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Accounting and Disclosure After Enron

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Accounting and Disclosure After Enron
Robert E. Litan

Thank you, Mr. Chairman, for inviting me to appear today to discuss accounting and disclosure issues in the wake of the Enron failure.[1]

I come to you with a somewhat different background than many of those who have appeared before you so far—not as a professional accountant or securities regulator, but as an individual who has spent most of his career in a policy research setting and in government working on a variety of issues, some of which have touched on Enron-related questions. In particular, much of my research has focused on the financial services industry, while in my years in government, I have helped enforce the nation's antitrust laws and have overseen or worked with the budgets with a number of federal agencies, including the SEC. Of perhaps greater relevance to the current hearing, I have co-authored a book with my colleague from AEI here today, Peter Wallison, on what we believe to be some of the cutting edge issues in accounting and disclosure,[2] and am in the process of co-authoring another book on disclosure policy in a world of increasingly global capital markets. I hope that through these various experiences and endeavors I can provide the Committee with some fresh insight into the challenges it and the entire Congress now confront.

Overview

The Enron failure poses some of the toughest policy challenges of any financial collapse in recent memory. The current situation is not comparable to the savings and loan or the banking disasters of the 1980s, which were nearly a decade in the making before Congress finally took action. By comparison, the disclosure problems that have surfaced in Enron have been apparent only over the past several years, especially the growing number of earnings restatements and the rising concern about "earnings

[1] The Enron failure raises numerous other public policy issues, including those relating to pensions (401(k) plans in particular), corporate governance, and derivatives disclosures, which Congress, the Administration and the regulatory agencies will be addressing this year and possibly beyond. I am confining my remarks here, however, to the issues itemized in the invitation letter from Chairman Sarbanes: "financial reporting by public companies, accounting standards, and oversight of the accounting profession."

management" expressed by the SEC and others. More importantly, whereas in the S&L and banking cases there were clear "solutions" on the "policy shelf", as it were, for Congress to implement (notably, the system of prompt corrective action for enforcing capital standards), only some ideas are on the shelf this time and there appears to be only a limited consensus on which ones ought to be adopted.[3]

This should not be alarming because improving the disclosure system is a complicated subject with few absolutely clear answers. As Paul Volcker pointed out in his testimony before this Committee on February 14, the growing complexities of business—reflected in a dizzying array of new financial instruments and corporate organizations—pose increasingly difficult challenges for any system of disclosure. The fact is that for many kinds of transactions, there are no single "right" answers, which helps explain why the Financial Accounting Standards Board often takes so long before setting new standards or refining earlier ones (and why International Accounting Standards instead are framed in a more generic fashion, allowing accountants more discretion in deciding how to account for various transactions than is the case under Generally Accepted Accounting Principles in this country).

The same is true for improvements to the system for overseeing auditing, or what I would call the "enforcement problem." There is a compelling case for replacing or at least supplementing the current system of state supervision and self-regulation of auditors, as this Committee already has heard from previous witnesses. But there are arguments for and against each of the possible reform measures, as I will explain shortly.

Meanwhile, Congress should be mindful that markets and regulators have already engaged in a lot of "self-correction" in the wake of the Enron affair and of the facts that this Committee and others have helped to uncover and publicize. Based on popular press accounts and conversations with knowledgeable observers, my impression is that a number of companies (including America's largest in terms of market capitalization, General Electric) already have delivered more disclosure; corporate boards, and their audit committees in particular, are paying closer attention to accounting issues and the

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[2] *The GAAP Gap: Corporate Disclosure in an Internet Age* (AEI-Brookings Joint Center for Regulatory Studies, 2000).

[3] Similarly, during the Depression, Congress and the Roosevelt Administration took some ideas that had long been on the policy shelf and adopted them into law, notably deposit insurance and the Glass-Steagall Act's separation of commercial and investment banking (although two years later, Senator Glass expressed regret about its passage).

choice of auditors; accounting firms have tightened up on their audits; financial analysts and credit rating agencies, chastened by their past performance, have become more discriminating; and the SEC is apparently doing the best it can with its limited resources to scrutinize corporate financial statements for possible problems.

So what should Congress do at this point? This Committee and others are taking the right approach by first gathering facts and views from the experts. But you will inevitably find that, at least so far, there are many conflicting views. You should also be wary of all those who profess to know for certain about what reforms are most appropriate. The fact is that we—the Congress, the Administration, the experts, investors and the wider public—are all in the process of trying to figure out the best response. I am no exception in this regard: my own thinking continues to evolve as I gain more facts and learn of additional policy suggestions, and I ask you to bear that in mind as you hear the remainder of my testimony.

Accordingly, my best advice at least on the disclosure-related issues, is that if Congress enacts legislation (rather than leaving the reform job solely to the SEC), it do so in a broad fashion allowing for significant flexibility. It can do this with broad, general instructions to the SEC, but leave the details to the Commission. Flexibility is important in this area precisely because it is complex, the answers to current problems are not obvious and often contentious, and the problems themselves may appear differently several months from now or even next year, than they do now.

In the remainder of my testimony, I distinguish between issues relating to accounting standards, enforcement issues, one issue relating to the fate of the accounting industry post-Enron (possibly even greater concentration), and a set of cutting-edge disclosure issues that should be addressed at some point.

Along the way I will briefly discuss certain of the Administration's proposals, as well as some of the reforms that I do not believe would solve any problems, or that conceivably might entail more costs than benefits.

Accounting Standards

The major, immediate accounting problem exposed by Enron's failure was the weak consolidation rule prescribed for highly leveraged "special purpose entities"

(SPEs). As this Committee and others in Congress have heard, Enron failed in part because of losses arising out of the many SPEs that it had created.

In brief, the rule for some time has been that sponsors of an SPE need not consolidate it so long as outside investors contribute a majority of its capital and that investment constitutes at least 3 percent of the SPE's assets. Putting aside the SPEs where Enron appears to have misled its auditor, Anderson, about the amount of outside investment (thus wrongfully avoiding consolidation), it is now clear that the 3 percent test was much too weak. FASB has since raised the 3 percent of assets threshold to 10 percent, clearly a move in the right direction.

The more difficult, larger issue relates to FASB's standard-setting process itself, however. As the Committee has heard from other witnesses, FASB is slow to set standards (the incredibly quick revision to the SPE rule being a notable exception) and when it does, it is often subject to political interference.

Changing the funding of FASB from voluntary contributions from accounting firms and companies (the current practice) to some sort of mandatory assessment system, as some have suggested, would solve neither of these problems, although it might diminish any perception that FASB must tailor its views to those of its funders (a charge I suspect that FASB would vigorously deny).

The slowness of FASB's standard-setting could be addressed more directly by having the SEC impose deadlines on rule changes, with the threat that the SEC would take action by a certain date if FASB didn't (as former SEC Chief Accountant, Lynn Turner, proposed before this Committee). I want to be clear: I'm not enthusiastic about the SEC taking over the standards-setting function altogether, which I fear could interfere with the other functions the Commissioners perform and could not guarantee any better outcomes. But I can see the value of having the *threat* of occasional SEC rulemaking as a way of keeping FASB's feet to the fire. The SEC could also become more proactive in reviewing, if not actually setting, FASB's rulemaking agenda on a regular basis, which could also help speed things up.

The downside of more active SEC involvement, however, is that it could result in even greater political interference in FASB's activities than already exists—most recently, with respect to FASB's efforts to set standards relating to the expensing of stock options and the accounting treatment of derivatives. There is a respectable view that

politics is inherent in any rulemaking process, especially one that is supposed to be in the public interest, and so we should simply live with the fact. Moreover, it can be reasonably claimed that setting accounting standards is not a science and we should stop pretending that it is something so pure that it shouldn't be affected by the views of the profession that applies them nor of the firms that have to abide by them.

At the same time, however, we should remember that the main purpose of accounting standards—at least for publicly held companies—is to protect the interests of *investors*, not accountants and not the firms themselves. Accounting standards should help investors understand all relevant financial facts that will enable them, if they want, to make projections about future cash flows. Where the standards are changed or not implemented out of concern for affected firms rather than investors, who tend not to be organized and who in any event can always choose not to invest in the companies that may be lobbying the Congress or FASB on a particular rule, then the outcome may not be socially desirable.

In short, it is not that politics should be kept out of the rulemaking process—it probably never can be—but that the current system, at times, can too heavily favor narrow interests over the interests of investors as a class (of course, this a problem that is not unique to accounting standards). In theory, putting more investor or public representatives on FASB could help rectify the imbalance. In practice, however, if Congress wants the rules to benefit narrow interests, then there is little that even a more balanced FASB can do.

Similarly, moving the standards-setting function to the SEC is not a panacea because Congress still exercises oversight of the SEC. The same would be true if FASB members were chosen directly by the Commission. As long as the SEC oversees FASB in some way and Congress oversees the SEC, I don't see how politics can be taken out of accounting standards-setting.

In principle, the only option I believe would have a chance of at least making some difference is to move standard-setting to an international body like the International Accounting Standards Board and thus accept international accounting standards (IAS), which the United States thus far has refused to do—largely out of the belief that U.S.

GAAP is superior to IAS.[4] Of course, this is not the rationale for moving to international standards that is typically cited. Instead, the case for IAS rests largely on the view that a single set of accounting standards worldwide would eliminate discrepancies in accounting standards across countries, thereby facilitating cross-border movement of capital. In addition, removing sources of uncertainty generated by differences in national accounting conventions should reduce the cost of capital. In the wake of Enron, others also have argued that a system like the IAS that allows accountants more discretion is superior to the heavily rule-based system of U.S. GAAP which seemingly invites circumvention. (Precisely the opposite argument can made, of course, *against* a system that allows more discretion, and thus potentially more freedom for managements to manage their earnings than already exists.)[5]

Whatever the merits of all of these arguments, the simple point I want to make here is that another potential, and possibly unrecognized, advantage of replacing U.S. GAAP with IAS is that it would dilute the political power of American interests—whoever they are—to influence the outcome of the standard-setting process. Take, for example, the fight over expensing stock options, which FASB was about to implement several years ago before it was stopped by a powerful lobbying campaign from the U.S. high-tech community. If standards were set solely by the IASB, our high-tech firms would make their views felt, but they could well run into significant opposition from standard-setters from other countries. Indeed, it is just for this reason that moving away from U.S. GAAP to IAS, if it were ever seriously considered, almost certainly would arouse strong opposition in this country.[6]

Accordingly, I do not believe that replacing U.S. GAAP with IAS is a politically viable option, even if the IASB, under the strong leadership of Paul Volcker and David Tweedie, among others, convincingly updates IAS in a way that persuades many in this country that the international standards are superior to U.S. GAAP.[7] I hold this belief for

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[4] The SEC allows foreign firms that want to list their shares here to use IAS, provided they also reconcile their financial statements to U.S. GAAP.

[5] A widely noted reason for the greater specificity of U.S. GAAP is that it is a response to the greater pressure of securities litigation in the United States than in other countries. If the United States adopted IAS, it is possible, if not likely, that our representatives would push the IASB to make IAS more specific over time for the same reason.

[6] Those who fear a loss of "financial sovereignty" also presumably would weigh in against any move to a single world standard-setter.

[7] Volcker is chairman of the trustees of the International Accounting Standards Board and Tweedie is the chairman of the IASB itself.

another reason: Even if U.S. GAAP were replaced, it is possible, if not likely, that FASB or something like it would continue to exist in order to issue interpretive rulings of the broader principles-based international standards. If this were the case, and I suspect there would be strong pressure to ensure that it would be if U.S. GAAP ever were replaced by IAS, then FASB's interpretive rulings would gradually lead to a U.S. version of IAS, as well as the "international version". If other countries did the same thing, IAS could fragment over time back into multiple national standards.

It is possible, of course, that fragmentation would not occur—that national accounting bodies such as the FASB would simply fade away. Whichever view is right—fragmentation or monopoly—I lean toward a much different approach, one I would call "constrained competition" in standard-setting. Under this approach—which appears to be gathering greater support within the academic community—U.S. law (or regulation) would give firms listing their shares on our stock exchanges a choice between using U.S. GAAP or IAS, without having to undergo the expense of reconciling the differences between the two standards, once some of the key differences between the standards are substantially narrowed. The remaining differences of lesser magnitude would continue to exist, and the two standards would simply compete, but the discrepancies would not be so large as to produce widely divergent results for most companies. In that way, investors would get the benefits of both greater harmonization (but not complete identity) of the two standards *and* the benefits of competition.

The benefits of competition in the standards-setting arena are no different than in any other context. Like any monopoly, whether private or public, a single standard-setting organization can stultify and be slow to adapt to market developments. Sound familiar? That's one of the main complaints about FASB. With competition, each standard-setter would have a market-based incentive to keep up with the times and not drag its feet. Furthermore, if it really is true that any move to international standards would eventually break down into national versions of those standards (or at least a U.S. version), then some competition is inevitable. Why not simply recognize that to be the outcome, encourage the SEC and FASB to set up a process for quickly narrowing some of the key differences between the standards—say, for example, with respect to revenue recognition, the handling of pro-forma statements, consolidation, and the expensing of stock options—and then let the competition begin?

Wouldn't there be a "race to the bottom" if competition in standard-setting is allowed? The post-Enron experience suggests the opposite would occur. Ask GE, IBM, Tyco or any number of other companies whose stock prices were pummeled by investors after the Enron affair became public. Investors (prompted to some degree by the business media) looked at the financial statements of these companies and apparently found their disclosures inadequate. The market encouraged each to become more forthcoming in its disclosures. Based on this most recent experience, I believe it is reasonably likely (although I admit not certain) that if firms had a choice in reporting standards the market eventually would punish the standard that analysts, academics and financial commentators would view as the weaker one from an investor protection point of view. For the same reason, I also believe there is a reasonable chance that competition in standards could weaken (although not entirely eliminate) political influence on standard-setting. At the very least, constrained competition is worth a real try, there being no other obvious solution to the problem of undue political influence.

Finally, what if after a reasonable period of competition one of the standards was driven out of the market, much as has happened in the markets for computer operating systems (for Intel-based personal computers) or video cassette tapes? If that is the result, then so be it. But given the international movement away from U.S. GAAP and toward IAS, it is likely that the loser in any competition would be U.S. GAAP, leaving IAS. But if national standard-setters nonetheless continued to issue interpretations of IAS, then the market would not have moved to a single standard.

Enforcement

However much accounting standards may be perfected, investors will not be protected if the standards are not properly enforced by auditors. In light of the rising numbers of auditing problems in recent years, culminating with Andersen's widely publicized failures with respect to its audit of Enron, attention has properly been focused on how best to improve the verification of financial statements. There are two basic approaches, which are not mutually inconsistent, but ideally should be reinforcing: improved monitoring or oversight of the auditors themselves and better (and more finely calibrated) incentives for those who conduct audits to carry them out properly.

Monitoring

I agree with others who have testified before this Committee who have criticized the current system of overseeing the auditing profession—a combination of self-regulation (and audit standard setting) by the AICPA and supervision at the state level. There is too much self-interest at the AICPA and its penalties are not credible, while state efforts lack resources and expertise.

As the Committee is well aware, the most discussed reform of the existing enforcement system is the creation of an independent body reporting to the SEC that would set and enforce auditing standards. SEC Chairman Harvey Pitt has outlined, and the Administration has basically endorsed, such a proposal for a new Public Regulatory Board (replacing the previous Public Oversight Board) that would have authority to set auditing standards and to investigate and punish wayward auditors (even while charges are pending). Most of the members of the PRB would be independent of the accounting industry, while the functions of the Board would be financed by assessments on accountants and the firms they audit. So far, to the extent the Pitt proposal has been criticized before this Committee and elsewhere, it is because it is said to not go far enough. A good case can be made that *all* of its members ought to be independent of accounting profession, and that its investigatory powers ought to be strengthened by at least giving it subpoena power.

If Congress is inclined to create a new monitoring authority like the PRB, then I agree with the SEC's critics on these points. But before Congress rushes to do this, I urge it at least to consider whether the *SEC itself* should be performing the oversight of auditors directly, although as I will argue shortly, it might make sense to establish a slimmed-down PRB to set auditing standards. Indeed, as I understand it, the Commission already has the requisite enforcement authority, but to the extent it doesn't, then Congress can easily give it what it requires. I can't think of many examples in the federal government where enforcement authority like this is effectively contracted out to an independent authority. I used to work at the Justice Department, and we certainly didn't contract out the entire enforcement job (although the Antitrust Division where I worked has engaged private counsel in specific, high profile cases).

Why then create an independent auditing authority? Certainly, it cannot be credibly claimed that the job of overseeing auditors is more complex than overseeing the

stock exchanges, investigating fraud or insider trading, or carrying out the rest of the Commission's statutory agenda. If nonetheless the reason for contracting out the supervision of auditors is that the SEC is short of staff and resources, as it clearly is, then there is an easy answer to that problem: give it the necessary resources and finance it by an assessment—or what is more accurately a user fee—on any one or all of the following: accounting firms, the firms they audit, or investors. Indeed, whether or not the SEC assumes the power of the PRB, it needs more resources, not just for more people but to raise salaries in order to stem its high rate of turnover, and if some kind of assessment is deemed necessary to finance the extra funding, then Congress should impose it.[8]

If the reason for creating an independent board is to shelter it from political interference, then that argument, too, shouldn't be decisive. The SEC has effectively contracted out the setting of accounting standards to the FASB, but that hasn't prevented affected interests from influencing what the FASB does. In fact, precisely because enforcement is an inherent government function that is carried out elsewhere by other federal agencies, Congress quite properly exercises its oversight responsibilities over those enforcement efforts. It would be no different if the SEC were to oversee the auditing profession directly.

The only plausible argument I have heard for creating the PRB is the claim that the enforcement of auditing standards requires an understanding of the intent behind the standards and so the two functions should be lodged in the same place. And since the thought of having the SEC write audit standards seems to many like a non-starter, better to have both jobs carried out by an entity like the PRB under the SEC's oversight.

My response to this line of argument is two fold. First, many regulatory agencies write complex rules that they enforce, so in principle there is no reason why the SEC couldn't do both. If the SEC felt it didn't have the requisite expertise to amend or rewrite the auditing standards that already exist—something that has not been demonstrated is necessary, by the way—it could look to an entity like the PRB to write the "first draft" and then formally amend or adopt the standards and any subsequent changes to them.[9]

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[8] Last week, the Committee heard testimony about the inadequate resources at the SEC from the U.S. Comptroller General David Walker.

[9] I do not believe there would be a significant danger of political interference in the setting of auditing standards, wherever that function is lodged, because of the highly technical nature of those standards and because it is difficult to predict in advance the impact on individual firms and industries of any generic

Second, even if the SEC delegates the writing of audit standards to a new PRB, it would still retain oversight over the organization. In this capacity, I do not see why the Commission and its staff, in carrying out their enforcement functions, could not be in regular contact with the members and staff of the PRB to clarify any possible misunderstanding over the meaning of particular audit standards.

So, at the end of the day, I favor lodging the investigation and enforcement functions overseeing the auditing profession within the SEC, while leaving the preparation and refinement of audit standards to an organization like the PRB.

Better Incentives

Putting the equivalent of more and better "cops on the beat" is not the only way to improve auditing. Harnessing incentives is just as, if not more, important because it may be cheaper and more effective.

A number of incentives for auditors to perform their jobs already exist, of course. Auditors care about their reputations. And they certainly care about their liability exposure. Just ask the partners of Andersen who face potentially huge liability costs over and above the amounts that their insurer may cover. Or ask the partners of any other Big Five accounting firm who must fear that the same thing could happen to them.

A problem with liability-based incentives, however, is that they can lead to overkill—to excessive caution as an understandable reaction to the threat of going out of business. Are there are other more finely tuned incentives that might help?

The Administration has suggested that CEOs repay any earnings-based bonuses if companies have to restate their earnings. This seems like an eminently sensible idea.

Another frequently mentioned proposal is to prohibit auditors from doing some or all types of non-audit work for their audit clients.[10] Some have suggested going further and limiting auditing firms only to audit work for all their clients. The rationale for these various limitations, of course, is to remove any incentives that auditors may have to compromise their audits in the hope of holding onto lucrative non-audit business. In fact, because this view is so widespread and out of a desire to preserve the reputations of their

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audit standard. This is not the case with accounting standards (such as the expensing of stock options) whose effects are much more easily anticipated and quantified in advance.

[10] The Administration's proposed prohibition would apply where the non-audit service "compromises the independence of the audit", presumably something the SEC would decide, presumably by generic rule.

audits, all of the Big Five firms, already have taken steps either to sell off some of their non-audit businesses entirely (notably, information technology consulting) and/or not to perform non-audit work for their audit clients. One question that you may want answered is whether these market-driven developments should be enshrined in some kind of legal prohibition on the non-audit activities of auditing firms.

I am skeptical about the value of any permanent prohibition, but not because I agree with those in the accounting profession who in the past have argued that there are positive synergies to being in both the audit and non-audit business. My skepticism instead is based on the fact that even if audit firms are limited only to audit work for clients, they still face the prospects of *losing their audit business*, which in a world of restrictions, would be the only business they have. As a result, audit firms could very well have the same incentives to compromise the quality of their work as they allegedly did before (My skepticism does not extend, however, to a prohibition on an outside auditor doing internal audit functions for the same client, which also appears sensible).

For the same reason, I am also somewhat skeptical of the value of another widely discussed proposal: the mandatory rotation of auditors every several years. It is possible, of course, that some auditors who know they are going to be replaced and have their work scrutinized closely by a successor, will be more careful in carrying out their work every year. But another effect may work in the opposite direction: once the rotation is over, auditors may tacitly promise good treatment in the "beauty contests" that firms would hold on a regular basis in choosing their next auditor.[11]

In short, as long as management continues to choose the auditor, the potential will always exist for a conflict that could compromise the quality of the audit. One response to this is to intensify oversight of auditors for precisely this reason, as already discussed. The other response is to mandate that managers of publicly held companies not be able to choose their auditors.

Who could do this instead? One obvious candidate is the audit committee, as several witnesses before this Committee have suggested. To maximize the committee's distance from management, it could be further required that all members of the audit committee on boards of directors be independent. Of all the options available, this is the

[11] In addition, a mandatory rotation system would eliminate the market signal that comes about when a company now voluntarily changes its auditor.

best one, although I would caution it is not perfect (probably nothing is). Management can still exert a subtle influence—directly or indirectly—over even independent board members (who tend to be chosen or recommended by management, after all). In addition, for this option to really work, audit committee assignments probably would have to become far more time-consuming than attending quarterly board meetings. To this add the post-Enron fear of many directors of even serving on an audit committee, and it is all but certain that if the hiring of auditors is moved to audit committees, directors will not serve on the them unless they are given much greater compensation than is now the case.

More radical alternatives would shift the hiring of auditors to third party entities––such as the stock exchanges, the SEC, or perhaps the PRB (if it is created), assuming that there is no appetite for having any of these organizations engage in the auditing itself (a massive undertaking that I clearly would not recommend). Having any one of these entities engage outside auditors would totally sever the link between the auditors and the firms they audit, and thus solve the conflicts problem. However, there are numerous practical problems associated with the assignment of auditors to the roughly 12,000 public companies that would require audits. In principle, the assignments could be made through bids or an auction, but a potentially very large bureaucracy would be required to administer that process. Also in principle, the cost and complexity could be reduced if the rights to audit numerous firms were lumped together. But in practice, how would the groupings be made, and on what basis? To what extent would firms found to have committed negligence in one or more cases be restricted from bidding for the rights to other audits? And then there is problem of ensuring that no single auditing firm or a select grouping of firms smaller than the Big Five effectively corners the market for audit services. This could be solved by imposing market share limits, but I fear such a step would also invite political interference into the auditor selection process (perhaps resulting in set-aside programs that might not be in shareholders' interests).

In short, because the practical difficulties of implementing any of the more radical measures appear too great, I believe an acceptable compromise is a rule requiring auditors to be hired by audit committees.

The Accounting Industry Post-Enron

One issue that has received relatively little public discussion in the wake of Enron's failure is what should be the attitude of public policy makers to the possible failure of the company's auditor. Clearly, this is a delicate matter, since Anderson is doing its best—at one time, with the apparent encouragement of the SEC—to settle the litigation against it. But what happens if the cases aren't settled, while audit clients continue to leave the firm?[12] It is certainly conceivable then that at some point the "Big Five" accounting firms reduce to the "Big Four", either through the migration of Anderson clients and/or partners to other firms or the outright failure of Anderson itself. Should policy makers be concerned about this possibility?

My short answer is "yes" because an industry that is already highly concentrated––the accounting profession—would become more so. The thousands of publicly held companies, not only here but worldwide, would have even less choice than they do now in auditors. With less competition, the result could well be higher prices and lower quality of auditing services. [13]

Since all this could happen without a merger, there is effectively no role for antitrust to play to ensure no diminution in competition (Although Andersen now is reportedly in merger talks with one or more of the Big Five, any deal could easily be held up because of Andersen's liability exposure.) The only other way that competition would not diminish if Anderson failed or dwindled in size is if new entrants were attracted to the auditing business, existing second-tier accounting firms captured more audit clients, or the Big Five (or Four, as the case may be) split up voluntarily (there being no way to force their split up absent any proof of an antitrust violation).

I don't know what public policy measures are or even should be available to encourage the split up of existing firms. Nor do I know what public policy, and perhaps specifically the SEC, could do to facilitate the entry of brand new firms to compete head to head with the Big Five or the Big Four, or to somehow promote more use of the second-tier accounting firms right below the Big Five. At the very least, policy makers

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[12] See, e.g., Kirstin Downey Grimsley, "Freddie Mac Drops Andersen; Delta May Follow Suit," *The Washington Post*, March 7, 2002 [noting that Andersen has so far lost three of its six largest audit clients].

[13] The Big Five not only dominate the U.S. auditing market, but as of 1999, accounted for 77 percent of the revenues of the 40 largest international accounting networks. Furthermore, as of the same year, the Big Five audited 98 of the top 100 companies in the world, measured by market capitalization. See Lawrence J.

should signal their openness to entry and the use of second-tier firms (although the widespread concern about mixing audit with non-audit functions will make it difficult for the Commission to encourage entry by firms in related fields, such as management consulting or financial services).

The only other way in which policy makers might be able to make a real contribution is to remove any legal restrictions (regulatory, tax, or otherwise) that may now impede foreign accounting networks from gaining the requisite licenses and competing here in the United States. Accordingly, at a minimum, I would urge the Committee to make inquiry of the SEC to determine whether there are any such restrictions—formal or informal—that now exist, either or both at the federal and state levels. If such impediments exist, I would then strongly encourage the Commission, and if necessary the Congress, to remove them—without waiting for any international agreement to gain reciprocal treatment from other countries (although that remains a worthy objective).

Beyond Enron

Finally, there are a range of issues relating to disclosure that have little to do with Enron, that may have received more attention had Enron not happened, and that should eventually get that attention once the preoccupation with fixing what apparently went wrong with Enron and other recent accounting affairs diminishes.

Peter Wallison is addressing in greater detail in his testimony one of these issues––the need for more and better *non*-financial information about companies than is now routinely generated. Here I refer to measures of consumer or worker satisfaction, product or service quality, successful innovation, education and experience of the workforce and management, and a variety of other non-financial indicators. Individually or collectively, these non-financial measures may shed far more light for investors on the future ability of firms to generate earnings or cash flow, and thus on the long-run fundamental value of their stock, than the figures in financial statements that are based on historical costs that are inherently backward looking. In the *GAAP Gap* we urge the SEC use its powers of persuasion in this area, perhaps by beginning to convene working groups of experts from

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White, *Reducing the Barriers to International Trade in Accounting Services* [AEI Studies on Services Trade Negotiations, 2002], p. 14.

different industries, to encourage firms to make more of these disclosures, and to do so consistently and repeatedly.

A second cutting edge issue is how best to harness the power of technology—computers and the Internet—to facilitate more complete and more rapid corporate disclosure. One large-scale and potentially revolutionary private sector initiative that already is under way is a collaboration by a growing number of companies, accounting firms and the AICPA to develop a common "tagging" system for various financial accounts, which goes under the acronym "XBRL". Once these tags are fully developed and implemented by companies, a wide range of users—not just sophisticated users like financial analysts—will be able easily to take very detailed data from companies and reconfigure it in multiple ways, using widely available spreadsheet programs.[14] Here, too, I would urge the SEC (and if necessary, urge the Committee to urge the SEC) to encourage this project and do what it can to publicize its importance and encourage companies to participate in the process of developing tags for information that may be industry-specific. The Commission may also want to consider ways in which it could encourage companies to use the tags at the earliest possible date. One possibility: require EDGAR submissions to be in XBRL by a specific date.

A related project is for the SEC to encourage more frequent reporting. Chairman Pitt's proposal (which the Administration has endorsed) to increase the number of "significant events" that must be disclosed as they unfold—in as early as 48 hours after they occur—is a move in the right direction.[15] So is the Administration's proposal to require disclosure within two days when corporate officials sell their company stock.

But policy should not stop there. With the Internet, many companies now or may soon have the ability to make available to the public their financial reports much more frequently than on a quarterly basis—weekly, if not daily. Indeed, financial institutions already typically balance their books every night. Why not then consider ways to have this financial information communicated in the same time frame?

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[14] This is currently not possible because although company annual reports and financial reports filed with the SEC are available online, they are in a format (HTML) that cannot be manipulated by users, but simply read and copied as a text file. The major aim of the XBRL project is to enable users to accomplish these manipulations themselves (by using a related language, XML) and also to locate companies and information through computer-based search engines.

[15] Such additional events include the departure of top executives and the loss or gain of an important customer or contract. Under existing rules, companies must file "8-K" reports on key intra-quarter developments within 5 to 15 days.

There will be objections to encouraging companies to make available unaudited financial information more quickly, but I believe these objections can be met. As it is now, quarterly financial data are unaudited and will remain that way unless the SEC or a new PRB come up with guidelines for more limited audits for more frequently reported data (in which case, liability thresholds would have to be adjusted to reflect any differences between the kinds of audits).[16] In any event, the capital markets would become much more volatile if investors came to believe that all unaudited financial information were useless. Even in the wake of Enron, I believe that the financial data produced by the overwhelming preponderance of public companies still have use, and I further believe that market participants hold that view as well (if not, stock prices would be well below where they are now). Accordingly, if in an age of computers and the Internet companies have the ability to publish their financial statements more frequently than every quarter, why shouldn't public policy encourage that result?

Actually, there is an even more compelling case for more frequent financial disclosures. This Committee has heard complaints from many witnesses previously about the seemingly uncontrollable trend toward earnings management—or the manipulation of quarterly earnings reports to achieve or exceed market expectations. To his credit, former SEC Chairman Arthur Levitt was one of the first to sound the alarm about this practice, which is evidenced by the significant increase in earnings restatements over the past few years. The problem is that in reading through numerous descriptions of the problem, I have yet to see an effective solution for it.

If, however, companies routinely reported their financial results much more frequently than every quarter, it is conceivable that investors and analysts would lose interest in the quarterly figures. Furthermore, it is highly doubtful that analysts would take the trouble to develop earnings forecasts more frequently than on a quarterly basis. Thus, there is a real chance that more frequent reporting could end incentives of managers—and their auditors—to engage in earnings management.

At the same time, I would be the first to agree that *mandating* more frequent reporting at this point is premature. Many firms simply may not be able to comply with such a requirement, even over a period as long as a month. Or the cost of compliance

[16] The Administration's proposal to require CEO certification of quarterly reports in addition to the annual reports may help, depending on the penalties and standard for invoking them. But the quarterly results still will be unaudited.

may be prohibitive. The challenge is to find a way to provide incentives to the firms that *are* able to report more frequently than quarterly to do so. Here, too, the Committee could play a constructive role by asking the SEC to review the options, and at the very least, lead a visible campaign to encourage more rapid reporting more suitable to the Internet age.

Finally, this Committee has commendably begun the process of exploring ways to improve financial literacy among the American public. Enron's failure has highlighted in the most dramatic way possible the need for diversification—especially in pension plans––which is one of the most basic financial lessons all Americans should know, as early as possible in life. In the same vein, I applaud the Administration's proposal to require companies to write their quarterly financial reports in "plain English," which should improve information flow to those investors who invest in stocks directly (rather than through mutual funds). At the same time, however, I would caution that no amount of rule-writing or editing by the SEC relating to these plain English statements is likely to prevent the future Enrons that are intent on deceiving investors. Accomplishing that goal will require the implementation of the kinds of other measures I reviewed earlier in this testimony.