



Consumer Federation of America



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April 10, 2002

The Honorable Michael G. Oxley
Chairman, Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable John J. LaFalce
Ranking Member, Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Oxley and Ranking Member LaFalce:

We understand that you intend to hold a committee mark-up of accounting reform legislation later this week. As you know, our organizations consider this an issue of utmost importance. We congratulate you for moving forward in a timely fashion to pass legislation.

To be meaningful, however, reform must be comprehensive, with strong auditor independence and oversight at its heart. As introduced, H.R. 3763, the "Corporate and Auditing Accountability, Responsibility, and Transparency Act," fails that test. Fortunately, many of the necessary strengthening amendments can be found in H.R. 3818, the "Comprehensive Investor Protection Act." It is our understanding that the sponsors of that bill intend to offer its various components as amendments during mark-up.

The following are the key areas where we believe H.R. 3763 must be amended in order to provide the strong, comprehensive reforms that are essential to restoring investor confidence in the accuracy of financial disclosures.

Auditor Independence

The central issue that any legislation must address in the wake of Enron and in response to the rapidly rising tide of corporate earnings restatements is why the auditors, whose job it is to prevent misleading disclosure, would sign off on financial statements that clearly fail that test.

The answer in Arthur Andersen's audit of Enron, as in so many other recent cases, is that the audit was independent in name only. Auditors' independence is undermined by their unwillingness to lose lucrative customers, by the revolving door that often exists between auditors and their audit clients, and by the close personal relationships that can grow up over the course of decades-long auditing engagements. A credible legislative response must address all of these conflicts.

While both H.R. 3763 and H.R. 3818 take steps to enhance auditor independence, H.R. 3763's provisions fall far short of what is needed. The essential components of H.R. 3818 that must be incorporated in any bill reported out of committee are:

- ! its broader ban on consulting services, which restores language from the Securities and Exchange Commission's proposed rule on a whole range of prohibited services that was later watered down in the final rule;
- ! its requirement that any non-audit services, including tax consulting services, be separately approved by the board audit committee based on a determination that they do not threaten the auditor's independence;
- ! its requirement that the SEC conduct periodic reviews of non-audit services to determine whether additional services should be prohibited, taking into consideration the four principles for determining auditor independence from the original SEC rule proposal;
- ! its requirement that national exchanges upgrade their corporate governance standards to require that auditors be appointed by and report directly to the audit committee, that audit committees meet regularly with auditors to review their work, and that auditors have an opportunity to meet with the audit committee without corporate officers, directors, or managers present;
- ! its inclusion of a requirement that auditors be subject to periodic, mandatory rotation (if not on a four-year basis, at least on a seven-year cycle); and
- ! its inclusion of a two-year cooling off period before members of the audit team could go to work for the audit client in any capacity and before any audit firm employee could assume certain key financial positions at an audit client without forcing a change of auditors.

Taken together, these reforms would restore the independence that is essential to the auditors' watchdog function. Because the accounting firms have scorned their professional responsibility to maintain the independence of the audit, because the current SEC Chairman has refused to acknowledge the centrality of this issue, and because the outside audit is meaningless if it is not independent, meaningful congressional action to restore auditor independence is essential.

Auditor Oversight

Both H.R. 3763 and H.R. 3818 would create a new independent body, subject to SEC oversight, to regulate accountants that audit public companies. Our organizations believe that, properly implemented, such an approach could provide much needed improvements to the current grossly inadequate system of accounting industry regulation. To accomplish that goal, however, the new regulator must have guaranteed independent governance, independent funding, rule-making authority, and strong investigative and enforcement authority.

Unfortunately, much of the language in H.R. 3763 is simply too vague to ensure that these essential standards for effective oversight will be met. In order to ensure that we do not end up with yet another "regulator" in the hip pocket of the accounting industry, the committee must amend its bill to:

- ! Authorize creation of *single* new regulatory body to which all firms that audit public companies and their employees must belong. H.R. 3763 appears to leave open the possibility of multiple new private regulators for accountants. This would create an inevitable rush to the bottom, as regulators competed for membership by setting the lowest possible standards permitted under the law. Under such a system, industry would continue to dominate its regulator by threatening a loss of membership, and with it funding, anytime the regulator attempted to rein in practices the industry is unwilling to abandon voluntarily. Given the accounting industry's history of using just such tactics to intimidate the Public Oversight Board, it is essential that this fundamental weakness in H.R. 3763 be repaired.
- ! Specify a funding mechanism that is immune from accounting industry domination. We believe the funding mechanism in H.R. 3818 meets this test, with its combination of mandatory membership fees and fees imposed on issuers that file audited financial statements with the SEC. We are open to other approaches as well, however, so long as they offer no opportunity for accounting firms to withhold funding or threaten to withhold funding as a way to undermine the regulator's authority.
- ! Define tough independence standards for all public board members of the new regulatory body. These standards should prohibit any ties between public board members and an accounting firm that is subject to regulation by the board both before and after serving on the board. Public board members should not be drawn from the ranks of current or former CPAs. And ties to the accounting industry trade association, the American Institute of Certified Public Accountants, should also be prohibited.
- ! Authorize the new regulator to set and review audit standards as well as quality control, independence, professional, and ethical standards. Current audit standards are generally considered too vague to be enforceable. They must be improved. That is a job for an independent regulator, not an industry trade association.

- ! Adopt the strong investigation and enforcement provisions from H.R. 3818 to ensure that the new regulator has the investigative authority and sanction power necessary to be effective.

SEC Funding

Both H.R. 3818 and a separate bill, H.R. 3764, would increase funding to the SEC for disclosure review and enforcement. We believe such funding increases are essential, but we urge you to look beyond these two areas. Following two decades in which the agency's workload has exploded while its staffing has been held largely flat, all aspects of SEC oversight are similarly under-funded and in need of a dramatic boost. With attention currently focused on the inadequacy of SEC resources, now is the time to provide that broader funding boost. Neither bill addresses this broader funding issue. Also essential is full funding for pay parity, which is included in H.R. 3818 but not H.R. 3763.

PSLRA Reform

It is no coincidence, in our view, that the recent dramatic rise in corporate earnings restatements began in the mid-1990s, following passage of the Private Securities Litigation Reform Act. With its safe harbor for misleading forward-looking statements, that legislation provided a powerful tool to company managers looking to inflate their stock price. Meeting the unrealistic expectations resulting from those overly optimistic projections created, in turn, an incentive to engage in "aggressive" accounting. By simultaneously limiting the liability of those whose job it is to keep company managers honest, PSLRA helped to create an environment in which a disaster such as Enron was not only likely, but inevitable.

The anti-investor provisions that won the opposition of then SEC Chairman Arthur Levitt (an early advocate of litigation reform), state securities regulators, government finance officers, pension managers, consumer groups, unions, and seniors groups should be repealed. Unfortunately, H.R. 3763 ignores this issue entirely. The most comprehensive package of reforms is contained in H.R. 3829, the "Shareholder and Employee Rights Restoration Act," introduced by Rep. Bart Stupak (D-MI) and Ranking Member LaFalce. Our organizations support its passage. Short of that, however, we also support the more limited PSLRA reform provisions included in H.R. 3818.

Conclusion

The overnight implosion of Enron has exposed gaping holes in the system of investor safeguards designed to ensure that investors receive full and fair disclosure about the companies in which they invest. Congress, and this Committee, have performed a valuable function in helping to define the aspects of the system most in need of repair. None is more central than the outside audit, which is the first line of defense for keeping corporate managers honest. And nowhere are the flaws in the current system more obvious -- audits that are independent in name only and regulatory oversight that is controlled by the industry.

This Committee has an opportunity, and a responsibility, to restore real integrity to the system of outside audits of public companies. Half measures and quick fixes will not do the job. Meaningful reform will require substantial strengthening amendments to H.R. 3763 along the lines outlined above. We urge you to put the interests of the millions of American households that entrust their savings to our financial markets ahead of the interests of accounting firms that have failed to maintain a minimally acceptable level of professional conduct and pass real, comprehensive reform.

Sincerely,

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cc: Members of the Financial Services Committee