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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
OF THE
HOUSE COMMITTEE ON ENERGY AND COMMERCE
ON
FINANCIAL REPORTING
AND THE
ROLE OF INDEPENDENT AUDITORS

Mr. Chairman and Members of the Subcommittee:

We appreciate the opportunity to appear here today to participate in your hearings on financial reporting, the role of independent auditors, and the SEC's oversight of the accounting profession.

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Your hearings over the past year have focused on the quality of audits conducted by CPA firms, and on alleged audit failures. I, and the other witnesses here today, will be discussing ideas and proposals regarding what needs to be done to improve audit quality, and reduce the number of alleged audit failures.

Based on our work in this area, and our observations of recent developments in the accounting profession, we believe there are four major areas where the public expects improvements to be made, and where I believe the profession must take action. The accounting profession should be:

-- providing better disclosure, and early warnings, regarding the condition of companies that are in precarious situations;

-- Improving its efforts in determining whether companies are complying with laws and regulations;

-- making sure internal controls and accounting systems are in place that will help prevent fraud and mismanagement in the companies being audited; and

-- reducing the secrecy that surrounds the peer review process, and making it mandatory for all public accounting firms that audit public corporations and government entities.

The quality of audits conducted by CPA firms, and your hearings on alleged audit failures during the past year, have been topics of great interest to GAO. When I became Comptroller General, one of my top priorities was to work toward the goal of improving audit quality within the government sector. We have installed a number of quality control procedures during the past several years at GAO to help insure and improve the quality of our work. We also have begun to conduct quality assessment reviews of the audit and investigative work of federal inspectors general, and of other federal internal audit organizations.

We recently have been involved in reviewing the quality of the work of other audit organizations outside the federal government. At the request of Congressman Jack Brooks, we reviewed the quality of CPA audits of federal grant funds provided to state and local organizations, and found significant problems. We reported to Congressman Brooks that about one-third of our sample of 150 audits conducted by CPA firms did not meet generally accepted government auditing standards. We referred thirty-two of the firms that conducted deficient audits to 15 State Boards of Accountancy for appropriate action.

In addition, as you know, we have been involved in assisting this subcommittee during its hearings on the audits of ESM Government Securities, Home State Bank, and Beverly Hills Savings and Loan Association. Our work for your subcommittee has helped to document the problems involving audits of these organizations. In providing assistance to your subcommittee, we had the opportunity to review some of the working papers of the CPA firms that audited those companies, and get a sense of the quality of their work and the complex issues the auditors faced in conducting their audits.

It is clear that there have been problems with a number of the audits conducted by the accounting profession, that the instances involving alleged audit failures -- although relatively few in number -- have had a significant impact on the lives of many Americans, and that some improvements need to be made.

We have observed that the recent problem audits tend to be associated with certain industries. In the 1970's, for example, there were problems in the real estate industry and with claims accounting and sensitive payments, primarily in the defense industry. In the 1980's, the problems have tended to involve the banking and savings and loan industries. These industries generally were in transition, because of deregulation, disinflation, or other reasons, and sometimes the auditors did not become aware of the risks, changes and problems being experienced by the companies within these industries until it was too late.

In other words, the auditors and the accounting profession sometimes have not been able to keep up with, or anticipate, the creative accounting and other actions taken by management of firms in the industries in transition. As a result, the public often has had no early warning regarding the precarious condition of some of these firms.

We have faced this type of situation in the federal government in recent years, and have tried to clearly identify, in our reports, the issues and financial problems affecting the organizations we audit.

For example, we audit several major financial entities, including the Federal Savings and Loan Insurance Corporation (FSLIC), the Federal Deposit Insurance Corporation (FDIC), and the Export-Import Bank of the United States. Our 1984 audit report on FSLIC revealed problems regarding the valuation of more than $1 billion of FSLIC's claims against the assets of three large savings and loans that were closed that year. We also observed serious problems relative to the savings and loan industry, such as narrow interest rate margins and poor quality loans and investments. We reported these problems, and their impact on the FSLIC fund, and issued a qualified opinion on the FSLIC 1984 financial statements.

We also found problems with the FDIC's 1984 statements, which were significantly overstated because they did not include an allowance for losses related to assets acquired from Continental Illinois Bank -- assets which were obviously impaired. Recently, at our urging, FDIC agreed to restate its 1984 financial statements to reflect a $1.3 billion cumulative allowance for those losses as of December 31, 1985.

With regard to the Export-Import Bank, we have reported since 1983 that its financial statements present a misleading picture of its true financial position. In our opinion, the Bank's statements do not reflect the losses that are likely to occur due to the probable uncollectibility of a significant portion of its loans that are owed or guaranteed by foreign governments. The Bank has not recognized that its loans are impaired even when foreign governments have repudiated their debts.

Let me give you one more example of the need for early warning -- the Farm Credit System situation. For years, the Farm Credit System has not had its financial statements prepared in accordance with GAAP -- Generally Accepted Accounting Principles, nor were they audited annually. Last year, we saw the problems in this System jump out at us with virtually no warning at all, culminating in a $2.7 billion loss and a request for federal assistance. The problems of the Farm Credit System, in my opinion, demonstrate not only the need for early warning, but also what can happen when financial statements do not follow acceptable practices, and financial audits are not performed on an annual basis to assure the reliability of data and reports.

One way to deal with this issue of early warning disclosure already exists in the standards for audit; the use of "matter of emphasis" comments in a separate paragraph of the auditor's report. This concept allows an auditor's report to emphasize a matter without qualifying the opinion. It is a relatively little used provision, available to auditors since 1974, that might well be a vehicle to use to begin to focus on the risks or deteriorating or changing financial condition of a company.

In addition to providing early warning of deteriorating financial conditions, the auditor has a responsibility with regard to detecting fraud. When companies face severe financial problems, such as those being faced today by the industries in transition that I mentioned a moment ago, it is then that the auditor must be most alert for problems -- and even fraud -- in the handling of transactions and presentation of financial reports.

The Chairman of the FDIC discussed the need for bank examiners to be alert for fraud recently when he reported that an FDIC survey of 75 banks that failed between 1980 and 1983 showed that "criminal misconduct by insiders was a major contributing factor in 45 percent of the failures." He said that bank regulators "must take the view that finding fraud is a primary objective of bank examinations - not an incidental activity." He also said the FDIC is working with a committee of the American Institute of Certified Public Accountants to develop a statement outlining the responsibilities of outside auditors in detecting fraud.

Auditing literature requires that auditors consider the possibility of the existence of material fraud in planning an audit engagement, and that additional audit steps be taken when it is detected.

We believe that auditors have not always been as successful as the public expects them to be in detecting management fraud, which involves such things as the improper charging of costs to the government by defense contractors, and the type of situation we saw recently involving the alleged check kiting at E. F. Hutton. Recently, some in the accounting profession have been proposing that a more active role be taken by the auditor in ferreting out this type of fraud.

It has been my experience that fraud is often allowed to occur because of a failure to institute proper internal control systems. This is an area that I have been concentrating on for some time now, and is why I so strongly supported the passage of the Federal Managers' Financial Integrity Act in 1982. That Act was a major step toward achieving two primary objectives: first, requiring federal managers to evaluate annually their internal control and accounting systems, and publicly report on the status of their completed and planned improvements; and second, providing an incentive for managers to correct long-standing weaknesses through increased manager accountability.

We have stressed the need for proper review of internal controls during our testimony on, and in working with the Congress in support of, enactment and implementation of the Single Audit Act of 1984. This Act requires external auditors (both government and private) of state and local governments to provide, in addition to the traditional financial statement opinion, reports on entity-wide internal controls, internal controls over major federal programs, and compliance with laws and regulations related to major federal programs. These reports contain information concerning whether or not an internal control system provides reasonable assurance that federal funds distributed to state and local governments are properly managed.

The report must identify the significant internal controls, those controls that the auditor evaluated, and the material weaknesses identified.

We believe the Single Audit Act is worth studying, and deserves consideration by the private sector auditors for possible use of certain of its provisions in their audits of public companies. This Act deals with three issues your subcommittee is focusing on; reporting on internal controls, reporting on compliance with laws and regulations, and using a standard of materiality that is not necessarily defined in terms of the total financial statements.

One thing the Single Audit Act does not require is a statement by management on internal control. This, however, is required in the federal sector by the Financial Integrity Act, which requires agency heads to provide an annual report on internal controls, which is then audited by GAO or the inspectors general. I strongly believe it is better to have management be responsible for preparing this type of report, and require the auditors to review it.

I think the profession also needs to look at its practices regarding self regulation, as it is doing with the Anderson Committee. The concept of peer reviews -- instituted in the 1970's -- has been a positive improvement in the profession, but the secrecy that surrounds that process presents something of a negative connotation to the public.

This is a point that others have also made. The Cohen Commission expressed a similar view in its 1978 report, and so did the former senior partner and chief executive of the firm of Peat, Marwick and Mitchell, Mr. Walter Hanson, during a speech in 1983 he made after accepting the AICPA's highest award, the Gold Medal for Distinguished Service. Mr. Hanson spoke on that occasion of the credibility of the Public Oversight Board, which he said could not last forever if the profession did not help it out in two significant areas. These areas were first, compulsory membership in the SEC Practice Section for all firms serving SEC clients, and second, public disclosure of the work of the Special Investigations Committee (SIC).

Mr. Hanson said that "The problem is that the public does not know what the SIC is doing and therefore they cannot assess the effectiveness of our regulatory process." He added that "... the veil of secrecy must be lifted", and suggested that the profession "... publicize what the SIC is doing with as much candor as we possibly can."

The Quality Assessment Reviews which GAO has begun to conduct of federal inspector general and internal audit organizations -- which are analogous to the profession's peer reviews -- are published for all to see. We point out areas where there is less than satisfactory compliance by the federal auditors with professional standards, and give the auditors the opportunity to comment on our findings, and state what they are doing to correct deficiencies.

It seems to me that it would help the profession to lessen the secrecy surrounding peer reviews, and to make peer reviews mandatory for all firms that audit public corporations and government entities.

When serious problems are found in peer reviews, or with audit failures, there should be appropriate educational or disciplinary action by the regulatory arm of the profession. We have had several discussions recently with the National Association of State Boards of Accountancy, and with various State Boards of Accountancy who are handling the referrals we made to them of CPA's we believed performed substandard work, and believe the profession is trying to improve in this area.

Mr. Chairman, I believe your hearings have shown that a consensus on the problems facing the accounting profession is developing, and that the basis for a consensus on solutions is beginning to form. The leadership of the profession must now begin to take action and implement some of the needed improvements. That leadership includes the heads of the accounting firms, the AICPA, the state boards of accountancy, educators, standards setters, and the heads of the various commissions and task forces that have been formed to study specific problems and issues affecting the profession. The SEC, of course, also has an important role to play as well.

The accounting profession traditionally has been slow to make changes. I was reminded of this when looking at the Price Waterhouse proposal, which contained a quote from John Carey, who said in his book "The Rise of the Accounting Profession"

"CPA's, being human, have rarely embraced change with enthusiasm, or happily abandoned the security of the familiar. Many of their advances, indeed, have been the result of outside pressures. But to do them credit, the CPA's have had the intelligence to recognize the significance of those pressures -- and to react to them before it was too late."

The late Senator Lee Metcalf, who held hearings on the accounting profession in the latter part of the 1970's, made a similar comment in his report "Improving the Accountability of Publicly Owned Corporations and Their Auditors." He said:

"The subcommittee believes there are many talented and dedicated people in the accounting profession who are eager to make the profession's performance meet its ideals. Subcommittee members prefer that the profession itself achieve reforms in cooperation with the SEC. It must be remembered, however, that the public has reasonable needs and expectations which must be satisfied, and the amount of time for achieving reforms is not unlimited. Therefore, the subcommittee expects the accounting profession and the SEC to act in a timely manner to implement the policy goals in this report."

I believe the leaders in the accounting profession understand the need to recognize and react to the pressures and to the public expectations facing them today, and I am hopeful they will do so.

Mr. Chairman, this concludes my prepared remarks. We would be pleased to respond to any questions you or the members of your subcommittee may have.