



Speech by SEC Chairman:
Renewing the Covenant With Investors

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A few weeks ago, another "earnings season" came and went. And once again, quarterly profits rang in strong as companies reaped the benefits of today's booming economy. And it's no wonder. Steady growth, low inflation, and record employment have cultivated fertile ground for America's companies. All the while, more Americans than ever before are investing in the stock market.

In times of great prosperity, however, it's easy to forget that investors commit capital because they have a basic confidence in the quality and integrity of America's markets. That faith does more than fuel markets – it makes markets possible. Nothing promotes and preserves this confidence more than a strong, transparent and accountable financial reporting framework.

More than eighteen months ago, I came to NYU to speak about the state of financial reporting. I expressed my concern that corporate America's motivation to meet Wall Street earnings expectations could be overriding common sense business practices. The zeal to project smoother earnings from year to year cast a pall over the quality of the underlying numbers.

In the time since, I've been encouraged by how this issue has taken hold in the minds of business executives, corporate directors, investors, and the financial media alike. Through the concerted work of many in the financial community, we have made progress – enacting new rules for audit committees and refocusing on fundamental concepts in the accounting framework.

Today, I can't have a conversation with a corporate board member without hearing how active and revitalized audit committees have become. Throughout America's boardrooms, the tough questions are being asked and the easy answers rejected. And that's never been more important. Audit committees play an indispensable role in challenging those practices that have the potential to undermine the quality of financial reporting.

Make Your Numbers, or Else

Yet, as I reflect more on my conversations with corporate executives, accountants, analysts and others, as I read stories that continue to illuminate an element of game playing, it's become increasingly clear that the essence of our misgivings about the state of financial reporting rests not in a particular disclosure or sales practice or single accounting technique.

Rather, it's an emerging *culture* rooted more and more in a particular way of thinking; an approach guided by short-term-expectations and, quite frankly, driven by an imperative to exceed them. It seems that what really matters in the marketplace is being obscured by a culture, in some respects, almost overtaken by the very drive and optimism that first gave it life.

In the past, I've referred to this mindset as a "culture of gamesmanship." A mindset that says "if a competitor is testing the limits of appropriate conduct, then so can I." If a rule doesn't expressly prohibit it, then it's fair game. If someone isn't playing the game, well then, they just don't get it.

Too many CFO's are being judged today not by how effectively they manage operations, but by how they manage the Street. Too many analysts are being judged not by how well they analyze a particular company, but by how well they assist in selling the latest deal. And too many auditors are being judged not just by how well they manage an audit, but by how well they cross-market their firm's non-audit services. Amidst this pressure and focus on short-term results, safeguarding the independence of the accounting profession has never been more critical.

Why Independence Matters

Independence is at the core of the profession, the very essence that gives an auditor's work its value. It is the space and the freedom to think, to speak, and to act on the truth. And truth is the lifeblood of investor confidence.

Today, the accounting profession stands at a pivotal moment in its history. During the last several months, you've no doubt noticed stories detailing broad reorganizations of the largest and most prestigious accounting firms. These proposals, designed to monetize some or all of the firms' consulting businesses, have the potential to advance the public interest by returning the core focus to accounting and auditing. But these constructive divestitures of consulting businesses must be accomplished without creating conflicts of interest through long-term financial relationships.

More than five decades ago, one of the profession's own said, "The accounting profession must be like Caesar's wife. To be suspected is almost as bad as to be convicted." There has always been this higher standard for the auditor. It is not enough that the accountant on an engagement act independently. For investors to have confidence in the quality of the audit, the public must *perceive* the accountant as independent.

Independence, at its most basic level, is exercised and honored by those

professionals who must abide by it, and assumed by those who must rely on it. It is a covenant between auditor and investor, and no one else; a covenant that says the auditor works in the interests of shareholders, not on behalf of management; a covenant that says the auditor must steer clear of having financial interests in the companies he or she audits; and a covenant that says the auditor's work stands separate and apart from their clients' business. These are the basic principles that have established the foundation of independence for more than six decades.

Transformation of a Profession

Yet, a tension within the profession between its commercial aspirations and its commitment to the public interest has existed almost from its inception. Over the past forty years, the profession has struggled with how to properly and effectively enshrine the values of independence while maintaining its competitive edge. And, as the forces of consolidation, globalization and product line expansion continued to transform the biggest accounting firms, a debate over the role of the auditor – and the inherent pressures of practicing within a firm offering clients a range of other professional services – became more acute.

In fact, today, auditing no longer dominates the practices of the largest firms. It accounts for just 30 percent of total revenues – down from 70 percent in 1977. Consulting and other management advisory services now represent over half – up from 12 percent in 1977. Since 1993, auditing revenues have been growing by 9 percent per year on average – while consulting and similar services have been growing at a rate of 27 percent each year.

It's no wonder that the Big 5 now position themselves globally as "multidisciplinary professional service organizations" rather than accounting firms. Among the expanded menu of services the major firms provide today are corporate finance, risk management, actuarial work, merger and acquisition analysis, network and database architecture, and asset management in addition to traditional accounting, auditing and tax work.

Serving Two Masters

As the firms expand their product lines, consulting and other services may shorten the distance between the auditor and management. Independence – if not in fact, then certainly in appearance – becomes a more elusive proposition. When an audit firm performs valuations of numbers that appear in its client's financials, the mandate for independence is threatened. When an audit firm performs the internal audit function its client would otherwise do, the ethic of independence is tarnished. When an audit firm also keeps its clients books, the principle of independence is undermined. And when some firms take on tax and other assignments where the size of the fee is based on the answer given, one has to wonder how such a practice is consistent with a culture that has long prided itself on objectivity.

Not surprisingly, product line expansion has been an outgrowth of market forces. And the audit is sometimes priced lower to attract clients willing to pay for higher margin consulting services. But, the audit foothold as a

distribution channel is at the very root of the inherent tension that these interdependent relationships foster. The audit engagement partner, upon whose shoulders much of the credibility of the profession rests, makes decisions each day that affect the underlying quality of the audit. These often unrecognized guardians of our capital markets exercise the judgment that validates the integrity of the financial information.

More than a hundred years ago, it was said, "A public accountant acknowledges no master but the public." But, when auditors engage in extensive services for an audit client truly unrelated to the audit, they must now also serve another master – management. In this dual role, the auditor, who guards the integrity of the numbers, now both oversees and answers to management.

Assuming the role of "relationship" manager, the auditor helps develop and coordinate extensive cross-selling and marketing strategies with, for example, his firm's information technology consulting group. And while it may never be quite so explicit, some auditors know, and others suspect, that their compensation is influenced by how well they "manage" that relationship in its entirety. As the firms' business objectives drive them into broader alliances, it's becoming more difficult to ascertain where one relationship ends and another begins. Some may argue that this is not an enlightened or realistic view of the marketplace. Increasingly complex audits require that firms branch out and develop greater and more diverse expertise. The profession, some say, must rely on its consulting business to attract and retain the best and brightest talent; that no direct link between consulting services and audit failures has ever been proven; and, more fundamentally, that a firm's motivation to protect its reputational capital serves as a sufficient inducement to act in the public interest.

Now, I recognize that new financial instruments, new technologies and even new markets demand more specialized know-how to effectively audit many of today's companies. If a firm is auditing a major computer company or a global financial services firm, it needs to have the necessary technological or financial skills. And, as technology becomes increasingly important to business and to the future of the profession, firms need to be able to develop and maintain these essential skills. When this broader skill set is being used to further the audit, that's good business and good for investors. But if those skills are used purely to build databases, structure employment payment plans, or devise financial strategies, I'm concerned that the audit function is simply being used as a springboard to more lucrative consulting services – instead of augmenting the firm's core focus.

Some argue that offering consulting services to audit clients facilitates the recruitment of talented professionals. But if these same services can be offered to other clients, isn't this more an argument for the synergies of a business model based on cross-selling services? In any event, a more competitive recruiting environment is not sufficient justification to awaken the specter of compromise or to jeopardize the integrity of audits.

One can't help but think that a renewed focus on *auditing* will generate greater recruitment and retention success. With the training and knowledge of world class business practices, and competitive financial rewards, I have no doubt that auditing will continue to be an exceptional "proving ground" for America's young professionals. What's more, the

need to reinvest in the audit is more important than ever in order to meet the demands of greater information and more complex businesses.

And finally, some say that appearance simply doesn't matter; that auditors should be free to perform almost any service unless it can be proven that a business or financial relationship directly undermines the audit. But that view misses one of the most important aspects of an auditor's responsibilities. It is not the bright line of right and wrong that the lack of auditor independence often implicates as much as it is that grey area where the answers aren't so clear; where the temptation to "see it the way your client does" is subtle, yet real.

Independence is, in many respects, a condition of the mind of the auditor, its reflection the trust and confidence of the public. To suggest that we should wait to experience erosion before we act to preserve this confidence is to ignore the wisdom of Benjamin Franklin, "'Glass, china, and reputation are easily cracked, and never mended well."

Working Towards a Solution

This nation's public accounting firms have been granted a unique and privileged franchise – a franchise that tells investors, "I stand with you." Questioning the dedication to that franchise is not the point. Preserving it is.

New and diverse revenue streams have created a mix of business relationships so unprecedented in breadth and scope, it's long past time to address meaningfully the effect all of this is having on a culture that has long prided itself on objectivity.

The Chairman of one major firm recently said that the pending sale of his firm's consulting practice is "the right thing to do." And the firm's clients have responded positively to its reaffirmation of the audit. This recognition of the importance of the audit and independence concerns – and taking action to alleviate these concerns – represents business statesmanship. This is a significant benchmark towards a workable solution.

Several others are considering similar responses to this growing issue and the Commission will endeavor to be constructive in expediting such actions. Others have raised "firewalls" as a way to minimize potential conflicts despite a sharing of profits and other links. I'm not so sure this provides sufficient protection.

In the coming months, the Commission will consider how to address the long-term ramifications of today's restructurings on both auditor independence and investor confidence. In my view, any regulatory action must address a few fundamental public policy questions: Should there be more appropriate limits on the types of services that an audit firm can render to a public company client? How should audit firms be structured to assure independence? What are the consequences, if any, of public ownership? Should firms be permitted to affiliate with entities who provide services to the firms' audit clients that the firms themselves would not be allowed to provide?

There are at least three possible ways to address these potential conflicts. Many in the profession once sought to establish broad "principles" of independence. Alternatively, greater public disclosure of the types and amounts of services offered could be required. Or, certain services considered inconsistent with an independent public audit could be prohibited. Each of these alternatives, as one might expect, has both advantages and drawbacks.

While principles may sound "high-minded," the lack of precision may not address the level of uncertainty as to which services are permissible and which ones are not. A public disclosure-based model, already used in the UK, could be worthwhile for certain types of perceived conflicts if such disclosure doesn't devolve into meaningless boilerplate.

Perhaps a more reliable way to safeguard independence would be to clearly define those consulting services that compromise the integrity of the audit without adding meaningful benefits to that audit. Like any rules, however, such an approach entails a degree of definitional precision.

While a "perfect" solution may not exist, that's no reason to sit back and do nothing. A careful balance of "bright line" rules establishing clear limits, coupled with greater disclosure, seems both warranted and prudent. But, even before the SEC considers ways to safeguard independence, I appeal to corporate America's audit committees to pay close attention to the types of services their auditors are performing and to question whether it would be more in their investors' interests to have some of those services performed by someone else.

The Golden Rule of Auditing

In recent months, one aspect of auditor independence called into question involves the golden rule of auditing: auditors cannot invest in their clients. Many of you, I'm sure, are aware of the widespread violations of the financial interest rules by one of the largest and most respected firms.

There is no doubt that certain violations were the result of a large merger, rapid expansion, and a system of less than modern rules of the profession and the SEC. The most significant public policy issue was never the egregiousness of any particular violation, but rather, the inadequacy of internal controls. In the aftermath of that difficult period, I've been encouraged by the response. That firm is working constructively with the SEC and undertaking significant modernizing efforts by investing in better systems and training.

To eliminate the lingering doubt on the profession from this episode, and in response to evidence of similar problems at other firms, the Commission's staff requested that the Public Oversight Board, an entity charged with oversight of the profession, undertake a special review of larger member firms' current compliance with SEC and profession independence rules. I'm pleased that these firms appear to be moving ahead with substantial commitments of money and resources towards implementing more effective systems.

Another part of this process, however, requires a careful scrutiny of the

past in order to improve upon the future. I know that some in the profession would prefer to say, "Let's put this episode behind us." But the profession's public responsibilities dictate that it remain a beacon of the public trust. We simply cannot overlook this fundamental tenet of independence and objectivity.

Nothing less than a serious assessment of the scope of yesterday's control deficiencies is needed to provide a basis for improvement. Some firms are close to an agreement on a method of reinforcing public confidence. I am hopeful that the others, with the support of audit committees and corporate America, will see the value in performing a constructive self-evaluation, in conjunction with the POB, both to learn from the past and to affirm their covenant with the public interest.

I'm sensitive to the demographic and business changes that have occurred over the last two decades, as well as their implications for overly strict rules on financial investments. I couldn't agree more with those who maintain that certain rules extending to retirement plans and relatives don't make sense today. We also need to reform those rules that unfairly impose burdens on dual-career families without a commensurate benefit to the investing public. The Independence Standards Board, which Bill Allen, our host today, chairs, recently has taken a significant and positive step towards reform. We at the SEC are committed to doing our part. But amidst this change, firms must remain committed to ensuring that their internal controls, like those of the clients they audit, identify and prevent the very failings they were designed to guard against.

Once again, I appeal to audit committee members to sit down with their auditors and inquire about past compliance and current safeguards to prevent such conflicts in the future.

A Case for Stronger, Independent Oversight of the Profession

More than three decades ago, Leonard Spacek, a visionary accounting industry leader, stated that, "You and I cannot survive as a group, obtaining the confidence of the public in our work, unless as a profession we have a workable plan of self-regulation."

Fourteen years after Leonard Spacek's comment, the profession implemented what it viewed as one of the most ambitious self-regulatory programs ever adopted. While this was a significant step forward, the Commission, and many in Congress, still had their doubts. "The jury is out," then SEC Chairman Harold Williams stated in 1978 upon the creation of the POB, "on whether [this] program of self-regulation will be successful."

In the midst of ever more complicated audit engagements and interwoven business relationships, it's become abundantly clear that a more modern and effective approach to self-regulation in the accounting profession today is an absolute necessity. Indeed, more effective oversight must be brought to bear on the profession's trade group, the AICPA, which seems unable to discipline its own members for violations of its own standards of professional conduct.

In my time at the Commission, I have come to appreciate the important role played by an independent oversight program. But, I am also aware of its limitations. In the last few months, however, a real opportunity emerged to give the POB the independence and the freedom to fully discharge its public responsibilities, unfettered by special interests.

The POB, under the leadership of Charles Bowsher, former Comptroller General of the United States, and with the support of its other distinguished members, has put forth a plan to modernize the profession's oversight and reinforce its commitment to the public interest. But this is only possible if the industry's leaders recognize and accept the importance of a truly independent oversight body.

By nature, I'm an optimist. And in helping to champion this plan for reform, I am encouraged. But it could be undermined by those who either fail to grasp the benefits of public confidence that arise from meaningful oversight, or who view reform with a sense of foreboding.

It is hard for me to fathom continuing industry resistance to the POB's plan. Can you really have meaningful oversight without giving the POB input into the profession's regulatory boards and its rulemaking and guidance mechanisms? Can you really deny the public's right to greater access through annual reports, special reports, and minutes of meetings? Can you really deny the POB the right to have "no strings" funding and the authority to conduct appropriate special reviews of firms' practices?

That last issue, long considered a given, has been called into question by recent events. The profession's AICPA has provided funding to the POB since its inception. This has never been a problem and the profession has a history of approving "no strings" funding.

Last week, I was saddened to learn that the AICPA's SECPS Planning Committee informed the POB that it was "cutting off" its funding for the special independence compliance reviews referred to earlier in my remarks. This development is a significant setback to self-regulation and independent oversight. Indeed, it raises serious questions as to the profession's commitment to self regulation.

As Mel Laird, the longest serving member of the POB and former Secretary of Defense, said when he heard of this action, "This is the worst incident in my 17 years on the POB's Board and we can't and won't permit this interference with our independence." Charles Bowsher said he was "shocked and dismayed" and that such a funding cut-off would not be tolerated. "This type of conduct," he said, "cuts out the heart of independent oversight."

I ask each of the major firms to follow the lead of Ernst & Young and PricewaterhouseCoopers and repudiate the termination of funding for the POB's review.

Action Plan

Our system of financial reporting remains second to none in creating

transparency, in limiting cost of capital, and in enhancing accountability. We must guard that preeminence with an ever present vigilance. Today, I am calling on key participants in the financial reporting process – companies, their audit committees, and the accounting profession – to join with the Commission in addressing issues that so clearly threaten to erode a fundamental underpinning of confidence in America's capital markets.

A Challenge for the Accounting Profession and Its Regulators

Learn From the Past. I challenge all the leaders of the major accounting firms to work with the Commission to develop a plan for constructively assessing the firms' past compliance with financial investment rules. Based on recent discussions, I am hopeful that we can soon reach agreement with several of the major firms. In addition, we ask that the profession continue to modernize its system of controls both domestically and on a worldwide basis, and for the POB to oversee and report on this progress. For our part, we pledge to use this information to help improve compliance systems in the future and not to punish minor, past mistakes.

Updating the Independence Framework. In addition, as the Commission's Chief Accountant stated in January, we commit to work with the profession and the Independence Standards Board to undertake in short order a long overdue modernization of certain financial investment rules. To do that, I commit that modernization will be as important a priority as the other initiatives we are discussing this morning, and I'm asking the staff to submit a rulemaking proposal to the Commission on this issue by summer.

Creating Stronger, More Effective Oversight. I also strongly endorse the notion of enhanced POB oversight of the accounting profession, and urge the profession to endorse it as well. Public confidence is not to be taken lightly. And effective, independent oversight is a signal avenue to foster and preserve that confidence. A revised charter setting forth what the present POB thinks it needs to get the job done is before the profession. The time for action is now.

And, since independence is so important to the integrity of this profession, I also believe the time has come to obtain majority public representation on the ISB.

Rebuilding the Accounting Profession's Business Model Around Independence. Lastly, I am asking the SEC staff to prepare a rulemaking initiative on how best to deal with the conflicts created by the profession's ever-expanding menu of services offered to public company audit clients. The rulemaking initiative should also look at firm affiliations and strategic alliances. I anticipate that any resulting rule proposal will be supplemented by public hearings to garner the broadest possible input.

Conclusion

It wasn't too long ago when the refrain, "Where were the accountants?" echoed loudly through the halls of corporations, the floors of the markets and the living rooms of many American families. We sometimes take for granted the freedom and power of independent thought and action. And

only after it's been compromised, do we fully realize how fundamental it is to the pursuit of economic opportunity.

Independence is a basic American ideal. It is a basic value and a basic requirement for fair and efficient markets to exist. I have talked about conflicts of interest. I have talked about compliance controls. I have talked about oversight powers. I have talked about cross-selling and the audit function. We can use labels, rationales, or justifications to argue why an auditor's independence is so important.

But in the final analysis, it's the pensioner who reads her monthly statement walking back from the mail box; it's the young college student who buys his first stock; it's the young couple who start a college fund for their new daughter; it's the manager of a firefighter or teacher retirement fund; it is every person who is the fabric of our markets who doesn't have to think twice about the quality of the numbers. The profession's independence gives American investors *their* independence by instilling a systemic confidence throughout our marketplace.

Confidence is not a measurable commodity that can be either mandated or purchased. Rather, it is a quality, an amalgam of beliefs, convictions, sensibilities that ultimately are the result of experience. Once lost, this fragile but strong characteristic is almost impossible to rehabilitate.

America's accountants have been both the beneficiaries and the source of investors' acceptance of the sanctity of reported numbers. This profession, dating back to the 15th century, has a tradition of fidelity to the public interest. We will safeguard this heritage by determining that the independent audit is not a means to anything else, but rather, a critically important end in itself. We will build on our past by being certain that independent oversight is so fundamentally a part of the industry's culture that it removes any uncertainty or doubt. We will give resonance to our markets when a critical self awareness of the past provides guidance for the future. This is our collective mandate, and I ask the leaders of the accounting profession to join in ensuring the profession's future is worthy of its past.

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