

TESTIMONY

OF

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC
ACCOUNTANTS**

BEFORE THE

**NEW YORK STATE SENATE HIGHER EDUCATION
COMMITTEE**

**RICHARD I. MILLER, GENERAL COUNSEL AND
SECRETARY**

PUBLIC HEARING:

**THE PURPOSE AND MISSION OF 21ST CENTURY
ACCOUNTING FIRMS
AND INDEPENDENCE OF CERTIFIED PUBLIC
ACCOUNTANTS
IN THE POST-ENRON ERA**

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THE GRADUATE CENTER, 365 FIFTH AVENUE

NEW YORK, NY

Mr. Chairman, and members of the Senate Higher Education Committee, my name is Richard I. Miller, and I am the General Counsel and Secretary of the American Institute of CPAs (AICPA). The AICPA is the national professional association for CPAs in the United States, with main offices here in New York. The AICPA's efforts are supported by the 54 state CPA Societies across the country, including the New York State Society of CPAs, who you will hear from later this morning and who will provide you with a focused state perspective on these matters.

The AICPA is a principal force in developing auditing standards, drafting model legislation, sponsoring educational programs and issuing professional publications to improve the quality of services provided by CPAs. In particular, the AICPA develops the standards that, after due process and formal adoption, govern the conduct of the various types of services provided by CPAs with respect to financial statements, such as audits, reviews, and compilations, and the reports issued thereon. Accordingly, the

AICPA provides numerous services that benefit multiple constituencies and on which multiple constituencies have come to rely. The most important of these constituencies is the public – whose reliance on audited financial statements is so essential to our economy and markets.

To that end, the AICPA has become the centerpiece of the accounting profession's self-regulatory system. Each of the AICPA's self-regulatory programs depends on the full cooperation and candor of the AICPA's members. The AICPA's self-regulatory programs include: the Joint Trial Board, which adjudicates disciplinary charges against AICPA members and state CPA society members; the Peer Review Program by which an independent accounting firm reviews and evaluates a representative sample of the firm's accounting and auditing engagements as well as the firm's manuals, for compliance with the applicable professional standards and; the SEC Practice Section which maintains a system of self-regulation for firms of members

that provide attestation services to public companies that includes peer reviews, required maintenance of appropriate internal quality controls and the imposition of sanctions on firms for failure to meet membership requirements.

On behalf of the more than 340,000 members of the AICPA, and those approximately 24,000 AICPA members from the state of New York, I thank you for the opportunity to discuss the accounting profession's self-regulatory process and our views on auditor independence. Clearly, any discussion on these issues is framed by the tragic business failure of Enron.

There is no question that the collapse of Enron represents a colossal failure that has caused great pain to its employees and investors. The repercussions have clearly and unmistakably shaken the public's confidence. Much has been heard about the failures that have occurred. But let us remember that the final curtain has not yet dropped. Ultimately, Enron's management,

board of directors, audit committee of the board, external auditor, as well as others, such as analysts and lawyers must address and redress the roles they played.

The AICPA shares the distress of all Americans concerning the tragic breakdowns that contributed to the fall of Enron. Our profession has an over 100-year history that is based on public trust and integrity and we have zero tolerance for any CPA who does not adhere to the rules. Each year, in excess of 15,000 audits of publicly traded companies are completed successfully without restatement or allegation of impropriety. Moreover, thousands of audits of private companies and business enterprises – from hospitals, charities, and youth groups to the newest businesses – are performed successfully every year by our members and serve as the bedrock of the U.S. economy.

But as we have come to realize, unprecedented disasters sometimes call for unprecedented actions. And, we want everyone to know

that the accounting profession is prepared for unprecedented change. Our history is marked by a willingness and commitment to respond to key market and economic events and make the changes required to ensure public trust and confidence.

Twenty-five years ago, the profession created the SEC Practice Section to improve accounting and auditing practice before the SEC. We also instituted peer review as a means to ensure the uniform and consistent application of the profession's high standards to all clients. Most recently, in 2000, the Panel on Audit Effectiveness, more commonly referred to as the "O'Malley Panel" of the Public Oversight Board, made recommendations for audit effectiveness that are being implemented.

However, we cannot and will not rest on the past. We know that in order to restore the public confidence in the auditing profession, our self-regulatory process must be strengthened for the future.

As a step in that direction, we support the proposal put forth by SEC Chairman Harvey Pitt as a framework for strengthening the regulatory oversight of auditors of publicly traded companies. Make no mistake about it, this proposal represents a change of monumental proportions for the profession, in that it eliminates self-regulation with public oversight and replaces it with a system of active public regulation. Specifically, this proposal will create a new governing entity, focused chiefly on two areas: discipline and quality control monitoring. The new disciplinary and practice monitoring boards would operate independently from the AICPA.

The proposal envisions a new disciplinary board dominated by representatives from the public that will take the discipline of CPAs and firms who audit public companies out of the hands of the profession. The board will be empowered to perform investigations, bring disciplinary proceedings, publicize results, and restrict individuals and firms from auditing public companies.

With respect to strengthening quality monitoring, the SEC proposal eliminates the current triennial firm-on-firm review for the largest firms and replaces it with a more rigorous and frequent form of monitoring the quality controls, with respect to a firm's audit practice. It anticipates formation of a permanent Quality Control staff, independent of any accounting firm, and composed of knowledgeable professionals, who would be deployed and overseen by the new publicly dominated body.

I want to emphasize, however, that we believe the proposal by Mr. Pitt is only appropriate for auditors of the financial statements of SEC registrants and not for auditors of the financial statements of privately held companies.

The AICPA is committed to working with both the SEC and Congress to make Chairman Pitt's proposal a reality. In addition to supporting Chairman Pitt's present efforts, the AICPA is

committed to working with the SEC to provide a new and improved financial reporting model that is suitable for companies of the Information Age, whose earning assets aren't accurately valued by traditional measures. The goal is a new financial reporting model that will provide better information to the investing public, that will deliver financial information in "real time" rather than only periodically, and that will move the financial reporting model from the industrial age to the information age.

In addition, I believe we must address inherent inequities in our current system, where it appears acceptable to lie to your auditor.

As we seek to draw lessons from Enron and consider certain reforms that may help prevent another business failure of this magnitude, it is essential to understand the framework in which the auditor of a publicly traded company does his or her job, to

recognize the safeguards that already exist to ensure auditor independence, and to reaffirm the responsibilities of the different parties in the financial reporting process.

Relevant to the issue of independence is non-audit services. The regulation of non-audit services has been debated extensively as of late. We believe the right question in looking at the matter is two-fold. First, what is encompassed within the category of non-audit services, and second, does limiting the accounting firm to providing “audit services only” make the auditor more objective and independent, and better able to serve the client?

It is important to recognize that non-audit services are services that businesses of all sizes want their auditor to perform, and they encompass a broad range of services. Take tax advisory services, for example. It is a service that a client’s auditor is competently, knowledgeably and more qualified to offer than someone unfamiliar with the client’s business. Yet, it is classified as a non-

audit service. Similarly, a full range of assurance services, including reports on internal controls, advice on accounting matters, and the issuing of comfort letters in connection with securities registrations are also within this category. I am confident that many would agree that these services should not be restricted.

In November 2000, the SEC, after considering extensive testimony, passed a series of rules governing the independence of auditors of SEC registrants. These rules clarified the allowable scope of services provided by audit firms to their audit clients. The rules are designed to provide greater transparency to investors through the consistent disclosure of services rendered to audit clients by auditors. Additionally, the rules provide that companies must disclose the fees not just for auditing, but also for non-auditing services, for the previous fiscal year in their annual proxy statements.

Further, the SEC, through its rules, charged public company audit committees with considering whether non-audit services by the auditor were compatible, in the audit committee's opinion, with maintaining auditor independence. This provision was consistent with the profession's Independence Standards Board Standard Number One, which requires the auditor to disclose its various roles to the audit committee and discuss independence with its members.

The ink has not dried on these new SEC rules and while the immediate desire to respond to the catastrophic failure of Enron is tempting, Enron's business failures were probably already underway long before these rules were promulgated. More importantly, it is not at all clear whether proscribing non-audit services would, in fact, reduce the possibilities that future Enrons would occur.

However, given the current state of affairs, the auditor independence issue needs to be examined in a new way. For this reason, the AICPA Board of Directors has decided that it will not oppose federal legislative attempts to restrict auditors who audit financial statements of SEC registrants from providing financial system design and internal audit outsourcing services to their clients. They made this move in order to help restore the public's confidence in our financial reporting system. In announcing this position, the Board also recognized that the reporting needs of private companies and their auditors are very different and should not be subjected to the same restrictions.

It is also important to examine the role and responsibility of a company's audit committee, as well. No audit committee should retain the services of an auditor whose independence it believes is compromised. Indeed, as the representatives of the shareholders, they must act if they believe that independence has been compromised.

Moreover, the assumption that the provision of non-audit services impairs independence not only lacks evidentiary support, but assumes that auditors, boards, audit committees and investors are unable or unwilling to make informed decisions and reasoned judgments based upon the full disclosure of fees in the proxy statement. We believe that is an unfair assumption... unfair to the auditors, unfair to the boards and unfair to the investors who are recipients of disclosure information.

In closing, on behalf of the accounting profession, the AICPA will diligently work with the SEC, Congress and other appropriate government entities to restore public confidence in the accounting profession. We believe that the economy and the investors in our capital market systems will benefit from a deliberative and thoughtful process. We look forward to the dialogue and the reforms that will result.