair to say that other business failures or restatements of financial statements have also sent signals that all is not well with the current system of financial reporting and auditing. As the largest corporation failure in U.S. history, Enron, however, provides a loud alarm that the current system may be broken and in need of an overhaul.

I will focus on four overarching areas—corporate governance, the independent audit of financial statements, oversight of the accounting profession, and accounting and financial reporting issues—where the Enron failure has already demonstrated that serious, deeply rooted problems may exist. It should be recognized that these areas are the keystones to protecting the public's interest and are interrelated. Failure in any of these areas places a strain on the entire system. The overall focus of these areas should be guided by the fundamental principles of having the right incentives for the key parties to do the right thing, adequate transparency to provide reasonable assurance that the right thing will be done, and full accountability if the right thing is not done. These three overarching principles represent a system of controls that should operate with a policy of placing special attention on those areas of greatest risk. In addition, an established code of ethics should set the "tone at the top" for expected ethical behavior in performance of all key responsibilities. The 1980s savings and loan crisis, for which this committee was instrumental in shaping the reforms to protect deposit insurance and the public interest, is a prime example of the serious consequences that can result when one or more components of an interrelated system breaks down.

My comments today are intended to frame the broad accountability issues and provide our views on some of the questions and options that must be addressed to better safeguard the public interest going forward. There will no doubt be many views on what needs to be fixed and how to do it. We look forward to working with the Congress to provide assistance in defining the issues, exploring various options, and identifying their pros and cons in order to repair any weaknesses that threaten confidence in our capital markets and that inhibit improvements in the current system and appropriate actions by the key players. In considering changes to the current system that gave rise to Enron and other earlier financial reporting failures, it will be important that the Congress consider a holistic approach to addressing the range of interrelated issues. From all that has been heard from the inquiries to date, it is clear that there is no single silver bullet to fix the problems. It is also clear that many parties are focusing on various elements of the issues but do not seem to be taking a comprehensive approach to addressing the many interrelated issues. This is what we are trying to do for the Congress.

On February 25, 2002, GAO held a forum on various governance, transparency, and accountability issues that was attended by experts in each of these areas. A summary of the results of the forum is being released today and is available at our web site.[1] Also, we have completed the study of the SEC's resources that you requested and the report is being released today.[2] I will discuss the results of that work today as well.

Before discussing these matters, I would like to quickly provide an overview of the current corporate governance system, the independent audit function, regulatory oversight, and the accounting and financial reporting framework. An attachment to my testimony graphically illustrates the interrelation and complexity of these systems.

[1]*Highlights of GAO's Forum on Corporate Governance, Transparency, and Accountability* (GAO-02-494SP, March 5, 2002).

[2]*SEC Operations: Increased Workload Creates Challenges*, (GAO-02-302, March 5, 2002).

Overview of the Current Governance, Auditing, Oversight Systems, and Financial Reporting

Public and investor confidence in the fairness of financial reporting is critical to the effective functioning of our capital markets. The SEC, established in the 1930s following the stock market crash of 1929 and the Great Depression, protects investors by administering and enforcing federal securities laws, and its involvement with requirements for financial disclosures and audits of financial statements for publicly traded companies. In this respect, the public accounting profession, through its independent audit function, has received a franchise to audit and attest to the fair presentation of financial statements of publicly traded companies. However, such a franchise brings with it not only the important role of attesting to the reliability of financial statements and related data, but also the concomitant responsibility of protecting the public interest and ensuring public confidence through appropriate independence, professional competence, and high ethical standards for auditors.

The SEC, the primary federal agency involved in accounting and auditing requirements for publicly traded companies, has traditionally relied on the private sector for setting standards for financial reporting and independent audits, retaining a largely oversight role. Accordingly, the SEC has accepted rules set by the Financial Accounting Standards Board (FASB)[3]—generally accepted accounting principles (GAAP)—as the primary standard for preparation of financial statements in the private sector. The SEC has accepted rules set by the American Institute of Certified Public Accountants' (AICPA) Auditing Standards Board—generally accepted auditing standards(GAAS)—as the standard for conducting independent audits of financial statements for private sector entities. The SEC monitors the performance of the standard-setting bodies and also monitors the accounting profession's system of peer review, which checks compliance with applicable professional standards.

The SEC also oversees the activities of a variety of key market participants. It does this using the principle of self-regulation. According to this principle, the industry regulates itself through various self-regulatory organizations (SROs) overseen by the SEC. SROs are groups of industry professionals with quasi-governmental powers to adopt and enforce standards of conduct for their members. They include the nine securities

[3]FASB, as part of the Financial Accounting Foundation (FAF), is a not-for-profit organization supported by contributions from accounting firms, corporations, and other entities that are interested in accounting issues. FASB consists of seven full-time members who are selected and approved by the FAF.

exchanges, such as the New York Stock Exchange (NYSE), which regulate their marketplaces and the National Association of Securities Dealers (NASD) which regulates the over-the-counter market. In addition to regulating member broker dealers, the SROs establish listing standards for those firms that list on their market.

The AICPA administers a self-regulatory system for the accounting profession that includes setting auditing and independence standards, monitoring compliance, and disciplining members for violations of ethic rules and standards. The Public Oversight Board, administratively created by the AICPA in consultation with the SEC in 1977, monitors public accounting firms' compliance with professional standards and oversees the Auditing Standards Board. State boards of accountancy license public accounting firms and individuals to practice public accounting within each state's jurisdiction.

The audit is a critical element of the financial reporting structure because it subjects information in the financial statements to independent and objective scrutiny, increasing the reliability and assurance that can be placed on those financial statements for efficient allocation of resources in a capital market where investors are dependent on timely and reliable information. Management of a public company is responsible for the preparation and content of the financial statements, which are intended to disclose information that accurately depicts the financial condition and results of company activities. In addition, public companies registered with the SEC must maintain an adequate system of internal accounting control. The independent auditor is responsible for auditing the financial statements in accordance with generally accepted auditing standards to provide reasonable assurance that the financial statements are fairly presented in accordance with GAAP. The auditor's opinion on the financial statements is like an expert's stamp of approval to the public and the capital markets.

U.S. stock exchanges require listed companies to meet certain corporate governance standards, including that boards of directors have independent audit committees to oversee the accounting and financial controls of a company and the financial reporting process. Audit committees can help protect shareholder interests by providing sound leadership and oversight of the financial reporting process by working with management and both internal and external auditors.

The interrelation and complexity of the systems of corporate governance, auditing, oversight, and accounting and financial reporting, which cumulatively are the foundation for maintaining investor confidence in our capital markets, is graphically illustrated in the charts attached to this statement. The many links within and between the systems further illustrate the strain that can be placed on the overall system when weaknesses occur within any part of the system.

I would now like to focus on each of the four overarching areas I mentioned earlier, starting with corporate governance.

Corporate Governance

I want to acknowledge immediately that serving on the Board of Directors of a public corporation is an important, difficult, and challenging responsibility. That responsibility is especially challenging in the current environment with increased globalization and rapidly evolving technologies having to be addressed while at the same time meeting quarterly earnings projections in order to maintain or raise the market value of the corporation's stock. These pressures, and related executive compensation arrangements, unfortunately often translate to a focus on short-term business results. This can create the perverse incentives, such as managing earnings to inappropriately report favorable financial results, and/or failing to provide adequate transparency in financial reporting that disguises risks, uncertainties, and/or commitments of the reporting entity.

On balance though, the difficulty of serving on a public corporation's board of directors is not a valid reason for not doing the job right, which means being knowledgeable of the corporation's business, asking the right questions, and doing the right thing to protect the shareholders and the public interest. A board member needs to have a clear understanding of who is the client being served. Namely, their client should be the shareholders of the company, and all their actions should be geared accordingly. Audit committees have a particularly important role to play in assuring fair presentation and appropriate accountability in connection with financial reporting, internal control, compliance, and related matters.

Enron's failure has raised many questions about how its Board of Directors and audit committee were performing their duties and responsibilities. These questions include the following:

- Did the board of directors fulfill its fiduciary responsibility to shareholders and protect the public interest in overseeing Enron's management?
- Did the board operate in a proactive manner and raise the appropriate questions designed to identify key problems and mitigate related risks?
- Did the board have the appropriate industry, financial, or other appropriate expertise?
- Did board members have personal or business relationships that may have either in fact or in appearance affected their independence?
- Did the board, especially its audit committee, have an active interface and appropriate working relationship with Enron's internal and external auditors?
- Did the board and its audit committee have appropriate resources to do the job including staff and independent advisors?
- Did the board and its audit committee report meaningfully on their activities?

These are fundamental questions that as I previously mentioned are being addressed by various investigations and, therefore, I will not comment on those issues. However, these issues are instructive and, as a minimum, call for a review of the applicable rules and regulations that govern boards of directors. In that respect, the Administration recently formed a group of top financial policymakers and regulators to consider corporate governance and disclosure reforms. The SEC has asked the NYSE and Nasdaq to review corporate governance and listing standards, of public companies, including the important issues of officer and director qualifications and the formal codes of conduct. The SEC Chairman recently announced that the NYSE has established a Special Committee on Corporate Accountability and Listing Standards to examine corporate governance issues, including the possibility of requiring continuing education programs for officers and directors, and the Nasdaq also is taking similar steps. The corporate chief executives who make up the Business Roundtable have stated that they are reviewing their voluntary standards for corporate governance. The AFL-CIO has petitioned the SEC to amend its proxy disclosure requirements regarding conflicts of interest reportable by Board members. The California Public Employees' Retirement System (CalPERS) is also reviewing definitions and standards for independent corporate directors.

These examples are not intended to be a complete listing of reviews underway on corporate governance requirements. We applaud these initiatives. Hopefully, they will provide the opportunity for a thorough review of corporate governance requirements. These efforts will help to identify and frame the issues and to serve as a basis for determining whether the fundamental underpinnings for effective performance of boards of directors and audit committees are in place along with controls to monitor performance. Some basic factors to consider in reviewing the various requirements that govern membership and responsibilities of boards of directors of public companies include the following:

- Is there a clear understanding of whom the board is serving and its fiduciary responsibility to shareholders and related impact on the capital markets?
- What type of relationship should the board have with management (for example, constructive engagement)?
- What, if any, selection process changes are necessary in order to assure the proper identification of qualified and independent board members?
- Is the nominating process for board membership designed to ensure that the board is getting the right mix of talent to do the job?
- Do board membership rules address who other than management would nominate Board members?
- Are the independence rules for outside directors and audit committee members sufficient to ensure the objectivity of the members?
- Do board membership rules address whether the corporation's CEO should be allowed to be the board chairman?
- Do board membership rules address whether independent board members should nominate the chairman of the board?
- Do board membership rules address whether members of corporation management, including the CEO, should be allowed to be board members, and if so, what percentage of total board membership?
- Do board membership rules address whether corporation service providers, such as major customers or other related parties, should be allowed to be board members?
- Do requirements ensure that the board will have access to the resources and staff necessary to do the job, including its own staff and access to independent legal counsel and other experts?
- Do requirements ensure that the responsibilities of board members, including the members who serve on audit committees and other committees, such as the nominating, finance, and compensation committees, are required to be committed to a charter that governs their operation?
- Do requirements address the appropriate working relationship between the audit committee and the internal and external auditors?

- Do requirements provide for the board of directors to establish a formal code of conduct to set the tone for expected personal and business ethical behavior within the corporation?
- Do requirements provide that waivers of the code of conduct are not expected and should such circumstances arise, which should be extremely rare, that any exceptions must be approved by the board of directors and publicly reported?
- Do requirements provide for public reporting on the effectiveness of internal control by management and independent assurances on the effectiveness of internal control by the corporation's independent auditors?
- Do requirements provide for public reporting by the board of directors, the audit committee, and other committees of the board on their membership, responsibilities, and activities to fulfill those responsibilities?
- Do the stock exchanges and the SEC have sufficient authority to enforce requirements governing boards of directors and audit committees and to take meaningful enforcement actions, including imposing effective sanctions when requirements are violated?
- Does the SEC have sufficient resources and authority to fulfill its responsibilities under the federal securities laws and regulations to operate proactively in monitoring SEC registrants for compliance and to take timely and effective actions when noncompliance may exist?
- Is the SEC efficiently and effectively using technology to manage its regulatory responsibilities under the federal securities laws by assessing risks, screening financial reports and other required filings, and accordingly prioritizing the use of its available resources?

Boards of directors and their audit committees are a critical link to fair and reliable financial reporting. A weak board of directors will also likely translate into an ineffective audit committee. That combination makes the difficult job of auditing the financial statements of large corporations, which usually have vast, complex and diversified operations, much more challenging.

Regulation and Oversight of the Accounting Profession

The model for regulation and oversight of the accounting profession involves federal and state regulators and a complex system of self-regulation by the accounting profession. The functions of the model are interrelated and their effectiveness is ultimately dependent upon each component working well. Basically, the model includes the functions of

- licensing members of the accounting profession to practice within the jurisdiction of a state, as well as issuing rules and regulations governing member conduct, which is done by the state boards of accountancy;
- setting accounting and auditing standards, which is done by the Financial Accounting Standards Board and the Auditing Standards Board, respectively, through acceptance of the standards by the SEC;
- setting auditor independence rules, which within their various areas of responsibility, have been issued by the AIPCA, the SEC, and GAO; and
- oversight and discipline, which is done through systems of self-regulation by the accounting profession and the public regulators (the SEC and state boards of accountancy).

The Enron failure has brought a direct focus on how well the systems of regulation and oversight of the accounting profession are working in achieving their ultimate objective that the opinions of independent auditors on the fair presentation of financial statements can be relied upon by investors, creditors, and the various other users of financial reports.

The issues currently being raised about the effectiveness of the accounting profession's self-regulatory system are not unique to the collapse of Enron. Other business failures or restatements of financial statements over the past several years have called into question the effectiveness of the system. A continuing message is that the current self-regulatory system is fragmented, is not well coordinated, and has a discipline function that is not timely nor does it contain effective sanctions, all of which create a public image of ineffectiveness. Reviews of the system should consider whether overall the system creates the right incentives, transparency, and accountability, and operates proactively to protect the public interest. Also, the links within the self-regulatory system and with the SEC and the state boards of accountancy (the public regulatory systems) should be considered as these systems are interrelated and weaknesses in one component can put strain on the other components of the overall system.

I would now like to address some of the more specific areas of the accounting profession's self-regulatory system that should be considered in forming and evaluating proposals to reshape or overhaul the current system.

Accounting Profession's Self-Regulatory System

The accounting profession's current self-regulatory system is largely operated by the AICPA through a system, largely composed of volunteers from the accounting profession. This system is used to set auditing standards and auditor independence rules, monitor member public accounting firms for compliance with professional standards, and discipline members who violate auditing standards or independence rules. AICPA staff support the volunteers in conducting their responsibilities. The Public Oversight Board oversees the peer review system established to monitor member public accounting firms for compliance with professional standards. In 2001, the oversight authority of the Public Oversight Board was expanded to include oversight of the Auditing Standards Board. The Public Oversight Board has five public members and professional staff, and receives its funding from the AICPA.

On January 17, 2002, the SEC Chairman outlined a proposed new self-regulatory structure to oversee the accounting profession. On January 20, 2002, the Public Oversight Board passed a resolution of intent to terminate its existence no later than March 31, 2002. The Public Oversight Board's Chairman was critical of the SEC's proposal and expressed concern that the Board was not consulted about the proposal. The SEC's proposal provided for creating an oversight body that would include monitoring and discipline functions, have a majority of public members, and be funded through private sources. No further details have been announced.

The authority for the oversight body is a basic but critical factor that can influence its operating philosophy, its independence, and, ultimately, its effectiveness. Related factors to consider include

- determining whether the body should be created by statute or administratively, such as is the case for the current Public Oversight Board;
- deciding the basic scope of the body's enabling authority, such as whether oversight authority should be limited to coverage of the public accounting firms that audit SEC registrants, which is the authority of the current Public Oversight Board, or whether it should be expanded to other public accounting firms that also provide audit services to a broader range of entities; and
- determining mission objectives clearly to ensure that protecting the public interest is paramount.

Membership of the oversight body and its funding may also influence the body's operating philosophy (proactive as opposed to reactive), independence, and resolve to actively assess and minimize risks within the system that affect protecting the public interest. Factors to consider include

- whether the membership should be limited to public members (exclude practicing members of the accounting profession), such as is the case for current Public Oversight Board, or whether membership should allow some practicing members of the accounting profession to sit on the board;
- how the members will be selected, including the chair, their term limits, and compensation; and
- how the amount and source of funding will be established since a problem with either may present potential conflicts or limit the oversight body's ability to effectively protect the public interest.

The responsibilities of the oversight body and its powers to perform those responsibilities will largely define whether the oversight body is set up with a sufficient span of responsibility to oversee the activities of the accounting profession and to take appropriate actions when problems are identified. Related factors to consider include

- whether the current system of peer review should be continued in its present form and monitored by the oversight body, such as was done by the Public Oversight Board, with oversight by the SEC;
- whether the oversight body should have more control over the peer review function, such as selecting and hiring peer reviewers, managing the peer review, and being the client for the peer review report;
- whether the oversight body's authority should extend to all standard-setting bodies within the accounting profession so that accounting, auditing, quality control and assurance, and independence standards are subject to oversight (currently the Public Oversight Board does not oversee the setting of accounting standards or auditor independence rules);
- whether the oversight body's authority related to standard setting should be expanded to direct standard-setting bodies to address any problems with standards and approve the adequacy of revised standards (currently the Public Oversight Board does not have such direct authority);
- whether the oversight body's authority should extend to the discipline function (currently the Public Oversight Board does not oversee the discipline function);
- whether the oversight body should have investigative authority over disciplinary matters (currently this function is housed within another component of the AICPA) or authority to request investigations; and
- whether the body within the self-regulatory system responsible for investigations of disciplinary matters should have power to protect

investigative files from discovery during litigation to facilitate cooperation and timeliness in resolving cases.

Accountability requirements can provide for stewardship of resources, help to set the operating philosophy of the oversight body, and provide a means of monitoring the oversight body's performance. The current Public Oversight Board issues an annual report and its financial statements are audited. Related factors to consider include

- whether the oversight body should prepare strategic and annual performance plans;
- whether the oversight body should have an annual public reporting requirement and what information should be included in the report, such as whether the report should be limited to the oversight body's activities or whether the report should provide more comprehensive information about the activities of the entire self-regulatory system, and whether the oversight body should have audited financial statements; and
- whether and, if so, how the Congress should exercise periodic oversight of the performance of the self-regulatory system and the performance of the oversight body.

At this time, the outcome of the SEC's proposal to establish a body for overseeing the accounting profession that would include monitoring and discipline functions is uncertain. There is considerable overlap in the functions of the current self-regulatory system and the functions of the SEC related to the accounting profession. For example, the AICPA sets auditor independence rules applicable to its membership, and the SEC sets auditor independence rules for those auditors who audit SEC registrants. Also, the AICPA disciplines its members for noncompliance with independence rules or auditing standards. The SEC, through its enforcement actions, disciplines auditors of SEC registrants who violate its laws and regulations, which include noncompliance with independence rules and auditing standards. In addition, the SEC also conducts various activities to oversee the peer review function of the self-regulatory system.

As proposals are considered for reshaping or overhauling the self-regulatory system, the overlap of functions with the SEC's responsibilities should be considered to provide for oversight of the accounting profession that is both efficient and effective. Related factors to consider include the following:

- whether current independence rules are adequate to protect the public interest;
- whether independence rules for auditors should be consistent and set by the government or private sector, or whether the status quo is acceptable;
- whether the current system of peer review is acceptable or whether the SEC should play a role that exercises more direct control or oversight of the accounting profession's compliance with standards; and
- how the investigative/enforcement functions of the self-regulatory system and the SEC can be jointly used to efficiently and effectively achieve their common objectives to resolve allegations of audit failure.

Similarly, the discipline functions of the SEC and the self-regulatory system overlap with the state boards of accountancy, which are the only authorities that can issue or revoke a license to practice within their jurisdictions. The communication and working relationship opportunities for efficiency and effectiveness that exist between the SEC and the self-regulatory system also exist for their relationship with the state boards of accountancy in resolving allegations of audit failure.

The Independent Audit Function

For over 70 years, the public accounting profession, through its independent audit function, has played a critical role in enhancing a financial reporting process that facilitates the effective functioning of our domestic capital markets as well as international markets. The public confidence in the reliability of issuers' financial statements that is provided by the performance of independent audits encourages investment in securities issued by public companies. This sense of confidence depends on reasonable investors perceiving auditors as independent expert professionals who have neither mutual nor conflicts of interests in connection with the entities they are auditing. Accordingly, investors and other users expect auditors to bring to the financial reporting process integrity, independence, objectivity, and technical competence, and to prevent the issuance of misleading financial statements.

The Enron failure has raised questions concerning whether auditors are living up to the expectations of the investing public; however, similar questions have been repeatedly raised over the past three decades by significant restatements of financial statements and unexpected costly business failures. Issues debated over the years continue to focus on auditor independence concerns and the auditor's role and responsibilities, particularly in detecting and reporting fraud and assessing the effectiveness of and reporting on internal control.

Auditor Independence Concerns

The independence of public accountants—both in fact and in appearance—is crucial to the credibility of financial reporting and, in turn, the capital formation process. Auditor independence standards require that the audit organization and the auditor be independent in fact and in appearance. These standards place responsibility on the auditor and the audit organization to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as being impartial by knowledgeable third parties.

Since the mid-1970s, many observers of the auditing profession have expressed concern about the expanding scope of professional services provided by the public accounting profession. Specifically, questions have been raised by the media, the Congress, and others concerning the propriety of performing both audit and certain nonaudit services for the same client. While these services and their perceived impact on accounting firms' independence have been the subject of many studies and while actions have been taken to strengthen auditor independence, the Enron failure has brought this issue once again to the forefront and has sparked new proposals to prohibit or limit auditors from providing nonaudit services to audit clients. A common concern is that when auditor fees for consulting services are a substantial part of total auditor fees, this situation can create pressures to keep the client happy and can threaten auditor independence.

Auditors have the capability of performing a range of valuable services for their clients, and providing certain nonaudit services can ultimately be beneficial to investors and other interested parties. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, the client, or both will have to make a choice as to which of these services the auditor will provide. These concepts, which I strongly believe are in the public interest, are reflected in the revisions to auditor independence requirements for government audits,[4] which GAO recently

[4] *Government Auditing Standards*, *Amendment No. 3*, *Independence* (GAO/A-GAGAS-3, January 2002).

issued as part of *Government Auditing Standards*.[5] The new independence standard has gone through an extensive deliberative process over several years, including extensive public comments and input from my Advisory Council on Government Auditing Standards.[6] The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The two overarching principles in the standard for nonaudit services are that

- auditors should not perform management functions or make management decisions, and
- auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

Both of the above principles should be applied using a substance over form determination. Under the revised standard, auditors are allowed to perform certain nonaudit services provided the services do not violate the above principles; however, in most circumstances certain additional safeguards would have to be met. For example: (1) personnel who perform allowable nonaudit services would be precluded from performing any related audit work, (2) the auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work were performed by another unrelated party; and (3) certain documentation and quality assurance requirements must be met. The new standard includes an express prohibition regarding auditors providing certain bookkeeping or record keeping services and limits payroll processing and certain other services, all of which are presently permitted under current independence rules of the AICPA.

The focus of these changes to the government auditing standards is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities and entities

[5]*Government Auditing Standards* were first published in 1972 and are commonly referred to as the "Yellow Book," and cover federal entities and those organizations receiving federal funds. Various laws require compliance with the standards in connection with audits of federal entities and funds. Furthermore, many states and local governments and other entities, both domestically and internationally, have voluntarily adopted these standards.

[6]The Advisory Council includes 20 experts in financial and performance auditing and reporting drawn from all levels of government, academia, private enterprise, and public accounting, who advise the Comptroller General on *Government Auditing Standards*.

that receive federal funding. However, these standards apply only to audits of federal entities and those organizations receiving federal funds, and not to audits of public companies. In the transmittal letter issuing the new independence standard, we expressed our hope that the AICPA will raise its independence standards to those contained in this new standard in order to eliminate any inconsistency between this standard and their current standards. The AICPA's recent statement before another congressional committee that the AICPA will not oppose prohibitions on auditors providing certain nonaudit services seems to be a step in the right direction.[7] In 2000, the SEC considered a principle-based approach for auditor independence rules applicable to auditors of SEC registrants, but decided in the end to set specific rules by types of nonaudit services. We believe a principle-based approach is more effective given the wide variety of nonaudit services provided by auditors and the continuing evolution of the market.

The new independence standard is the first of several steps GAO has planned in connection with nonaudit services covered by government auditing standards. In May 2002, we plan to issue a question and answer document concerning our independence standard, and I will ask my Advisory Council on Government Auditing Standards to review and monitor this area to determine what, if any, additional steps may be appropriate. In addition, the Principals of the Joint Financial Management Improvement Program, who are the Comptroller General, the Secretary of the Treasury, and the Director, Office of Management and Budget, have agreed that the 24 major federal departments and agencies covered by the Chief Financial Officers Act should have audit committees. The scope, structure, and timing of this new requirement will be determined over the next several months. This will include determining what role these audit committees might play in connection with nonaudit services.

Another auditor independence issue, which also existed with Enron, concerns the employment by the client of its former auditor. The revolving door between auditors and the companies they audit has existed for years. This is due in part to the mandatory retirement of partners from public accounting firms, often before the partners are ready to leave the profession. Another contributing factor that entices auditors to work for audit clients is the lucrative compensation for executives in public

[7]Testimony of AICPA Chairman before the House Energy and Commerce Committee (Subcommittee on Communications, Trade and Consumer Protection), February 14, 2002.

companies. Employment by the client of its former auditor can have a clear implication on the quality of audits and has been cited as a factor in the savings and loan scandal of the late 1980s. The AICPA asked the SEC in 1993 to prohibit public companies from hiring their audit partner for a year after an audit. The SEC rejected the proposal as too difficult to enforce. However, Enron has resurfaced the issue. One congressional proposal would prohibit an accounting firm from providing audit services to a company whose controller or chief financial officer had worked for that public accounting firm. This issue again raises the auditor independence perception problem and provides another opportunity to further enhance auditor independence. A factor to consider in this debate includes mandating a "cooling off period" in which a partner or senior auditor from a firm cannot go to work for a former audit client for a period of time after separating from their firm.

A related issue is whether an audit firm should be allowed to serve as the client's auditor of record without a limit on the period of time. Currently, there are no time limits for rotation of audit firms, although the AICPA requirements for member firms that audit SEC registrants require partner rotation every 7 years. The concerns are that the auditor may become too close to management over a period of years and, therefore, threaten the auditor's objectivity. Also, the auditor's familiarity with the business operations of the client may result in a less than thorough audit. Opposing arguments against auditor rotation include that there is a significant learning curve for a new auditor and, during that time, there is a greater risk of the auditor overlooking transactions that may result in misleading financial statements. Also, auditor rotations can increase audit costs for the client.[8] Building on the current AICPA requirement for rotating the audit engagement partner every 7 years, rotating addition key members of the audit team is another alternative to consider. Rotating addition key members of the audit team should have less of an impact of the auditor's learning curve and not increase audit costs, although this option would still leave open the appearance of an independence issue for the firm.

[8]Federal, state, and local government auditors generally have their responsibilities defined by law or regulation. Therefore, rotation of government auditors raises different considerations than in the private sector. However, the rationale behind rotation of auditors (enhancing auditor independence) is addressed in *Government Auditing Standards*. The standards add organizational criteria that consider factors in the appointment, removal, and reporting responsibilities of the head of the audit organization to ensure independence. The organizational criteria for determining auditor independence are in addition to personal and external requirements that are considered in judging the independence of government auditors.

Study groups over the years have recognized that corporate boards and their audit committees could and should play a more significant role in strengthening the independence of audits. The situation with Enron and its auditors is another event that highlights the necessity to reexamine relationships of boards of directors, audit committees, and management with the independent auditor in order to strengthen the objectivity and professionalism of the independent auditor and to enhance the independent audit. Factors to consider in making changes include the following:

- Who should be the client for the audit?
- Should the audit committee be actively responsible for hiring, determining fees, and terminating the auditor?
- Should there be more required communication and interaction between the auditor and the audit committee?
- Should the audit committee preapprove the provision of certain nonaudit services by audit firms?
- Should the audit committee be required to review and approve the staffing of audit firm personnel?

Auditor's Roles and Responsibilities for Fraud and Internal Control

Under current auditing standards, auditors are responsible for planning and performing the audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement, whether caused by error, illegal acts, or fraud. As stated over the years by many who have studied the profession, no major aspect of the independent auditor's role has caused more difficulty than the auditor's responsibility for detecting fraud. In August 2000, the Panel on Audit Effectiveness concluded that the auditing profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management.[9] The study expressed concern that auditors may not be requiring enough evidence, that is, they have reduced the scope of their audits and level of testing, to achieve reasonable assurance about the reliability of financial information that the capital markets need for their proper functioning. The study recommended that auditing standards be strengthened to effect a substantial change in auditors' performance and thereby improve the likelihood that auditors will

[9] *The Panel on Audit Effectiveness Report and Recommendations* (August 31, 2000). The Panel was formed by the Public Oversight Board at the request of the SEC to study the effectiveness of the audit model and other issues affecting the accounting profession.

detect fraudulent financial reporting. The AICPA is working on a new auditing standard to improve auditor performance in this area, which it expects to issue by the end of this year.

We have long believed that expanding auditors' responsibilities to report on the effectiveness of internal control over financial reporting would assist auditors in assessing risks for the opportunity of fraudulent financial reporting or misappropriation of business assets. Currently, the auditor's report on a public company's financial statements does not address internal control or purport to give any assurance about it, and auditors are not required to assess the overall effectiveness of internal control or search for control deficiencies. The important issues of the auditor's responsibility for detecting and reporting fraud and for reporting on internal control overlap since effective internal control is the major line of defense in preventing and detecting fraud. Taken together, these issues raise the broader question of determining the proper scope of the auditor's work in auditing financial statements of publicly owned companies. The auditor would be more successful in preventing and detecting fraud if auditors were required to accept more responsibility for reporting on the effectiveness of internal control. The Congress recognized the link between past failures of financial institutions and weak internal control when it enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 that grew out of the savings and loan crisis. The act requires an independent public auditor to report on the effectiveness of internal control for large financial institutions.

For all of the financial statements audits that we conduct, which include the consolidated financial statements of the federal government, and the financial statements of the Internal Revenue Service, the Bureau of Public Debt, the Federal Deposit Insurance Corporation, and numerous smaller entities' operations and funds, we issue separate opinions on the effectiveness of internal control over financial reporting and compliance with applicable laws and regulations. We require extensive testing of controls and compliance in our audits. We have done this for years because of the importance of internal control to protecting the public interest. Our reports have engendered major improvements in internal control. As you might expect, as part of the annual audit of our own financial statements, we practice what we recommend to others and contract with a CPA firm for both an opinion on our financial statements and an opinion on the effectiveness of our internal control over financial reporting and compliance with applicable laws and regulations. We believe strongly that the AICPA should follow suit and work with the SEC to require expanded auditor involvement with internal control of public companies.

The AICPA Chairman recently expressed the accounting profession's support for auditor reporting on the effectiveness of internal control.[10] Auditors can better serve their business clients and other financial statements users and protect the public interest by having a greater role in providing assurances of the effectiveness of internal control in deterring fraudulent financial reporting, protecting assets, and providing an early warning of internal control weaknesses that could lead to business failures. The SEC, the AICPA, and corporate boards of directors are major stakeholders in achieving realistic auditing standards for fraud and internal control. However, as we stated in our 1996 report on the accounting profession,[11] the SEC is the key player in providing the leadership and in bringing these parties together to enhance auditor reporting requirements on the effectiveness of internal control. We believe it would be difficult for the AICPA to unilaterally expand audit requirements without SEC support.

Accounting and Financial Reporting Model

Business financial reporting is critical in promoting an effective allocation of capital among companies. Financial statements, which are at the center of present-day business reporting, must be relevant and reliable to be useful for decision-making. In our 1996 report on the accounting profession,[12] we reported that the current financial reporting model does not fully meet users' needs.

We found that despite the continuing efforts of standard setters and the SEC to enhance financial reporting, changes in the business environment, such as the growth in information technology, new types of relationships between companies, and the increasing use of complex business transactions and financial instruments, constantly threaten the relevance of financial statements and pose a formidable challenge for standard setters. A basic limitation of the model is that financial statements present the business entity's financial position and results of its operations largely

[10]See footnote 7.

[11]*The Accounting Profession Major Issues: Progress and Concerns* (GAO/AIMD-96-98, September 24, 1996).

[12]See footnote 11.

on the basis of historical costs, which do not fully meet the broad range of user needs for financial information.[13]

In 1994, the AICPA's Special Committee on Financial Reporting, after studying the concerns over the relevance and usefulness of financial reporting and the information needs of professional investors and creditors, concluded that the current model is useful as a reliable information basis for analysts, but concluded that a more comprehensive model is needed that includes both financial information and nonfinancial information. In addition to financial statements and related disclosures, the model recommended by the study would include

- high-level operating data and performance measures that management uses to manage the business;
- management's analysis of changes in financial and nonfinancial data;
- forward-looking information about opportunities, risks, and management's plans, including discussions about critical success factors, as well as information about management and shareholders; and
- background about the company, including a description of the business, its industry, and its objectives and strategies.

The Committee acknowledged that many business entities do report nonfinancial information, but it stressed the need to develop a comprehensive reporting package that would promote consistent reporting and the need to have auditors involved in providing some level of assurance for each of the model's elements. Opposing views generally cite liability concerns as a risk to reporting forward-looking and other related nonfinancial information, concerns over cost of preparing the information, and concerns whether more specific disclosures would put business entities at a competitive disadvantage. Although standard setters have addressed certain issues to improve the financial reporting model, a project

[13]The accounting and reporting model under generally accepted accounting principles is actually a mixed-attribute model. Although most transactions and balances are measured on the basis of historical cost, which is the amount of cash or its equivalent originally paid to acquire an asset, certain assets and liabilities are reported at current values either in the financial statements or related notes. For example, certain investments in debt and equity securities are currently reported at fair value, receivables are reported at net realizable value, and inventories are reported at the lower of cost or market value. Further, certain industries such as brokerage houses and mutual funds prepare financial statements on a fair value basis.

to develop a more comprehensive reporting model has not been undertaken.

Enron's failure and the inquiries that have followed have raised many of the same issues about the adequacy of the financial reporting model, such the need for transparency, clarity, and risk-oriented financial reporting, addressed by the AICPA's Special Committee on Financial Reporting. The limitations of the historical cost-based model were made more severe in the case of the Enron failure by accounting rules and reports designed for a pipeline operator that transitioned into a company using numerous offshore, off balance sheet, quasi-affiliated, tax shelter entities to operate, invest in, trade or make a market for contracts involving water, electricity, natural gas, and broadband capacity. However, criticism of the financial reporting model should also consider the criticisms of the corporate governance system, the auditing profession, and the regulatory and self-regulatory oversight models which may impact the quality of financial reporting. Also, human failure to effectively perform responsibilities in any one or all four of these areas has been raised by the many inquiries following Enron's sudden failure. Also, Enron's November 8, 2001, reporting to the SEC (Form 8-K filing), which restated its financial statements for the years ended December 31, 1997 through 2002, and the quarters ended March 31 and June 30, 2001, acknowledges that the financial reports did not follow generally accepted accounting principles and, therefore, should not be relied upon.

Among other actions to address the Enron-specific accounting issues, the SEC has requested that the FASB address the specific accounting rules related to Enron's special purpose entities and related party disclosures. The SEC is expecting the FASB to revise and finalize the special purpose accounting rules by the end of this year. The FASB has stated its is committed to proceed expeditiously to address any financial accounting and reporting issues that may arise as a result of Enron's bankruptcy. In that respect, the FASB at a recent board meeting set a goal of publishing an exposure draft by the end of April 2002 and a final statement by the end of August 2002 that would revise the accounting rules for special purpose entities. The SEC has also announced specific areas for improving disclosures, including

- more current disclosure, including "real-time" disclosure of unquestionable material information;
- disclosure of significant trend data and more "evaluative" data;
- financial statements that are clearer and more informative for investors;

- disclosure of the accounting principles that are most critical to the company's financial status and that involve complex or subjective decisions by management; and
- private-sector standards setting that is more responsive to the current and immediate needs of investors.

In addition, the SEC has announced plans to propose new corporate disclosure rules that will

- provide accelerated reporting by companies of transactions by company insiders in company securities, including transactions with the company;
- accelerate filing by companies of their quarterly and annual reports;
- expand the list of significant events requiring current disclosure on existing Form 8-K filings (such events could include changes in rating agency decisions, obligations that are not currently disclosed, and lock-out periods affecting certain employee plans with employer stock);
- add a requirement that public companies post their Exchange Act reports on their Web sites at the same time they are filed with the SEC; and
- require disclosure of critical accounting policies in Management's Discussion and Analysis of Financial Condition and Results of Operations contained in annual reports.

The SEC Chief Accountant has also raised concerns that the current standard-setting process is too cumbersome and slow and that much of the FASB's guidance is rule-based and too complex. He believes that (1) principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues, (2) the FASB needs to be more responsive to accounting standards problems identified by the SEC, and (3) the SEC needs to give the FASB freedom to address the problems, but the SEC needs to monitor projects and, if they are languishing, determine why.

We support the SEC's stated plans to specifically address the accounting issues raised by the Enron failure and the broader-based planned initiatives that begin to address some of the overarching issues with the current financial reporting model. It will be important that these initiatives be aimed at the end result of having a financial reporting model that is more comprehensive while, at the same time, more understandable and timely in providing current value financial information and nonfinancial information that will provide users with data on the reporting entity's business risks, uncertainties, and outlook, including significant assumptions underlying the nonfinancial information. We also support a more direct partnering between the SEC and the FASB to facilitate a mutual understanding of priorities for standard-setting and realistic goals for achieving expectations.

On balance, standard setting is inherently difficult and subject to pressures by those parties most affected by proposed changes. Today's business environment that includes increased globalization, rapid technological advances, real-time communication, and extremely sophisticated financial engineering is a difficult challenge for accounting standard-setters as our commercial world moves from an industrial base to an information base. Further more, creative use of financial reports, such as the recent phenomenon of using "pro forma" financial statements to present a "rosier picture" than GAAP may otherwise allow, adds another challenge for standard-setters and regulators. On December 4, 2001, the SEC issued FRR No. 59, *Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases*. One of the key points in the cautionary advice release was that the antifraud provisions of the federal securities laws apply to a company issuing "pro forma" financial information.

With that said, we believe that the underlying principles of accounting and financial reporting are still valid, namely, that financial reporting must reflect the economic substance of transactions, be consistently applied, and provide fair representation in accordance with generally accepted accounting principles. In applying these underlying principles, it is important to recognize the variety of users of financial information and their financial acumen. One size will not likely fit all, and targeted audiences for reported financial information may need to be identified, such as sophisticated investors, analysts, and creditors versus the general public. We also believe that the auditors need to be active players in developing a more comprehensive model with the objective of adding value to the information through independent assurances. Finally, effective corporate governance, independent auditors, and regulatory oversight must accompany accounting standards and financial reporting. For meaningful and reliable financial reporting, it is not enough to say the rules were followed, which is the minimum expectation. Those with responsibilities for financial reporting and their auditor must ensure that the economic substance of business transactions is, in fact, fairly reported.

I would now like to turn to the results of the work that you requested in asking us to look at the resource issues at the SEC.

The SEC's Ability to Fulfill Its Mission

Over the last decade, securities markets have experienced unprecedented growth and change. Moreover, technology has fundamentally changed the way markets operate and how investors access markets. These changes have made the markets more complex. In addition, the markets have become more international, and legislative changes have resulted in a regulatory framework that requires increased coordination among financial regulators and requires that the SEC regulate a greater range of products. Moreover, as I discussed earlier, the recent, sudden collapse of Enron and other corporate failures have stimulated an intense debate on the need for broad-based reform in such areas as financial reporting and accounting standards, oversight of the accounting profession, and corporate governance, all of which could have significant repercussions on the SEC's role and oversight challenges. At the same time, the SEC has been faced with an ever-increasing workload and ongoing human capital challenges, most notably high staff turnover and numerous vacancies.

In our work requested by this Committee, for which our report is being released at this hearing, we found that the SEC's ability to fulfill its mission has become increasingly strained due in part to imbalances between the SEC's workload (such as filings, complaints, inquiries, investigations, examinations, and inspections) and staff resources.[14] Although industry officials complimented the SEC's regulation of the industry given its staff size and budget, both the SEC and industry officials identified several challenges that the SEC faces. First, resource constraints have contributed to substantial delays in the turnaround time for many SEC regulatory and oversight activities, such as approvals for rule filings and exemptive applications.[15] Second, resource constraints have contributed to bottlenecks in the examination and inspection area as the SEC's workload has grown. Third, limited resources have forced the SEC to be selective in its enforcement activities and have lengthened the time required to

[14]Staff resources are measured in this report in terms of full-time equivalent staff years.

[15]A company files an exemptive application when it seeks an SEC decision to exempt a new activity from existing rules and laws.

complete certain enforcement investigations.[16] Fourth, certain filings were subject to less frequent and less complete reviews as workloads increased. Fifth, today's technology-driven markets have created ongoing budgetary and staff challenges. Finally, the SEC and industry officials said that the SEC has been increasingly challenged in addressing emerging issues, such as the ongoing internationalization of securities markets and technology-driven innovations like Alternative Trading Systems[17] (ATSs), and exchange-traded funds.

The SEC routinely prioritizes and allocates resources to meet workload demands, but faces increasing pressure in managing its mounting workload and staffing imbalances that resulted from its workload growing much faster than its staff. Critical regulatory activities, such as reviewing rule filings and exemptive applications and issuing guidance, have suffered from delays due to limited staffing. According to industry officials, these delays have resulted in forgone revenue and have hampered market innovation. Oversight and supervisory functions have also been affected. For example, staffing limitations and increased workload have resulted in the SEC reviewing a smaller percentage of corporate filings, an important investor protection function. In 2001, the SEC reviewed about 16 percent of the annual corporate filings, or about half of its annual goal of 30 to 35 percent. Although the SEC is revamping its review process to make it more risk-based, recent financial disclosure and accounting scandals illustrate how important it is that the SEC rise to the challenge of providing effective market oversight to help maintain investor confidence in securities markets.

SEC Staff Turnover

In addition to the staff and workload imbalances, other factors also contribute to the challenges the SEC currently faces. SEC officials said that although additional resources could help the SEC do more, additional

[16]The SEC Chairman has recently announced an initiative called real-time enforcement, which is intended to protect investors by (1) obtaining emergency relief in federal court to stop illegal conduct expeditiously, (2) filing enforcement actions more quickly, thereby compelling disclosure of questionable conduct so that the public can make informed investment decisions, and (3) deterring future misconduct through imposing swift and stiff sanctions on those who commit egregious frauds, repeatedly abuse investor trust, or attempt to impede the SEC's investigatory processes. According to the SEC, insufficient resources may inhibit the effectiveness of this initiative, which depends upon prompt action by enforcement staff.

[17]An ATS is an entity that performs functions commonly performed by a stock exchange.

resources alone would not help the SEC address its high staff turnover, which continues to be a problem. Furthermore, in recent years the staff turnover and large differentials in pay between the SEC and other financial regulators and industry employers resulted in many staff positions remaining vacant as staff left at a faster rate than the SEC could hire new staff. Although the SEC now has the authority to provide pay parity, its success will depend upon the SEC designing an effective implementation approach and the agency receiving sufficient budgetary resources. We also found that the SEC's budget and strategic planning processes could be improved to better enable the SEC to determine the resources needed to fulfill its mission. For example, unlike recognized high performing organizations, the SEC has not systematically utilized its strategic planning process to ensure that (1) resources are best used to accomplish its basic statutorily mandated duties and (2) workforce development addresses the resource needs that are necessary to fulfill the full scope of its mission, including activities to address emerging issues.[18]

As we noted in our 2001 report on the SEC's human capital practices, about one-third of the SEC's staff left the agency from 1998 to 2000.[19] The SEC's turnover rate for attorneys, accountants, and examiners averaged 15 percent in 2000, more than twice the rate for comparable positions government-wide. Although the rate had decreased to 9 percent in 2001, turnover at the SEC was still almost twice as high as the rate governmentwide. Further, as a result of this turnover and inability to hire qualified staff quickly enough, about 250 positions remained unfilled in September 2001, which represents about 8.5 percent of the SEC's authorized positions. SEC officials said that they could do more if they had more staff, but all cited the SEC's high turnover rate as a major challenge in managing its workload. Likewise industry officials agreed that many of the challenges that the SEC faces today are exacerbated by its high turnover rate, which results in more inexperienced staff and slower, often less efficient, regulatory processes.

Although the SEC and industry officials said that the SEC would always have a certain amount of turnover because staff can significantly increase

[18]High performing organizations are organizations that have been recognized in the current literature or by GAO as being innovative or effective in strategically managing their human capital.

[19]*Securities and Exchange Commission: Human Capital Challenges Require Management Oversight* (GAO-01-947, September 17, 2001).

their salaries in the private sector and some staff only plan to stay at the SEC for a period of time, many said pay parity with other financial regulators could enable the SEC to attract and retain staff for a few additional years. The SEC estimated that a new employee generally takes about 2 years to become fully productive and that pay parity could help them keep staff a year or two beyond the initial 2 years. Although industry officials said they were generally impressed by the caliber of staff that the SEC hires and the amount of work they do, they said that staff inexperience often requires senior SEC officials to become more involved in basic activities. Industry officials also said that certain divisions, such as Market Regulation, could benefit from staff with a fundamental understanding of how markets work and market experience. They said that such experience could help speed rulemaking and review processes. However, SEC officials said that they have a difficult time attracting staff with market experience, given the government's pay structure.

Some officials said that the SEC's turnover rate should decrease after pay parity is implemented. Presently, the SEC professional staff are paid according to federal general pay rates. On January 16, 2002, the President signed legislation that exempted the SEC from federal pay restrictions and provided it with the authority necessary to bring salaries in line with those of other federal financial regulators. That legislation also mandated that we conduct a study to look at the feasibility of the SEC becoming a fully self-funded agency. Although the SEC now has the authority to implement pay parity, as of March 1, 2002, the SEC has not received an additional appropriation to fund its implementation. In addition, the SEC has to take a number of steps to effectively implement this new authority.

Although the SEC's workload and staffing imbalances have challenged the SEC's ability to protect investors and maintain the integrity of securities markets, the SEC has generally managed the gap between workload and staff by determining what basic statutorily mandated duties it could accomplish with existing resource levels. This approach, while practical, under the circumstances, has forced the SEC's activities to be largely reactive rather than proactive. For instance, the SEC has not put mechanisms in place to identify what it must do to address emerging and evolving issues. Although the SEC has a strategic plan and has periodically adjusted staffing or program priorities to fulfill basic obligations, the SEC has not engaged in a much needed, systematic reevaluation of its programs and activities in light of current and emerging challenges. Given the regulatory pressures facing the SEC and its ongoing human capital challenges, it is clear that the SEC could benefit from an infusion of funding and possibly additional resources. However, a comprehensive, agency wide planning effort, including planning for use of technology to leverage available resources, could help the SEC better determine the optimum human capital and funding needed to fulfill its mission.

Closing Comments

A number of witnesses who have recently appeared before this Committee and other congressional committees to discuss Enron's failure have stated that our nation's system of capital markets is recognized around the world as the best. I share that view. Our capital markets enjoy a reputation of integrity that promotes investor confidence that is critical to our economy and the economies of other nations given the globalization of commerce. This reputation is now being challenged. The effectiveness of our systems of corporate governance, independent audits, regulatory oversight, and accounting and financial reporting, which are the underpinnings of our capital markets, to protect the public interest has been called into question by the failure of Enron. Many of the issues that are being raised have previously surfaced from other business failures and/or restatements of financial statements that significantly reduced previously reported earnings or equity. Although the human element factor, and the basic failure to always do what is right, are factors that can override systems of controls, it is clear that there are a range of actions that are critical to the effective functioning of the system underlying our capital markets that need attention. In addition, a strong enforcement function with appropriate civil and criminal sanctions is also needed to deal with noncompliance.

The results of the forum that we held last week on governance, transparency, and accountability identified major issues in each of the areas, which I have addressed in my remarks today, that endanger their effective functioning to protect the public interest. As is usually the case in issues of this magnitude and importance, there is no single silver bullet to quickly make the repairs needed to the systems supporting our capital markets. The fundamental principles of having the right incentives, adequate transparency, and full accountability provide a good sounding board to evaluate proposals that are advanced. A holistic approach is also important as the systems are interrelated and weak links can severely strain their effective functioning. I have framed a number of the key issues today for congressional consideration. As always, we look forward to working with you to further refine the issues, and develop and analyze options and take other steps designed to repair the system weaknesses that today pose a threat to investor confidence in our capital markets.

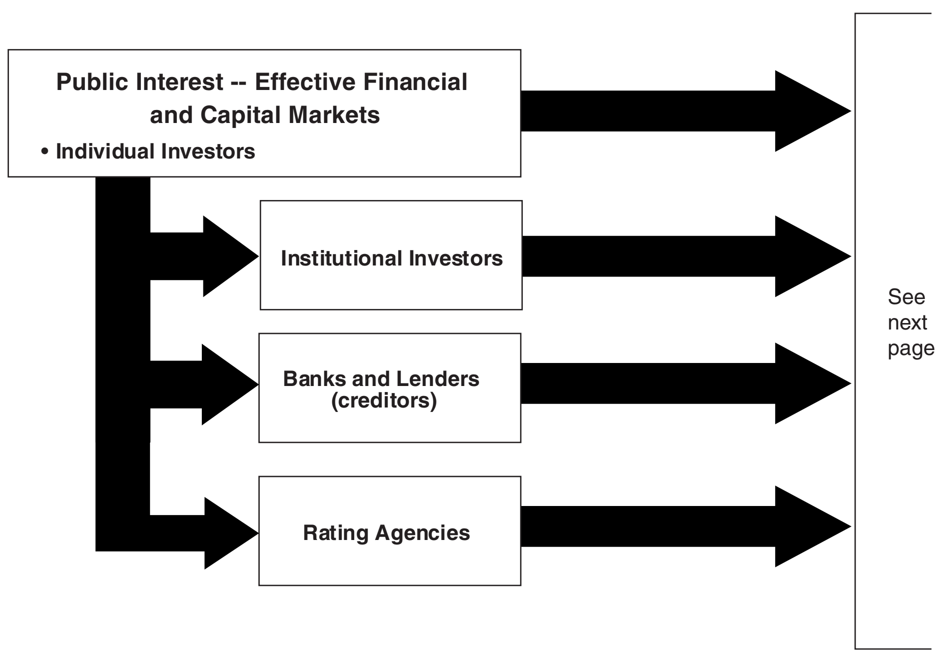
In summary, Enron's recent decline and fall coupled with other recent business failures pose a range of serious systemic issues that must be addressed. Effectively addressing these issues should be a shared responsibility involving a number of parties including top management, boards of directors, various board committees, stock exchanges, the accounting profession, standard setters, regulatory/oversight agencies, analysts, investors, and the Congress. In the end, no matter what system exists, bad actors will do bad things with bad results. We must strive to take steps to minimize the number of such situations and to hold any violators of the system fully accountable for their actions.

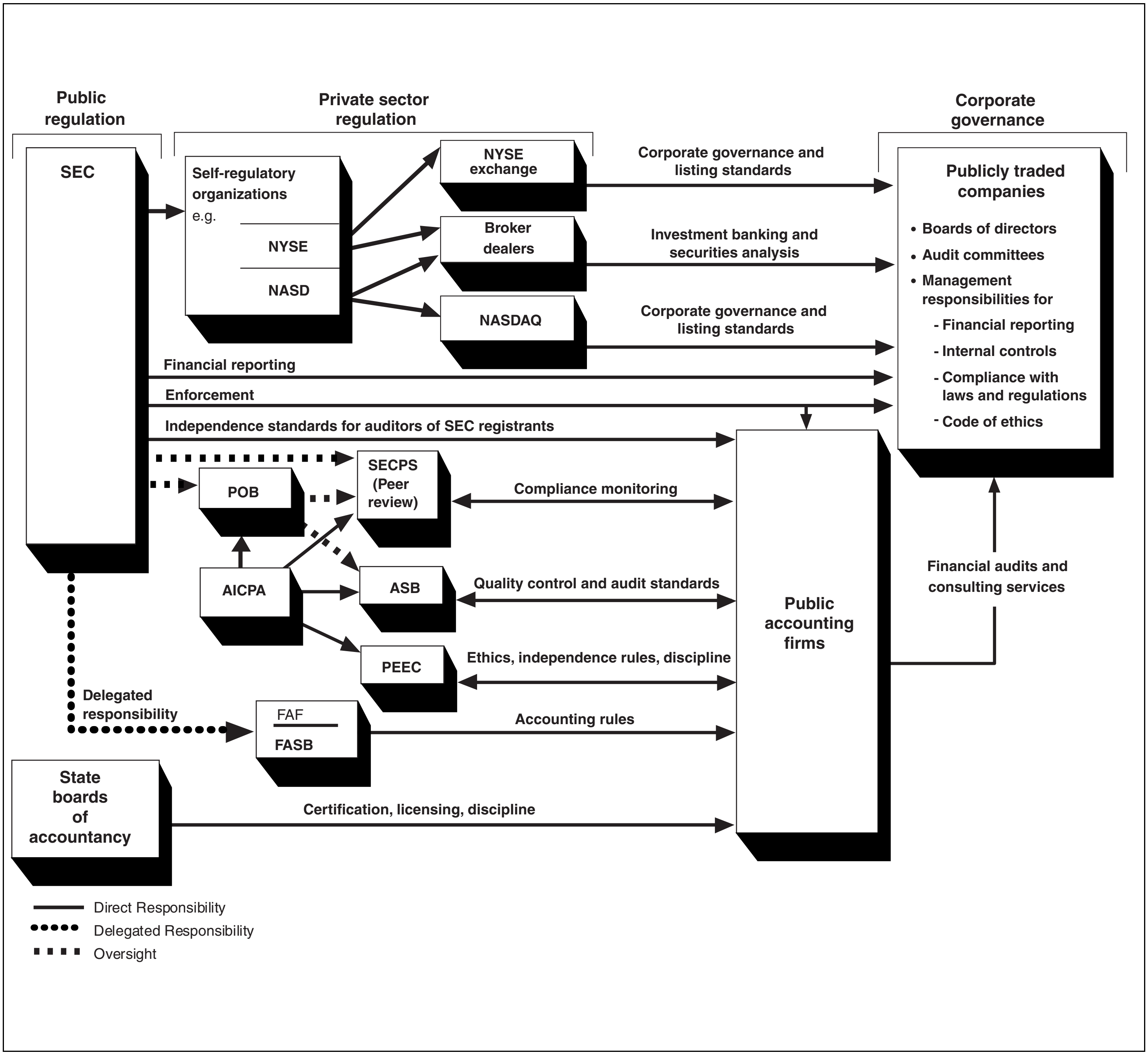
Mr. Chairman, this concludes my statement. I would be please to answer any questions you or other members of the committee may have at this time.

Contacts and Acknowledgments

For further information regarding this testimony, please contact Robert W. Gramling, Financial Management and Assurance, at (202) 512-6535. Individuals making key contributions to this testimony include Cheryl E. Clark, Michael C. Hrapsky, Thomas J. McCool, Jeffrey C. Steinhoff, and Orice M. Williams.

Attachment I: Overview of Regulatory and Private Sector Structure




Public regulation
Private sector regulation
Corporate governance
SEC
Self-regulatory organizations e.g.
NYSE
NASD
NYSE exchange
Broker dealers
NASDAQ
Corporate governance and listing standards
Investment banking and securities analysis
Corporate governance and listing standards
Publicly traded companies
• Boards of directors
• Audit committees
• Management responsibilities for
- Financial reporting
- Internal controls
- Compliance with laws and regulations
- Code of ethics
Financial reporting
Enforcement
Independence standards for auditors of SEC registrants
SECPS (Peer review)
POB
Compliance monitoring
AICPA
ASB
Quality control and audit standards
PEEC
Ethics, independence rules, discipline
Public accounting firms
Financial audits and consulting services
Delegated responsibility
FAF
FASB
Accounting rules
State boards of accountancy
Certification, licensing, discipline
Direct Responsibility
Delegated Responsibility
Oversight

GAO's Mission

The General Accounting Office, the investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO E-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to daily e-mail alert for newly released products" under the GAO Reports heading.

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm,
E-mail: fraudnet@gao.gov, or
1-800-424-5454 or (202) 512-7470 (automated answering system).

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G. Street NW, Room 7149,
Washington, D.C. 20548

[redacted]