July 22, 2000

Dear Audit Reform Conferee:

As the market continues to stagger under the weight of investor distrust, the accounting firms who helped create the current crisis by turning a blind eye to accounting abuses have predictably seized upon the conference negotiations as their last, best opportunity to weaken the critical corporate reform legislation now before you. Unfortunately, the lists of recommended changes identified by Senator Phil Gramm and Chairman Michael Oxley indicate that they have at least two champions on the committee who are more than ready to assist them in that task.

Although there are a number of areas where we believe the Senate legislation could and should be strengthened, that is not the focus of this letter. Instead, we are writing to urge you to reject these transparent attempts to gut the legislation's key audit reform provisions. In particular, we urge you to reject amendments by Senator Gramm and Representative Oxley that would:

- Eviscerate reforms that would make audits more accurate and independent;
- Gut the standard-setting and enforcement powers of the new auditor oversight board, and
- Shield dishonest auditors from accountability to their victims, including the elimination of the bill's lengthened statute of limitations for securities fraud.

1) Do not scale back the auditor independence reforms.

The only thing that explains why auditors so often sign off on financial statements they know to be misleading is the near total lack of independence in the so-called independent audit. To be credible, any audit reform legislation must minimize the overwhelming financial incentives auditors face to turn a blind eye to accounting irregularities. From the outset of this debate, however, one of the accounting firms' top priorities has been to limit the scope of any auditor independence reforms.

The accounting industry was completely successful in the House, which did nothing more than codify steps the major accounting firms said they would not oppose, by adding internal audits and financial system design and implementation to the list of non-audit services auditors are prohibited to provide to audit clients. They were somewhat less successful in the Senate. For, although the Senate bill prohibition on non-audit services is only slightly broader than the House bill's, it is combined with a strong package of reforms designed to improve audit committee oversight of the audit. As a result, the accounting firms and their champions on the committee continue to press several amendments to further erode the bill's protections on this key issue.

<u>Do not remove the statutory prohibition on certain non-audit services</u>.

The Senate bill lists nine classes of services that auditors would be prohibited from providing to audit clients. This list is taken from the Securities and Exchange Commission rule proposal of 2000, which sought to ban auditors from providing those non-audit services that the Commission had identified as creating the most egregious conflicts of interest. The SEC rules were watered down in response to a ruthless industry lobbying campaign. The bill seeks to restore the full scope of the proposed rules.

Senator Gramm, however, has proposed to eliminate the statutory language listing specific non-audit services that auditors would be prohibited from providing to audit clients. Instead, he suggests making it the "first priority" of the new board to address this issue. Senator Gramm argues that this is necessary to preserve the flexibility of the board to write auditor independence rules. However, nothing in the bill would prevent the board from expanding on the list of prohibited services should new abuses be identified. The board would simply be precluded from narrowing the scope of the ban beyond those identified in the SEC proposed rules.

> *Congress must not risk a repeat performance in which accountants succeed in watering down the consulting ban; it must include the list of banned services in statutory language.*

<u>Do not open up new loopholes in the rules</u>.

In delegating this authority to the auditor oversight board, Senator Gramm also proposes to enable, even encourage the board to open up broad new exemptions to the prohibition on non-audit services, particularly for small companies. Expanding the board's exemptive authority for small companies is also the thrust of a proposal by Chairman Oxley, though he also goes further. His amendment would replace the board's ability to grant exemptions on a case-by-case basis with unlimited exemptive authority.

In considering both these proposals, it is important to note that, while recent attention has focused on audit failures at major corporations, just over half the financial statements required to be restated between 1997 and 2001 were from companies with under $100 million in revenues. Clearly, we need to be strengthening the audits of these companies, not eliminating existing protections that minimize auditor conflicts of interest. Furthermore, neither the Securities and Exchange Commission nor the accounting profession itself has ever granted a small-firm exemption from the auditor independence rules. Thus, at a time when Congress is looking to enhance auditor independence, these amendment would erode auditor independence standards. That is unlikely to restore investor confidence in the reliability of corporate disclosures.

Chairman Oxley suggests that his amendment is needed to allow the board to designate future classes of non-audit services as exempted from the bill's prohibition. But, as the bill makes clear, services not listed in the legislation, or added by the board or commission later through the rule-making process, would already be permitted, as long as they were approved in advance by the audit committee. Thus, the amendment is not needed to accomplish this goal.

> *Because they run counter to the whole thrust of the audit reform legislation, amendments to open up new loopholes in auditor independence rules should be rejected.*

<u>Do not gut the requirement for audit committee pre-approval of non-audit services</u>.

The Senate bill recognizes that no list of prohibited services will ever allow for every circumstance that could undermine auditor independence, particularly as new lines of service are developed and marketed. Someone must accept responsibility for ensuring that auditors are not hired to perform services that undermine their independence, and that responsibility logically resides with the audit committee of the board. Unfortunately, audit committees have been loath to accept that responsibility. Requiring audit committee pre-approval of non-audit services makes the responsibility explicit.

Accounting firms are clearly concerned that, once audit committees are given this explicit responsibility, they will be less willing to hire auditors to perform non-audit services. For that reason, they have made a priority of scaling back this provision. PricewaterhouseCoopers has suggested an amendment that would accomplish this by allowing audit committees to adopt blanket policies and procedures for pre-approval that would not require specific review by the audit committee of the particular services to be offered, making the requirement meaningless. Senator Gramm goes even further, by suggesting that the "specific statutory requirements for pre-approving non-audit services" be eliminated altogether.

> *The bill's requirement for audit committee pre-approval of non-audit services is an essential component of its auditor independence reforms and must be retained intact in the final bill.*

<u>Do not eliminate the provision making audit committees directly responsible for overseeing the audit.</u>

In order to help clarify that auditors are responsible to shareholders, not company management, the bill gives the board audit committee responsibility for hiring, compensating, and overseeing the audit. It also gives the audit committee the tools it needs to perform this function effectively, by improving auditor reporting to the committee, for example, and by permitting the committee to hire outside counsel or independent experts to assist it in evaluating disputes between management and auditors. In his list of "other concerns" about the bill, Senator Gramm suggests that these provisions be eliminated. To do so would leave in place the current system, where auditors view themselves as responsible to management rather than shareholders and act accordingly.

> *Provisions to improve audit committee oversight of the audit are essential components of the bill's auditor independence provisions and must be retained in the final bill.*

2) Do not limit the powers of the new oversight board.

The second prong of the accounting firms' attack on this reform legislation has been to limit the independence and effectiveness of the new auditor oversight board it creates. While the House bill would simply recreate the current discredited self-regulatory system under a new "independent" label, the Senate bill contains most of the provisions needed to ensure that its new oversight board is a strong and effective regulator. (A notable exception is that the bill provides only a one-vote majority for public board members and does not do enough to ensure their independence. This oversight would allow the accounting industry to easily gain control of the board.)

The accounting firms' campaign to erode the oversight board's authority was interrupted by the Worldcom disaster, which scared off those who had declared their intention to offer weakening amendments on the Senate floor. As a result, they have a pent up list of demands to present to the audit committee designed to ensure that the new regulator ends up as yet another puppet of the industry it is supposed to regulate.

Do not limit the board's standard-setting authority.

The Senate bill makes the auditor oversight board responsible for setting auditing, quality control, and ethics standards to govern registered firms engaged in preparing and issuing audit reports. The accounting firms are adamantly opposed. And small wonder. After all, a regulator who is limited to enforcing standards written by the regulated profession is doomed to ineffectiveness.

Contrary to the industry's arguments, the board's access to adequate funding should ensure its ability to hire all the expert staff needed to oversee this process. Expertise gained through inspections and investigations will help the board to identify those areas where improved standards are needed. Furthermore, ample opportunity for private-sector participation in the standard-setting process is provided. The bill allows the board to rely on existing standards as a starting point, for example, and it does nothing to limit the ability of firms or trade association groups to suggest new standards or comment on proposed changes. Final decisions and authority, however, would reside with a board responsible to the public, not one representative exclusively of industry interests.

The truth is that the accounting profession has failed miserably in fulfilling its standard-setting authority. They have produced auditing standards that, in the words of former SEC Chief Accountant Lynn Turner, are so vague as to be unenforceable. Academic experts have commented on the failure of industry-drafted audit standards to require auditors to do the things they would need to uncover fraud by top executives. Instead, the accountants' professional expertise has been used to produce standards that rely on suggestions rather than mandates -- standards designed to protect auditors from liability, rather than promote high quality audits.

> *If audit standards are to receive much needed improvements and the board is to have the authority it needs to be effective, it must be given authority to set the standards it will be charged with enforcing.*

Do not limit the board's authority to enforce securities laws.

The Senate bill gives the new regulatory board authority to enforce securities laws related to the audits of public companies. In an attempt to strip out this provision, Senator Gramm and Chairman Oxley have suggested that it raises questions about whether the board is, in fact, a private entity. However, no such questions have been raised about the private status of a comparable board, the National Association of Securities Dealers. In fact, NASD Regulations specifically describe its functions as including, "on-site examinations of securities firms to determine their compliance with federal securities laws ..." and determining "member compliance with the anti-fraud provisions of the Securities Exchange Act of 1934, the Securities Act of 1933, ...". It is ridiculous to suggest that an industry self-regulatory organization can be entrusted with this authority, but that an independent regulatory body cannot.

Even if the Securities and Exchange Commission receives all the added resources authorized by the House and Senate, it will benefit from having its enforcement resources supplemented by those of the board -- just as it has benefited from having its enforcement resources supplemented by those of NASD-Regulation and the other securities industry self-regulatory organizations. The bill gives the SEC extensive oversight authority to ensure that the board does not act as some renegade regulator, including authority to approve proposed sanctions. This authority is strengthened by the board's reliance on SEC assistance in its investigations when seeking documents and testimony from public companies.

> *The bill makes clear the private status of the board; efforts to undermine its authority by calling that status into question must be rejected.*

Do not eliminate the requirement that auditors test for compliance with internal controls.

The Private Securities Litigation Reform Act required auditors to adopt procedures "designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts." While this would seem to be the minimum investors should be able to expect from the independent audit, it is a responsibility that auditors have resisted.

The Senate bill would add backing to this provision by requiring the board to adopt a new audit and attestation standard related to testing of internal controls and by requiring annual reports to include a management assessment of internal controls attested to by the auditor. Because it would make it more difficult for them to continue to evade their responsibility to adopt procedures designed to detect illegal acts, the accounting firms have put this provision on their hit list, and Senator Gramm has put its elimination on his list of suggested changes.

It is difficult to see how accountants could attest to management's assessment of internal controls without conducting the type of testing required under the bill's proposed audit and attestation standard. Furthermore, as the bill makes clear, this is testing that should be, and should have been, conducted as a part of any thorough audit. The bill leaves auditors free to include the cost of this testing in their overall audit fee, but it does prevent them from claiming this as a new, separate mandate to be billed for separately.

> *Because the testing of internal controls is an essential part of an effective audit, and the only reliable basis for the attestation auditors are being required to make on annual reports, both provisions work together and must be retained in the final bill.*

Do not take other steps to limit the board and commission's regulatory authority.

This list does not begin to exhaust the amendments being proposed by Senator Gramm, in particular, to weaken the board and SEC's oversight authority. One has to admire the thoroughness with which he has gone through the bill and identified seemingly every provision designed to give the oversight board and SEC effective regulatory authority, and proposed their elimination.

According to his list of "other concerns" about the bill, for example, he proposes to eliminate SEC authority to sanction firms that engage in either "a single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which the registered public accounting firm knows, or should know, that heightened scrutiny is warranted" or "repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." He would eliminate not only the board's ability to seek an SEC subpoena for third parties to produce documents or give testimony to assist it in its investigations, but also the board's ability to *request* documents from anyone other than a registered accounting firm. His list includes eliminating the treatment of decisions to deny applications for membership as a disciplinary action, which requires that the Commission and states receive notice of the decision. It also makes the decision is subject to Commission review. And he seeks to eliminate the board's ability to adopt rules that are "necessary or appropriate in the public interest or for the protection of investors."

> *These and other amendments suggested by Senator Gramm represent a transparent attempt to cripple the new auditor oversight board and to limit the regulatory authority of the SEC; they must be rejected.*

3) Do not protect auditors from accountability to their victims when they are guilty of fraud.

A third priority for accounting firms is to limit their liability in instances in which they are found guilty of wrong-doing and sanctioned by the new oversight board. Representative Baker and Chairman Oxley have suggested setting up a restitution fund to compensate investors using funds from fines and disgorgement of ill-gotten gains. This is a concept we support (though we would need to see the legislative language before we could endorse this specific proposal). However, such an approach is not sufficient to ensure that defrauded investors are able to recover their losses. In the recent Xerox case, for example, the $10 million fine imposed, while enormous when compared to previous such fines, was a pittance when compared to investor losses. Such efforts will be incomplete if not accompanied by strong investor rights to recover their losses through private lawsuits.

Throughout this legislative debate, the accounting firms have succeeded in limiting their liability in several ways. An amendment to restore aiding and abetting liability for those who contribute to securities fraud was kept off the Senate floor, despite the fact that lack of such liabiity is being used by every Enron defendant that can remotely lay a claim to it. The Senate bill provides such extensive confidentiality protections to disciplinary actions that inspection reports will not reveal defects, disciplinary hearings will be held in private, and sanctions will not be made public until all appeals have been exhausted or withdrawn. As a result, years could pass before investors ever get notice of a possible problem at an audit firm. Accountants have a variety of other suggestions for the conference committee to ensure that their victims cannot hold them accountable. At the top of their list and that of the securities industry and various other special interest groups is the lengthened statute of limitations included in the Senate bill.

<u>Do not eliminate the lengthened statute of limitations for securities fraud</u>.

Elimination of this provision is also at the top of Senator Gramm's list of key suggested changes to the corporate reform bill. Senator Gramm argues that the shortened statute of limitations was part of an effort to curb abusive lawsuits, but former SEC Chairman Richard Breeden argued for a lengthened time period on the grounds that a short statute of limitations encourages a rush to the courthouse. Senator Gramm also argues no evidence supports lengthening the statute of limitations. This ignores the extensive evidence compiled by the SEC that the short limitations period, combined with heightened pleading standards, and the stay of discovery pending motions to dismiss was working to inhibit lawsuits against secondary defendants. It also ignores the perfect case example offered by Enron, which was able to keep problems at the company hidden for years. As a result, lawsuits based on the earliest accounting violations at that company will almost certainly be time-barred.

> *The modest increase in the statute of limitations provided by the Senate bill will help to ensure that the victims of future Enrons will not be prevented from recovering their losses simply because the company was able to hide its fraud for three years; it must not be eliminated from the bill.*

Conclusion

Recent polls indicate that the public has little faith in either the administration or Congress to resolve the current market crisis. The House could and should have taken decisive action to restore that faith, by passing the Senate bill as soon as it received it. It could still do so, adding a few minor amendments as appropriate on the floor and sending the bill back to the Senate for final passage. That would send the clear message to American investors that Congress and the administration are capable of acting in a bipartisan fashion to adopt a strong package of reforms.

By insisting on holding a conference, the House has subjected the outcome of that process to suspicions that special interest groups will achieve in behind-closed-door negotiations what they were unable to achieve in the full glare of public scrutiny that accompanied the Senate floor debate -- a steady erosion of the bill's investor protections. The amendments being pushed by special interest groups and supported by Senator Gramm and Chairman Oxley offer ample justification for those suspicions.

We urge you to turn aside efforts to undermine the bill and to insist on quick passage of a bill that retains all of the key reforms contained in the Senate bill. The health of our markets and the faith of the American people in their government's ability to act decisively in the public interest are hanging in the balance. For more information, contact Travis Plunkett at the Consumer Federation of America at 202-387-6121.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Scott Harshbarger
President
Common Cause

Kenneth McEldowney
Executive Director
Consumer Action

Edmund Mierzwinski
Consumer Program Director
U.S. Public Interest Research Group