

THE FEDERALIST SOCIETY

and its

CORPORATIONS PRACTICE GROUP

present

**The 6th Annual Corporate Governance
Conference**

**Panel -- Auditing and Accounting in the Wake
of Global Crossing and Enron**

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The Cornell Club
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THE FEDERALIST SOCIETY

Auditing and Accounting in the Wake of Global Crossing and Enron

PANELISTS:

Mr. Andrew Cochran, Counsel, U.S. House of Representatives Committee on
Financial Services

Mr. Scott Univer, General Counsel, BDO Seidman

Mr. Roy Van Brunt, D.C. Director, Ten Eyck Associates

Hon. Edwin D. Williamson., Sullivan and Cromwell, and former Legal Advisor U.S.
Department of State

Mr. J.P. Donlon, Principal Dilenschneider Group, *Moderator*

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2 MR. DONLON: Good afternoon. My name is
3 J.P. Donlon. I'll be the moderator for this
4 afternoon's panel. I'm a Principal with the
5 Dilenschneider Group. We're a strategic
6 communications firm. But before this, I was Editor in
7 Chief of *Chief Executive* magazine. It's somewhat
8 intimidating being the only non-lawyer in this room,
9 but then I did try to moderate groups of chief
10 executives, so I've had some practice with trying to
11 tame the lions.

12 We're going to self-introduce our
13 distinguished panel. They will speak for six to eight
14 minutes, presenting some ideas and information that
15 will be helpful to us. I think it is very clear from
16 your discussions thus far that investors in the
17 general public have not only lost patience with
18 Corporate America's greed but also its inability to
19 cope with what is going on.

20 You may have seen this quotation from
21 Stanley O'Neil, the co-head of Merrill Lynch, in the
22 current issue of the *Economist*, with the headline,

1 | "The Wickedness of Wall Street". O'Neil said that
2 | "There is a certain air of cynicism surrounding every
3 | institution that underpins our capital markets." I
4 | think he was thinking, among others, of those in the
5 | auditing and accounting profession.

6 | But more to point, this cynicism has gone
7 | beyond reasonable questioning and could easily turn
8 | destructive. What should be done to divert this
9 | potentially destructive force? I think beyond the
10 | establishment of a degree of trust and confidence is a
11 | need to somehow deal with these destructive forces. I
12 | think it will be the core of our discussion.

13 | I would like to turn to our first panel
14 | speaker, Roy Van Brunt, who will introduce himself,
15 | talk, and then I'm going to ask each panelist to move
16 | in succession so we get all of our ideas out on the
17 | table. Then, we'll entertain your questions.

18 | MR. VAN BRUNT: When I came in this morning,
19 | Andrew Cochran stopped me and asked me how long I had
20 | worked at the SEC. I told him it was a two-part
21 | answer; the first part was "too long" and the second
22 | part was "16 years".

1 I was a member of the SEC accounting staff
2 in corporation finance, and in the Office of the Chief
3 Accountant for 16 years. I left in 1996 to join Ernie
4 Ten Eyck's practice of accounting, consulting and
5 litigation support, which is where I've been for the
6 last six years.

7 I'll limit my introduction to those
8 comments. Some of your firms may have experience with
9 Tenike, and some may not. We do expert witness and
10 investigative forensic type accounting and consulting.
11 With that in mind, my comments this afternoon are
12 going to be offered in the context of putting
13 historical perspective on what is likely to happen to
14 accounting regulation in the post-Enron era.

15 I think most people would consider, now,
16 that something is going to transpire with respect to
17 regulation of the accounting profession, whether
18 modifications of its current state of self-regulation
19 or government intervention. To do that, I'd like you
20 to keep some historical perspective in mind.

21 The gentleman this morning who examined the
22 legislative histories of the '33 and '34 Acts

1 | synopsised my opening comments a little bit, but I'll
2 | add to what he said as a reminder. The '33 and '34
3 | Acts were put together to solve the greatest economic
4 | calamity that the country had experienced until that
5 | time in 1930.

6 | The follow-up to what he said is that the
7 | '33 and '34 Acts also gave birth or legitimacy to what
8 | heretofore had been just a small industry of auditing.
9 | That is, when the Congress established those two Acts,
10 | unanimously as they did, they were burdened with the
11 | problem of defining who would ensure that the
12 | information that they were requiring to be filed would
13 | be meaningful, accurate and representationally
14 | faithful.

15 | There was some consideration that the
16 | government would do the auditing itself, and the
17 | people from what would become the American Institute
18 | of CPAs actually appeared before Congress and proposed
19 | the idea that they could do a better job than the
20 | government. That probably wasn't very hard to sell.

21 | But there was some skepticism. One of the
22 | Congressmen asked at that time, "well, who will audit

1 | you, if you're going to audit these companies?" The
2 | immediate response that was given, sold and accepted,
3 | was the term "our conscience". That is how the
4 | accounting profession got its legitimacy, and why it
5 | has enjoyed its inherent popularity for the past 68
6 | years.

7 | I would remind you that the SEC is 68 years
8 | old. As with most persons who reach that advanced
9 | age, our memories are of a younger person in the vigor
10 | of health, the bastion of all protectivism and the
11 | best thing going. But I would suggest that you think
12 | of it as someone who is 68 years old and a little
13 | stooped, with a few warts here and there and things
14 | that don't work as well as they used to. You will
15 | find that to be a better description of the SEC as it
16 | exists today.

17 | For about 40 years after the Act was passed,
18 | the accounting profession seemed to enjoy immense
19 | credibility and the faith of the public without much
20 | question. About the mid '70s, that fabulous post-
21 | Vietnam flower-power, truth and justice era, the
22 | business community underwent significant calamities in

1 | the financial statement area. There were remarkable
2 | audit failures and massive questions about how the
3 | auditors could have missed these types of things. Is
4 | auditing working or not?

5 | Stop me if this begins to sound very
6 | familiar. Many questions were posed as to whether
7 | this cottage industry of auditing was capable of
8 | regulating itself, or whether it needed to do
9 | something different. At that point in history, the
10 | American Institute of CPAs proposed a series of
11 | changes to its self-regulation that seemed to satisfy
12 | most critics and vacate the need for a move towards
13 | federal regulation of accountants. Accountants,
14 | remember, are state license holders. Federal
15 | regulation of state licensing is, in the first place,
16 | tricky to think about and, in the second place, hard
17 | to execute.

18 | The AICPA, in 1977, posed serious changes in
19 | its own internal structure:

20 | It created an SEC practice section to which
21 | the large firms who audit public companies would have
22 | to belong;

1 It established a program of peer review,
2 where the firms would review other firms every three
3 years, at their internal controls, and make sure that
4 things were working the way they were supposed to;

5 It created a quality control inquiry
6 committee, where any civil litigation that was filed
7 would automatically trigger an examination of the
8 audit failure in an effort to make improvements and
9 avoid similar failure.

10 The public oversight was formed: a quasi-
11 independent agency that nobody seemed to pay attention
12 to. It was funded basically by the AICPA, and was
13 composed of five very respected, very well meaning
14 people, all of whom did their jobs in terms of
15 regulating the accounting profession on a part-time
16 basis -- it had no full-time employees.

17 Since then, from 1977 until now, the
18 profession has had a 25-year holiday to try to prove
19 that it is able to regulate itself. And I think the
20 point where we find ourselves today, post-Enron, is a
21 scorecard or a review book on whether or not the
22 accounting profession has been able to do that, and

1 | whether or not it can do it or has the will to do it.
2 | And if it hasn't, what should be changed in order to
3 | bring about regulation?

4 | The problems that we've encountered are
5 | problems that relate to auditors' independence. I
6 | found it somewhat amusing that the primary standard by
7 | which an accountant or director is judged to be
8 | independent or having no financial interest in his
9 | client whatsoever is that they should have no interest
10 | in their client other than an equity interest.

11 | Perhaps with respect to judging
12 | independence, someone who holds an equity interest
13 | might not really be considered truly independent of
14 | what he is supposed to be looking at. The problems
15 | with auditors' independence have centered largely on
16 | the growth of consulting and other services that are
17 | provided in audit practices to the extent that they
18 | actually seed the revenue base of the auditing that is
19 | done for a given client. And this raises questions
20 | with respect to whether or not the auditor will be
21 | willing to take difficult positions, hard stands, and
22 | tell his client he won't give a clean opinion on a set

1 | of financial statements if doing so puts him at risk
2 | of losing that client.

3 | If the client will go someplace else, and
4 | take his consulting and auditing budgets to another
5 | firm, the accounting firm has a harder time finding
6 | feet of concrete instead of feet of clay. I don't
7 | think that situation is going to be changed by any of
8 | the proposals that are currently circulating their way
9 | through Congress, or by most of the proposals that are
10 | currently circulating through Harvey's commission. I
11 | recognize that the SEC needs to be proposing things
12 | and looking like they're trying to get a handle on
13 | this.

14 | I'll close my comments with what I think is
15 | a far simpler method that could be enacted in the
16 | space of two or three days and would solve a lot of
17 | invested emotion on this subject. The simplest system
18 | would be one that says a company can choose its own
19 | auditor. That is not different than it is today. The
20 | fee for that audit, however, would not be set by the
21 | accounting firm or the company; a reasonable fee for
22 | doing an audit of this company would be set by the

1 SEC. They will tell the auditor and the company what
2 the fee is.

3 If there was a dispute between the company
4 and the auditor over the adequacy of that fee, given
5 what had to be done and the cost of the audit, that
6 dispute would be arbitrated and settled by the
7 Enforcement Division of the SEC.

8 The important point is the next one. And
9 that is, unlike the current environment where a
10 company can change order at its own whim and simply
11 notify the SEC that it has changed accountants, I
12 would say that a company can't change accountants. A
13 company would not be permitted to change auditing
14 firms without the previously getting the permission of
15 the SEC. That is, they can change if they want to; if
16 they have a reason to. They go to the SEC and explain
17 why they want a change, and the Commission decides
18 whether to allow it.

19 However, the SEC can change auditors for a
20 company, if in the course of their review of
21 registration statements and exchange of comment
22 process with the company, their view is that the

1 | accountant has moved to a position lacking sufficient
2 | independence. I can't tell you how many times as a
3 | staff member, an accountant would come in with his
4 | client to explain in a difficult and technical
5 | accounting matter and speak for the entire meeting in
6 | the first-person plural -- "we". The accountant can't
7 | be "we". The accountant is an "it" that is separate
8 | from the company, if he is independent. If the staff
9 | perceived a lack of independence, the Commission could
10 | just unilaterally change the accountant.

11 | And the last point would be that no non-
12 | audit services could be provided by the accounting
13 | firm without the pre-approval of the audit committee.

14 | MR. COCHRAN: I'm Andy Cochran. I'm the
15 | Senior Counsel for Oversight and Investigations for
16 | the House Financial Services Committee. I've
17 | practiced accounting -- I was a CPA in Ohio; a Reagan
18 | Official; I've spent some time practicing corporate
19 | law in the Washington area; and I joined the Committee
20 | in March 2001.

21 | In November, as we were working on the
22 | after-effects of September 11 and the news broke about

1 Enron, Chairman Oxley asked me to review what was
2 going on because, blessing or curse, I was the former
3 CPA amongst the senior counsels. I was asked to take
4 a look at the accounting guidance on special purpose
5 entities and try to explain it to members and staff.
6 That's kind of like being the pathologist at the first
7 autopsy in med school. You cut open the body and you
8 say, "Oh boy, here's what I found," and see who runs
9 to the door first. I helped to draft Sections 2 and 6
10 of the Carter Bill: the sections on the Auditor
11 Oversight Board and on the improved disclosures of off
12 balance sheet items.

13 We're proud of what we've done so far -- I
14 am speaking personally, and not necessarily expressing
15 the views of the members and staff and Chairman. But
16 we were the first to really have an Enron hearing; the
17 first to have a hearing on Global Crossing; the first
18 to introduce into the *Congressional Record* the actual
19 accounting guidance on special purpose entities and
20 indefeasible rights of use. We were the first to talk
21 about the S&P's concept of core earnings, and to
22 contrast its treatment of stock options with GAAP and

1 | compare it with the International Accounting Standards
2 | now being discussed, and to talk about the
3 | convergence.

4 | We still think -- and I think many people do
5 | -- we still have the best capital markets in the
6 | world; overall, the best corporate governance in the
7 | world. But we've seen some cracks in confidence.
8 | It's interesting to note that the reactions to the
9 | market crash of 1929 took five years to build. I
10 | think the reactions to the Enron and Global Crossing
11 | accounting scandals are going to take about one year
12 | to really get through it. I think that at the end of
13 | this year, the regime for accounting, for corporate
14 | governance, and for financial disclosure, will be very
15 | much different than the regime we saw at the end of
16 | the last calendar year.

17 | The SEC is very close to releasing proposals
18 | on a public accounting board similar to the oversight
19 | board we have in Carter. Chairman Pitt is going to
20 | say something about that very soon. We've just seen
21 | the SEC put out guidance on what to put in the MBNA: a
22 | lot more items, a lot quicker. We've seen more talk

1 | about the NYSE rules. So much has happened in just
2 | the last four days.

3 | But we are very pleased that though the
4 | multi-tiered system of oversight created in the '33
5 | and '34 Acts did not react well in the '90s, it is now
6 | working to correct these problems and build for the
7 | future. We passed Carda in April, and we're looking
8 | forward to seeing something come from the Senate that
9 | we can reconcile.

10 | There are elements of the Sarbanes Bill that
11 | would specify certain auditing standards: a fee for
12 | the oversight board to be paid by the issuers, even
13 | the numerator and denominator; what foreign accounting
14 | firms would have to do, which will be an interesting
15 | congressional jurisdictional matter. I really think
16 | this goes way too far.

17 | There will be some mainstream conservative
18 | groups who speak often about excessive big government
19 | coming from the Democrats that are very concerned and
20 | will probably opine on this bill in the next few days,
21 | if they haven't today. I think that's going to
22 | surprise some people because they're going to get into

1 | this debate and possibly even threaten to put a vote
2 | on this bill into the rating for senators who vote for
3 | the Sarbanes draft.

4 | One of the sorriest legacies I think we take
5 | from this debacle has been the fact that the SEC
6 | really failed in its oversight responsibilities during
7 | the Clinton-Levitt years. The SEC under its own rules
8 | was supposed to review Enron several times after 2000.
9 | The SEC didn't fight for funding and didn't fight for
10 | more disclosure. It chased what I think is more of a
11 | smokescreen to auditor independence, instead of going
12 | after the meat and potatoes of real disclosure.

13 | Roy's proposal, though interesting, seems
14 | somewhat close to the Sarbanes bill in that it is
15 | anti-competitive in many of its aspects. Whoever sets
16 | the fees, controls the money and makes the decisions
17 | really runs the industry. All the proposals I've seen
18 | not only cut non-audit services, but would end up
19 | federalizing auditing and consulting, however you want
20 | to define it. And that will be thrown into the
21 | courts. What we do in Carter is specify two areas of
22 | consulting using rather specific terminology, which

1 | the market is accepting. That will be barred, and
2 | we're pleased with that.

3 | Now, I want to make the point that law is no
4 | substitute for good character. The short-term
5 | mentality that helped produce the '90s bubble is now
6 | turning around and demanding a quarterly response, a
7 | complete response in one-quarter, to the problem.

8 | We should take the longer term view of a
9 | year and see where we're going to be if the SEC has
10 | demanded certain things; MDNA, as it should, has
11 | demanded more disclosure of the balance sheet
12 | information; if what Harvey calls the public
13 | accountability board is well on its way to being in
14 | place.

15 | I met twice in the last week with Ed Jenkins
16 | and Bob Hertz, the current and future chairman of
17 | FASB. All of a sudden, FASB is turning around a
18 | project on revenue recognition. They hadn't done
19 | anything official in 27 years. In early 2001, FASB
20 | gave up trying to do something on special purpose
21 | entities. They announced it. And this is another
22 | case where the Levitt SEC didn't do anything. FASB

1 | basically released two little letters 11 years ago on
2 | special purpose entities, creating this now infamous
3 | three-percent rule. And now, after the Enron debacle,
4 | all of a sudden FASB is getting re-energized.

5 | We want to see a more stable source of
6 | funding, for FASB that is not driven by politics. If
7 | it is tied to the SEC and the congressional bill, it
8 | is going to be tied to politics, and we don't think
9 | that is going to help. Again, that is driving the
10 | process towards excessive regulation of the market.
11 | So, FASB is going to have a proposal on special
12 | purpose entities by the end of this month. They are
13 | going to have something final by the end of the year.
14 | Those are announcements from their website.

15 | I want to see the glass as more than half-
16 | full and filling up. By the end of this calendar
17 | year, we will have a much different regime for
18 | financial disclosure and accounting oversight than we
19 | did a year ago, all without the excessive heavy hand
20 | of legislation that can do more harm than good.

21 | MR. UNIVER: Thank you, J.B. My name is
22 | Scott Univer. As a general counsel of an accounting

1 | firm, I have been asked to speak at a number of
2 | programs recently, and I have to tell you, in my
3 | position I generally feel like the token Christian at
4 | the lion convention. But it is my hope that this
5 | audience will be kinder and gentler, with due
6 | acknowledgement to Chairman Pitt.

7 | What I would like to talk about is the Enron
8 | success story -- all right, now you can call for the
9 | guys with the white nets and the jackets that tie in
10 | the back.

11 | (Laughter.)

12 | MR. UNIVER: Enron has been trumpeted in
13 | many places, not least here, as being an example of
14 | the failure of capitalism, of the failure of
15 | government deregulation; not least the failure of the
16 | accounting profession, which I represent -- at least
17 | one firm of which I represent. However, I would like
18 | to make the timid and modest point that we really
19 | ought to put this in perspective. We can
20 | realistically look at Enron as a success story because
21 | the company collapsed and the market did eventually
22 | catch up to the clear fraud that was going on. The

1 | numbers ultimately could not be evaded, although they
2 | could be evaded for a while.

3 | By the way, let me get serious here for a
4 | second. I do not mean in any way to minimize the fact
5 | that there was fraud, illegality, and a great deal of
6 | injury and damage done to the many people who have
7 | lost their jobs, their savings and their investments.
8 | In the case of Arthur Anderson, it is a very fine firm
9 | that has apparently been driven into extinction. I
10 | think quite unjustly. All of this is the cost of what
11 | has gone on at Enron. I don't mean to minimize that
12 | at all.

13 | But I would submit to you, respectfully,
14 | that the damage and the great injury that have
15 | occurred were caused by delay in discovering the fraud
16 | and delay in the market catching up to the fraud; not
17 | ultimately by the fraud itself. In any system, good
18 | laws, no matter how well shaped, cannot substitute for
19 | good character. Ultimately, there is always going to
20 | be fraud. There is always going to be dishonesty.
21 | The question is, can we fashion a system that will
22 | detect fraud and, to the extent it can be done,

1 | prevent fraud in less time or in real time? That is
2 | the way of evading or avoiding the kind of injury that
3 | happened here.

4 | After all, with respect to Enron, the stock
5 | in the company declined over 80 percent during 2001,
6 | when the bulk of the misstatements took place. I
7 | think they took place mostly during three quarters of
8 | 2001. During that time, the stock went from \$80 to
9 | \$10. Clearly, the market was picking up signals some
10 | place, even if the SEC and other regulatory agencies
11 | weren't. The market was figuring out that something
12 | was going wrong -- not as it should have been; not
13 | disarmed and hampered by the lack of disclosures, by
14 | the fraud and concealment. But the market was
15 | figuring out that something was going wrong.

16 | The lockdown of employee sales of their
17 | stock in qualified plans, which has also been
18 | trumpeted as a tremendous failure of the regulatory
19 | system, has also been exaggerated. When looked at in
20 | perspective, one must take into account the fact that
21 | there really were only 11 days when employees could
22 | not sell their stock in the company. The lockdown was

1 | caused by a changeover in the qualified plans, which
2 | had been announced well beforehand so that employees
3 | who wanted to sell before that time could have. So
4 | that was not a symptom of the failure of the
5 | regulatory system.

6 | Finally, the collapse of Enron itself was
7 | caused by the demise of the stock price. The special
8 | purpose entities were set up with guarantees for
9 | outside investors, or so-called outside investors,
10 | some of whom weren't so outside, and guaranteed them
11 | against loss. If the stock price was to fall below
12 | certain triggers set in the \$45- and \$50-per-share
13 | range (this at a time when the stock was trading at
14 | \$90 or above and nobody foresaw a problem), Enron was
15 | obligated to issue more stock to put into the special
16 | purpose entities to safeguard the outside investors
17 | from loss.

18 | Enron stock fell partly because of lack of
19 | confidence in the market in general, because of
20 | problems in the telecommunications industry, the
21 | bursting of the dot-com bubble and other environmental
22 | factors. But, it also fell because of specific lack

1 | of confidence in Enron. As the stock price fell,
2 | these triggers were hit and the company was obligated
3 | to issue new stock into these entities, further
4 | driving down the price and bringing down the house of
5 | cards.

6 | So ultimately, there is an argument that can
7 | be made that the market did catch up to these people,
8 | and the fraud could not have been sustained
9 | indefinitely. Should it have been sustained as long
10 | as it was? No. Obviously not. The question before
11 | us today is, can we devise a system where that period
12 | of delay is minimized? That brings us to how can we
13 | fix the problems that we know about. That requires
14 | that we know what is broken before we fix it.

15 | I'm afraid that government efforts to fix
16 | problems in the economy, in the market, often suffer
17 | from the rule of unintended consequences. They cause
18 | more problems than they fix. We have to keep in mind
19 | that the S&L crisis was actually the result of the
20 | government's effort to prop up the S&L industry, which
21 | had become the victim of hyperinflation in the '70s
22 | which was initially caused by inappropriate government

1 | monetary problems.

2 | What kinds of problems has it been proposed
3 | we can now fix with government remedies? One is a
4 | common feature of several of the bills that have been
5 | proposed in Congress, as well as the Administration's
6 | ten-point plan: the insufficient personal
7 | responsibilities of directors and officers. These
8 | people are not sufficiently on the hook. This is one
9 | of the perceived problems. I would suggest to you
10 | that existing audit committees are very well on the
11 | hook as it is.

12 | I recently saw a study that indicated that
13 | 10(b)(5) litigation, class action securities fraud
14 | litigation, is up to a new record high and that there
15 | were over 484 such lawsuits filed in 2001. This is up
16 | from 164 in 1991. And this is despite the passage of
17 | the 1995 Private Securities Litigation Reform Act,
18 | which was intended to make it harder to file such
19 | suits, and which in many respects did make it harder.
20 | Notwithstanding the impact of the '95 Reform Act, such
21 | 10(b)(5) claims have more than doubled, and officers
22 | and directors are almost always defendants in such

1 suits. It is something of a mystery to me how you can
2 get people to serve on boards anymore.

3 On top of that is the increasing
4 criminalization of civil conduct, making it possible
5 for directors on boards to face actual criminal
6 prosecution for conduct that was only a few years ago
7 viewed as, at worst, negligence.

8 What is another problem that government
9 could possibly fix now? Another issue raised in many
10 of the forums convened about Enron is the insufficient
11 rotation of auditors with clients, or audit personnel
12 within an audit firm, on a given client -- something
13 that Mr. Van Brunt's proposal addressed a moment ago.

14 I would suggest in response to those kinds
15 of criticisms that most frauds occur early in an audit
16 relationship. It so happened that Enron did not.
17 Arthur Andersen had been Enron's auditor for a long
18 time, or a relatively long time. Statistically, most
19 frauds occur early in the audit relationship, so
20 mandated turnover or rotation would not address that.
21 What mandated turnover might conceal, however, is
22 opinion shopping, which is the phenomenon of companies

1 | not liking the answers they're getting back from the
2 | auditors with concrete feet, and therefore looking for
3 | auditor with lighter or looser footwear.

4 | Another thing that the mandatory rotation of
5 | public company audits would do among the audit firms
6 | is strip the remaining large public companies away
7 | from the non-Big Four firms, one of which I happen to
8 | represent. That is, the BDOs, the Grant Thorntons,
9 | the MaGladreys of the world now have a fairly large
10 | number of public clients, although not nearly as large
11 | as the Big Four. Those clients would basically be
12 | stripped away from the non-Big Four firms, and we
13 | would therefore see an increasing concentration, even
14 | beyond what we have now, of the public company audit
15 | from being handled by only four firms, assuming that
16 | all four firms survive.

17 | The newly elected chairman of KPMG said
18 | recently that he thinks what happened to Andersen
19 | could happen to any of the remaining four. So, we
20 | could have even further concentration.

21 | What about the influence of non-audit
22 | revenue? This has been completely accepted by the

1 | press and by most of the commentators on the subject,
2 | that auditors are unduly influenced by non-audit
3 | consulting revenues. I submit that this is a complete
4 | red herring. There really isn't any evidence of that.
5 | Arthur Levitt looked high and low, far and wide, for
6 | such evidence during his administration and couldn't
7 | find it. Now, he's been quoted recently as saying,
8 | "a-ha, you see -- Enron, I told you; there really was
9 | such evidence; there is undue influence." But I
10 | submit to you that Enron is not an example of that.
11 | Many people quote the fact that \$27 million in
12 | consulting fees were paid to Arthur Andersen.

13 | If that if you're willing to sell your
14 | integrity for \$27 million -- and I do not suggest that
15 | that's what happened here with Andersen; I don't know
16 | what happened with Andersen and I have no inside
17 | knowledge. If you're willing to sell your integrity
18 | for \$27 million, you're probably willing to rent it
19 | for \$25 million. Those are big numbers. If the
20 | dollars are enough to influence your integrity,
21 | independence objectivity, then big dollars will do it,
22 | whether they're for auditing or for non-auditing fees.

1 | So, I don't think that's the issue there.

2 | It's interesting to note, although not many
3 | people know it, that Andersen's total fees in 1999
4 | were \$47 million, \$42 million of which were audit
5 | fees. That was the year during which most of these
6 | decisions were made. There is not yet, and Andersen
7 | is not, an example of undue influence on audit
8 | judgment from non-audit fees. If that's not the
9 | problem, let's not fix that either.

10 | There are several other suggested problems
11 | and remedies, but I think the point that I'm making is
12 | getting across. My generalized point is, let's be
13 | very careful about fixing something before we know
14 | what it is exactly that's broken because most of the
15 | remedies that have been proposed pose the danger of
16 | causing problems at least as large as what they set
17 | out to solve.

18 | MR. WILLIAMSON: I'm Edwin Williamson. I'm
19 | a partner at Sullivan & Cromwell. I think I'm around
20 | most Federalist Society events. I'm probably more
21 | known for my 2-1/2 years of professional existence
22 | that were not at Sullivan & Cromwell. I spent 2-1/2

1 | years as the legal advisor in the State Department in
2 | the first Bush Administration.

3 | At Sullivan & Cromwell, the bread and butter
4 | practice has very much been the public offerings,
5 | mainly representing underwriters, but also
6 | representing issuers. I've probably done 50-plus IPOs
7 | and many other sorts of public offerings. So, I'm
8 | sort of living down in the bowels with the short
9 | strokes of accounting rules and disclosure rules and
10 | so forth. That's where I've spent most of my life.

11 | I find that I agree with many of Scott's
12 | observations, and I want to try to avoid repeating
13 | them, but maybe giving the nod particularly where I
14 | agree. I was going to address four issues that I
15 | think are suggested by our program outline.

16 | The first is what compromises independence.
17 | I very much agree that the additional fees that a firm
18 | gets from consulting is not what tipped the scales.
19 | The auditor that can be bought or that does not have
20 | the adequate stiffness in the spine can have a problem
21 | with the size of auditing fees alone. In any case, I
22 | think the solution is that the market is working this

1 out. Boards are seeing a need to separate these
2 functions. There are plenty of people who can make up
3 their own minds on this. Directors with an acute
4 awareness of their potential liability can get around
5 to asking the right questions.

6 A specific delineation of what accounting
7 firms can and can't do will lead just another sort of
8 regulatory imbroglio that will have to be sorted out
9 at some point. A version of the Sarbanes Bill has
10 very specific restrictions on what auditors can do.
11 While that may come close to working with public
12 arena, I gather that there are attempts by states to
13 also impose similar restrictions. This would be a
14 terrible damper on the growth of small businesses; not
15 only the small business non-public clients of the
16 small auditing firms but those auditing firms
17 themselves.

18 On the question of PRO, Professional
19 Regulatory Organization, I'm skeptical that somebody's
20 going to come up with a great new idea here. At the
21 end of my comments or during the question and answer
22 point, I would like to address some of Roy Van Brunt's

1 | suggestions. But, I want to address the question of
2 | how we got here.

3 | First, I think that we have seen an
4 | increasing trend towards very precise accounting
5 | rules, a cookbook approach. In other words, you add
6 | two eggs, you beat for 30 seconds, you add a half-cup
7 | of cream. If it produces a lousy cake, too bad. You
8 | followed the rules and you didn't think about beating
9 | for 45 seconds rather than 30 seconds. Nobody steps
10 | back and takes a hard look at whether or not what has
11 | been produced is actually the right picture; whether
12 | it really makes sense.

13 | I probably should preface my comments with a
14 | disclaimer. Our firm, like most firms, has been in
15 | various aspects of the post-Enron/Arthur Andersen
16 | case. We're representing Mr. Duncan and there are
17 | other aspects of Enron that we're involved in. We
18 | represent the Financial Accounting Standards Board. I
19 | don't do any of that work, so I can easily say that
20 | these are all my comments and not those of the firm.

21 | To return to my point, I think what you
22 | ended up with -- for example, the three-percent rule -

1 | - is an approach to accounting that is very much like
2 | the approach to taxes. There is a bright line out
3 | there and everybody engages in avoidance as opposed to
4 | evasion. And avoidance is legal, as long as you don't
5 | cross the bright line. This, again, is following the
6 | bright line and not stopping to ask whether the
7 | picture makes sense. Again, while the auditors
8 | express an opinion that the financials fairly present
9 | the results of operations and so forth, it seems to me
10 | that stepping back and looking at the forest as an
11 | exercise is generally not followed.

12 | Secondly, I would criticize the SEC,
13 | particularly during the Levitt period, for focusing on
14 | the wrong thing. There was a lot of effort spent on
15 | the plain-English rules. What it boiled down to were
16 | questions of taste. I can remember specific comments
17 | letters saying that systems should be described as
18 | simply as possibly but no simpler. There are some
19 | things that are complicated. We also saw some
20 | increasingly complex accounting rules applied in
21 | unexpected ways.

22 | In this period of intense focus on what was

1 | happening and the review of the dot-coms and so forth,
2 | those still happened. The SEC should face the fact
3 | that the Corporation and Finance Division is not a
4 | merit regulatory body, and focus on making sure that a
5 | good picture gets out.

6 | Part of the accounting rules and, to some
7 | extent, the disclosure rules have been an attempt to
8 | get into merit regulation, an attempt to slow down
9 | access to the market. Now, with the Court adopting
10 | the Speaks Caution Rule, the lawyers have not objected
11 | to this at all. So, we're as happy as anyone else to
12 | write across the face of a prospectus that it is all
13 | junk and you'd have to be a fool to buy this stock.

14 | In some of the areas, the accounting rules
15 | have appeared to me to be attempts to screw up
16 | financial statements. The idea of running stock
17 | options through the income statement makes no sense in
18 | trying to figure out whether or not a company is
19 | profitable and what it makes. The dilution aspect of
20 | stock options is obviously material to investors, and
21 | that is shown in diluted earnings per share
22 | calculations and other disclosures as to the amount of

1 | potential dilution.

2 | To run the fair value of an option on the
3 | date of grant, which may or may not be the fair value,
4 | through the income statement, even though that option
5 | is never exercised seems to me a distortion of basic
6 | accounting. The requirement of amortization of Good
7 | Will -- whether it's necessary or not -- the mistake
8 | has been rectified under this sort of blanket
9 | outlawing of poolings, although that really might be
10 | the correct way to describe a merger between two
11 | companies.

12 | The result of this is that people really
13 | must go to other sources for information on which they
14 | base their investment decisions. I think the legal
15 | profession is guilty to an extent because we play
16 | defensive ball, and statutory documents have become
17 | defensive documents. Therefore, you really end up
18 | with a greater alliance on analysts.

19 | I'm echoing what Scott says -- I really
20 | don't think you need more rules. Plain English is not
21 | enough; I think we need a little more common sense.

22 | MR. DONLON: I want to exercise moderator's

1 | prerogative, focusing our first question. What I see
2 | is that the investor community feels that this is a
3 | rigged game. So, the question is, what is going to
4 | change their mind? It's been advanced that what's
5 | needed is more disclosure, whatever that means, and
6 | better disclosure.

7 | Do any of these proposals that you've been
8 | talking about address the fundamental issue of trust
9 | and confidence with respect to the average person, a
10 | person who carrying a 401(k), who does not read the
11 | proxy statement assiduously? Certainly, the Vanguards
12 | and Fidelitys are not going to get the boost. The
13 | Schwabs aren't, and neither will Merrill Lynch or
14 | anybody else.

15 | MR. VAN BRUNT: If people don't read the
16 | disclosures that are out there right now, I'm not an
17 | advocate of the argument that more disclosure will
18 | solve it. For the four years that it tried to
19 | regulate auditors' independence, the late and
20 | unlamented Independent Standards Board paid to have
21 | studies done with respect to what investors actually
22 | consider before they made investments. The vast

1 majority never read a 10-K or a 10-Q. So, any
2 disclosure rules that simply force more disclosure
3 into disclosure documents is arguably foolhardy.

4 MR. DONLON: But Roy, aren't they relying on
5 the professionals to do some of the due diligence for
6 them?

7 MR. VAN BRUNT: They're relying on better,
8 and they are relying on professionals, but they're not
9 relying on more. The problem with Enron is, those
10 notes on the financial statements run six, seven,
11 eight, nine pages for a given note. Nobody could read
12 them and nobody could understand them. Having more
13 disclosure crammed into that note is not going to
14 solve the problem.

15 MR. COCHRAN: One of those notes we
16 introduced in the record, footnote 16 in one of the
17 quarterly statements, and footnote 7 in the Annual
18 Report didn't explain relationships, they didn't have
19 all the numbers and they didn't have any effect on the
20 balance sheet. I think there would be a beneficial
21 impact for the professionals in having those items
22 disclosed, and that is what's coming now.

1 The whole result of Enron and Andersen going
2 down is that it forces people to pay up. This is
3 where there are some good things coming out of the
4 trial bar, even for hardcore Federalists. Some well-
5 placed criminal prosecutions might be beneficial.
6 It's fascinating that the first prosecution sure looks
7 like it's going down.

8 All that system and what the NYSE is doing
9 and what institutional investors are doing; the multi-
10 tiered system of regulation and enforcement is now
11 reacting. I had a conversation with a very visible
12 commentator in late April about testifying for us. I
13 thought he was a free market guy, and he just reamed
14 us. Last night,, it was the same thing with Harvey
15 Pitt. I'm not going to bring up his name; you
16 probably see him every once in a while. Last night,
17 he was far more optimistic than he was six weeks ago.
18 The real thing here is corporate governance for the
19 future, and the market is already seeing that 50 to 80
20 percent of the battle is being fought and won, and
21 will be won eventually, by the multi-tiered system.
22 So, I'm more optimistic.

1 MR. UNIVER: Let me chime in with my
2 agreement with Andrew. I'll even say a good word for
3 plaintiffs lawyers that we face from time to time.
4 The ecosystem needs vultures; that doesn't mean you
5 want to sit down and dine with them, but they are
6 neccesary.

7 (Laughter.)

8 MR. UNIVER: My apologies to any of you who
9 are in the audience.

10 MR. DONLON: John Bogel, the former chairman
11 of Vanguard, made the remark in a very excellent piece
12 in the *American Spectator* about a month ago that there
13 were more corporate earnings restatements in the first
14 11 months of this decade than the entire decade of the
15 1990s. I'm not sure whether that's true or not, but
16 that suggests to me that this goes far beyond Enron,
17 Global Crossing and others.

18 AUDIENCE PARTICIPANT: Mr. Donlon, I think
19 you have this exactly right. I think it's a question
20 of structure; not policy or laws. The first thing
21 with the structure that's really wrong is that GAAP
22 accounting is hopelessly corrupted and should be

1 | thrown away wholesale. In the interim, publicly
2 | traded companies reveal their tax returns because the
3 | accounting for the tax returns is a lot more stringent
4 | than that required for debt. And in the long run, you
5 | need new standards. Those standards should not be
6 | created by the companies, the accountants or the
7 | government, but by the investors. People like Warren
8 | Buffet know what they need and they can set the
9 | standards.

10 | The role of the SEC and government should be
11 | to ensure with felony penalties that these standards
12 | are kept. And in the long run, to make sure that you
13 | have a level playing field and everybody does what
14 | they're supposed to do, you have to get rid of all of
15 | these limited liability laws. Everybody has to be
16 | responsible for what they do and for what they don't
17 | do. And then you'll get good governance.

18 | MR. COCHRAN: FASB is actually moving toward
19 | a two- or even three-tiered process of financial
20 | disclosure standards or allowances. And with Key
21 | Metrics, we had two hearings on the credibility of
22 | GAAP; what we called the GAAP gap. I don't know if

1 | you followed any of the value reporting initiatives
2 | pursued by Price Waterhouse and other theorists.

3 | You have to be careful here because, what is
4 | going to be standardized? One of the problems we saw
5 | was the forward-looking statements and pro forma
6 | releases. The market is now punishing all those, and
7 | I think we're going to see the end. This isn't coming
8 | from me but from other market participants: Abby Cohen
9 | said in the FDIC conference last week that we're going
10 | to see the end of a lot of these pro forma releases.

11 | So, we have to be careful with what this
12 | non-GAAP information's going to be. But there ought
13 | to be some metrics for reporting company information.
14 | If GAAP isn't eliminated, at least it goes beyond GAAP
15 | to a wide range of performance measures. I think
16 | we're moving in that direction. But I'm concerned
17 | that it won't be standardized in the professions and
18 | the money managers won't agree, so I hope they get
19 | involved.

20 | MR. UNIVER: Let me agree in a very
21 | restrained and timid fashion with the questioner. I
22 | think there's a valid point to be made there.

1 American accounting and the GAAP rule system is what
2 is known by the accountants as rule-based, as opposed
3 to much of the often principles-based European
4 accounting system. That is what I think many
5 advocates are now suggesting the U.S. system needs to
6 turn towards. The principle behind revenue
7 recognition being X, Y and Z, you figure out the rules
8 that apply in this specific situation.

9 I agree that U.S. GAAP has become far too
10 fine-textured and fine-grained. The rules have gotten
11 too numerous, too complicated and too specific. There
12 is a corresponding danger, however, in rushing too far
13 in the other direction, towards a principles-based
14 system. That is the increasing subjectivity of the
15 accounting system, so that each accountant can look at
16 the forest and not pay attention to the trees, coming
17 up with his or her own impression of what the earnings
18 for the company were. That isn't a good system
19 either, and I'm suggesting moderation in our retreat
20 from rules-based accounting so that we do not go too
21 far toward pure principle-based.

22 MR. VAN BRUNT: It's far more complex than

1 | that because when you move from a rules-based model to
2 | a principles-based model, you do not build more
3 | credibility of into the work of the accountant. I'm
4 | not the world's greatest defender of it because I
5 | think the idea is the world's worst creation. The
6 | accountant has two clients, both of whom apply the
7 | same principle: I have assets; the principle is they
8 | need to be depreciated. The question is over what
9 | life they should be depreciated and how quickly over
10 | that life.

11 | Client A says I believe the life for
12 | goodwill or any other intangibles should be 20 years.
13 | Without a rule that says it should be 40, the
14 | accountant has no basis to object to that and say that
15 | the statements don't fairly prevent. The next client
16 | down says five; the next client down says 50. There's
17 | no rule by which to hold anybody.

18 | So then, you're in the position of asking
19 | the accountant to opine on a series of financial
20 | statements, all of which operate under different
21 | rules. But because they generally apply the same
22 | principle, they'd be in conformity with some standard.

1 | It's a meaningless disclosure. No one will benefit
2 | from it.

3 | MR. UNIVER: GAAP was an invention of the
4 | accounting profession. It's not something that came
5 | down from Mt. Sinai. They owe their allegiance to the
6 | companies. The companies are the ones who pay their
7 | bills, and it's not a question of ancillary services.
8 | The accountants' interests are the companies'
9 | interests. Who are these financial statements
10 | supposed to serve? They're supposed to serve the
11 | investors. So, why not let the investors determine
12 | what goes into them. Let the investors determine the
13 | standards.

14 | MR. COCHRAN: GAAP is a creation of the
15 | historical cost-based manufacturing economy. At a
16 | time when, increasingly, intangibles are the basis of
17 | a company's value of the last 10 or 15 years,
18 | intellectual property, software, etc., it is
19 | impossible to , value the company's assets and its net
20 | worth and its whole worth to people.

21 | MR. DONLON: Good point. What you're saying
22 | is that it was creaking well before this.

1 MR. WILLIAMSON: Well, a couple of things.
2 One is that I agree. There's no doubt that the rules
3 about what should be disclosed ought to be made and
4 formulated by those who use those financials. But, I
5 see absolutely no evidence that the financial
6 community has been able to get its act together and
7 having meaningful input in this. I'd be happy to see
8 it.

9 One of the things I do is represent all the
10 foreign issues. I know a biotech company that had
11 about \$13 million in revenues. It was an English
12 company that did a U.S. IPO. It spent over a million
13 and a half dollars reconciling its UK financial
14 statements to U.S. GAAP. I would be willing to bet
15 that not a single investment decision was made on the
16 basis of that reconciliation.

17 They kind of liked it because in this great
18 focus on revenue recognition, the SEC has all the
19 little rules as to when you can recognize revenue from
20 your collaboration agreements. They had to restate
21 them and back out revenues. I said, "Doesn't that
22 sort of bother you?" They said, "Oh, no. We've

1 | already announced them once and now we'll announce
2 | them again."

3 | (Laughter.)

4 | MR. WILLIAMSON: The only thing I'm
5 | satisfied that one can generalize about the Enron
6 | situation is that it all proved that half of what
7 | Lincoln said was correct: that is, you can fool all of
8 | the people some of the time.

9 | My broker said that on October 22, 2001, he
10 | called 11 top analysts who followed Enron, and every
11 | one of them said that Skilling's resignation was for
12 | valid personal reasons. Lay is back in charge. The
13 | problems are over. All of the questionable accounting
14 | has been corrected; it is over and done with. It is a
15 | great buy at 15. Fortunately, he decided to be a
16 | contrarian and sold.

17 | AUDIENCE PARTICIPANT: There's a lot of
18 | hyperbole flying around here now. I'm not an
19 | accountant, but I understand there's something like
20 | 80,000 pages that compile the proposal we now call
21 | GAAP, and I think the suggestion that you throw the
22 | baby out with the bathwater in getting rid of it is

1 | just silly, frankly.

2 | The problem corporate lawyers then have is
3 | telling their clients what to do. We have to have
4 | some rules in place to at least define what the
5 | boundaries are because if we don't, disclosure
6 | statements are going to look like the Manhattan Yellow
7 | Pages.

8 | AUDIENCE PARTICIPANT: Addressing FASB, I
9 | believe there is an emerging issues task force that's
10 | attempting to determine the information that's going
11 | to be put into a press release, and institutionalize
12 | some sort of press release format because what the
13 | dot-coms were doing was releasing any information in
14 | an effort to build up the market perception that the
15 | company was doing better. It's not as if they
16 | reported better earnings.

17 | I've been in FASB meetings where they'll
18 | convene with not only FASB directors and accountants
19 | but they'll also have representatives of other
20 | personages in the private sector in which they're
21 | dealing. Or perhaps on a derivatives issue, they'll
22 | have a broad constituency of representation in those

1 FASB meetings.

2 What ends up being the case is there's a
3 huge amount of corporate pressure on FASB to low-bar
4 and drive down to the lowest acceptable, credible
5 guidelines so that management can really report the
6 highest revenue possible. If options are only
7 reported at a point in dilutive earnings, then the
8 non-management shareholders are at a disadvantage
9 compared to management, shareholders and directors'
10 ability to exercise options.

11 Meanwhile, they're reporting the fattest
12 earnings possible that were probably tweaked, or
13 perhaps even fraud. At a minimum, they should be
14 accounted for. I personally think they should be
15 impacting reporting the income, the same way that old
16 goodwill used to impact net income. I don't think --

17 MR. WILLIAMSON: Would you run the revenues
18 from proceeds from stock sales through the revenue
19 line? If you're trying to figure out the value of an
20 entity or the future performance of an entity based on
21 its historical net income, putting in an artificial
22 charge that doesn't have anything to do with its

1 | profit is misleading.

2 | AUDIENCE PARTICIPANT: Respecting your point
3 | -- I don't mean to cut you off -- that, however, is a
4 | management --

5 | MR. WILLIAMSON: There are tons of places to
6 | disclose the amount of options that are granted. It's
7 | all over the proxy statements and notes of the
8 | financials. What are you doing to this bottom line?
9 | I think you're actually making it a less valuable
10 | number and it's driving people to other sources.

11 | AUDIENCE PARTICIPANT: I have two
12 | observations. One has to do with the notes, the
13 | financial statements, which are actually more
14 | important than the schedules because they tell you
15 | what they came from. If you find any notes that are
16 | puzzling or opaque, it should be to throw them away.
17 | It's just a matter of having some kind of public
18 | process to ask an issuer what the note means, and to
19 | have that information added to the record.

20 | Secondly, how do you get auditors to do the
21 | right thing all the time? I think the most successful
22 | mechanism would be to make all the partners in a firm

1 | want to have all the other partners do the right
2 | thing. It used to be that CPA firms were general
3 | partnerships, where everybody's personal assets were
4 | available to pay out. But ten years ago, they gave
5 | them limited liability partnerships. Therefore, if you
6 | have a firm with 4,000 or 5,000 partners, each of
7 | which is arguably a millionaire, that's \$5 billion
8 | that's not available for recovery in any action. I
9 | think on the plaintiff's side of things, it's very
10 | important to have those assets available, so that all
11 | the other partners are very wary of what any one
12 | partner can do to the rest of them.

13 | MR. VAN BRUNT: I can respond on behalf of
14 | those poor partners, none of whom that I know of are
15 | millionaires in their own right, at least not from the
16 | practice of accounting; although there may be some at
17 | Andersen. If reducing personal liability, eliminating
18 | the personal liability of the general partnership as a
19 | legal matter, by instituting an LLP causes a problem,
20 | then I don't think that explains what happened at
21 | Andersen. Those people are out of jobs, out of their
22 | capital accounts, they have a problem going forward

1 | with their careers; some of them were retired and had
2 | nothing whatsoever to do with this, they've lost their
3 | retirement checks, or will. I don't think that's a
4 | practical answer.

5 | You can't, as a real matter in a firm that
6 | large, have everybody looking over everybody else's
7 | shoulder. It doesn't work. Every firm has quality
8 | control procedures. Ours does; the others do.
9 | Hopefully, those things work. I don't know what went
10 | wrong at Anderson. Something did, but it wasn't the
11 | personal liability of the partners that was the
12 | guarantor of good work being done there or not.

13 | AUDIENCE PARTICIPANT: I've done quite a bit
14 | of work in Germany on the European Union corporate
15 | takeover law. One thing I see is that there's a lot
16 | less disclosure in European Companies than in American
17 | companies. This standards-based system may have some
18 | advantages, but it is easily manipulated to the will
19 | of management. And it is not necessarily a system
20 | that institutional investors have a lot of confidence
21 | in. I'm not so sure the United States should think
22 | about abandoning a system that we have used and has

1 | given us what is perceived around the world to be the
2 | best disclosure system in the world, without looking
3 | at what's happening in other countries. Look at Japan
4 | and you see that there has been a great deal more
5 | concealed than in the United States. How many of the
6 | S&P 500 have had serious problems with restatements of
7 | earnings of a substantial magnitude? It's not that
8 | many. And so, yes, there's a problem, but I wonder
9 | whether politicians in particular are blowing this out
10 | of proportion.

11 | MR. DONLON: Professor, you're aware that
12 | the Europeans are laughing in their cuffs over what
13 | they see as our hubris, as having dictated to them the
14 | superiority of GAAP, when we're the ones having the
15 | Global Crossings and the Tycos.

16 | AUDIENCE PARTICIPANT: And they have the
17 | Deutsch Telecom and all the acquisitions they've been
18 | making that investors really have not understood what
19 | has been going on with some of the major European
20 | companies. There's been no way to value these
21 | acquisitions; management talks big; and it turns out
22 | the stock ends up being --

1 MR. DONLON: So you're suggesting there are
2 many Global Crossings and Worldcoms in Europe that
3 have yet been undiscovered.

4 AUDIENCE PARTICIPANT: That are being
5 discovered.

6 MR. COCHRAN: International Standards are
7 weak around the consolidation side. The important
8 thing is that we're supposed to move toward
9 convergence in 2005. We eliminated the pooling
10 method. And the stock option issue is going to be a
11 very big, sore point. There's still a large body of
12 thought on the Hill that stock options should not be
13 considered a compensation expense and run through the
14 revenue statement. That is going to be a very
15 interesting feature.

16 And the S&P core earnings concept -- expense
17 of stock options -- on the international side, is
18 something to think about in corporate practice, along
19 with convergence and the supposed end of those
20 reconciliations.

21 AUDIENCE PARTICIPANT: It doesn't have to be
22 all one way or the other. We don't have to either

1 | expense stock options or just treat them as a
2 | footnote. There are intermediate approaches.

3 | AUDIENCE PARTICIPANT: I'm interested in
4 | comments on how to take the Andersen model: a firm
5 | that had a reputation for having an excellent national
6 | practice control, to the point where back in the '80s
7 | when we did some cases against Rob Andersen and named
8 | certain Andersen partners, we wouldn't have dreamed of
9 | naming the firm simply because these were people who
10 | clearly failed to follow the direct advice from their
11 | national practice people.

12 | What incentive did a firm like Andersen have
13 | to abandon this model and apparently to descend to a
14 | level of practice where the client was able so readily
15 | to dictate these choices? I think this notion of fair
16 | presentation is one of the best things that's been
17 | said all day. GAAP started out as a principles-based
18 | system. That's what the "P" stands for.

19 | But we live in a complex world. So the
20 | interpretations have got to be more and more complex.
21 | But even today, the auditing firm, presumably through
22 | its national practice group, is supposed to be able to

1 | say that taken as a whole, these financial statements
2 | fairly present the condition of the company. So even
3 | if you are filing a check-the-box rule about three
4 | percent, if the final thing is that you have 15
5 | special purpose entities, and every one of them is
6 | only three percent and hiding X amount of debt, even
7 | following the rules, it seems to me the result would
8 | have been absurd and that someone should have come up
9 | with some opinion or idea. And they couldn't do this.
10 | So, how does the system disincentivize this kind of
11 | thoughtfulness?

12 | MR. VAN BRUNT: I think it's a two-part
13 | answer, and I need to disclaim somewhat because
14 | Andersen is a client of our firm, although not in this
15 | matter. So, I'm going to talk generically about my
16 | understanding of what would have led to the decision.

17 | I think there's an ample body out there to
18 | indicate that the accounting that was in question was
19 | run through the firm's national office, and that the
20 | advice that the national office gave to the local
21 | practice office was not necessarily advice that the
22 | local practice office followed with respect to

1 | reaching their final conclusion. That brings me to
2 | the first part of what I think is a proposed answer.

3 | The profitability and the distributions to
4 | partners in the big firms are not on a firm-wide basis
5 | as much as they are on the profitability of the local
6 | practice offices where the decisions are made. So,
7 | you've lost, in the last 15 to 20 years, over my
8 | experience at the commission, that centralized
9 | national firm authority over what a local practice
10 | office does, they're now more advisory sometimes than
11 | they are automatically.

12 | The second dimension of your answer is
13 | because of the rules-based system that we have. I was
14 | pretty critical of EITF in my comments earlier; I
15 | think it's the worst thing that was ever created
16 | because what happens under it is the client says "show
17 | me where it says I can't do it this way" and the local
18 | partner who's trying to sign off on the account has no
19 | ability to do that without something in writing that's
20 | been discussed in the profession.

21 | So, rather than decisions being made on the
22 | personal view of the partner or the practice office,

1 | now issues get floated in a non-due process method to
2 | the EITF, where they get consensus from 15 of the 17
3 | members. And then, there's EITF 00-23A subparagraph
4 | 92 that says you can't do it this way in this
5 | situation. That's where I think the answer is going.
6 | That's what drives the rules-based accounting system:
7 | the need to come back to the client and say, "here's
8 | where it says you can't do that", as opposed to, "I
9 | say you can't do that." It doesn't make any sense.

10 | MR. UNIVER: First of all, for the benefit
11 | of the audience, EITF stands for Emerging Issues Task
12 | Force. It was an attempt by the accounting profession
13 | to set up a group that could address these kinds of
14 | emerging issues more quickly than FASB and other
15 | conventional standard-setting groups. It was
16 | recognized that some of these debates were dragging on
17 | year after year without resolution, and clients needed
18 | answers. Obviously, that process has had its own
19 | problems.

20 | This debate reminds me about what has been
21 | said about the difference between Russian Communism
22 | and Chinese Communism. It was said that in Russia,

1 | everything that was not forbidden was permitted; and
2 | in China, everything that is not permitted is
3 | forbidden. That is the kind of difference we have
4 | here. The rules-based system, as it gets more
5 | complex, more dense, more fine-grained, tends to
6 | create opportunities for a lawyerization of the
7 | accounting profession.

8 | As the rules get more intense, accountants
9 | are not only prompted by clients but also by their own
10 | incentives to look for ways, within the rules as
11 | they're stated, to present accounting statements in
12 | the light that is not objectively most clear or
13 | disclosing but in the light that's most favorable to
14 | the client's position. The rules permit them to do
15 | so. Again, I'm not in favor of a principles-based
16 | system; that has its own danger.

17 | In general the rules have to be pruned back.
18 | And I don't know what the mechanism is to do that,
19 | especially since a lot of them grew to the thicket
20 | that they were in, in the effort of the accounting
21 | profession not only to answer client questions but
22 | also, frankly, to shield its members from lawsuits.

1 If accountants can point to a specific rule
2 they follow, it's very hard to hold them legally
3 liable. That is another aspect of the lawyerization
4 of the profession.

5 MR. DONLON: The SEC needs a good accounting
6 gardener.

7 AUDIENCE PARTICIPANT: How do the panelists
8 feel about Chairman Pitt's proposal to have a panel
9 that would not be dominated by people in the
10 accounting profession to assist in accounting
11 regulation? Is it necessary? Irrelevant? Misguided?

12 MR. COCHRAN: It is necessary and it is
13 going to happen. He is going to do it himself. It is
14 en carta. It is going to be in any bill that passes
15 Congress. It is going to have five members; two of
16 whom are not going to be in the profession at all.

17 Actually, it will be a big improvement. The
18 problem with the Public Oversight Board and the
19 Securities Practice Section of the SEC was that it had
20 no oversight or enforcement capability. It was
21 underfunded. There wasn't a staff. It wasn't
22 permanent; it was part-time. That was wrong. You

1 know, it is unfortunate, the way that developed. They
2 quit, and there were some really good people on that
3 board.

4 But, I think Harvey Pitt and the Congress
5 are very intent on having a real oversight enforcement
6 function. Is that function going to take over FASB
7 and do all the accounting standards under very
8 specific guidelines established in law by Congress? I
9 don't think so. Not this year. That is the part in
10 the Sarbanes Bill that I don't like, and I don't think
11 it is going to become law. But, oversight and
12 enforcement with recommendations as in Section 2 of
13 our bill has got some real teeth.

14 MR. WILLIAMSON: I think that it is a good
15 idea. I think the accounting rules have gotten lost
16 in the minutiae that had become so solely developed by
17 the accounting profession.

18 What I'm worried about is the attempt to use
19 the accounting rules to accomplish other objectives.
20 That is what is present in the stock option proposal,
21 for example. There's such an angle about what is
22 perceived about overcompensation that we're going to

1 | punish these guys by decreasing their earnings, and I
2 | think that's the wrong approach. As long as the focus
3 | is on what is really good disclosure and fair
4 | presentation; that is a good step.

5 | MR. WILLIAMSON: I don't see that we get any
6 | credit for it in the market. So, for all of you who
7 | are proposing that we continue to keep our necks in
8 | the nooses while our professional colleagues do not,
9 | please stand up and say what good boys we are.

10 | (Laughter.)

11 | MR. WILLIAMSON: I want to switch to a
12 | couple of things that Roy raised and his five
13 | proposals. One, I'm curious about how this proposal
14 | that audit fees would be set by the SEC would work.
15 | On what basis? Hourly? Quality? Value? Size of the
16 | deal?

17 | MR. VAN BRUNT: The premise of that part of
18 | my point is, *arguendo*, in the accounting profession
19 | the audit fee has been cut back and minimized as much
20 | as possible so that we don't risk losing a client to
21 | somebody else. In the course of doing that, the way
22 | that audits are conducted is vastly different than

1 | they in the '70s and '80s when I got out of school and
2 | got my certificate in the first place. That is,
3 | there's a suggestion that there's not enough actual
4 | auditing being done, and the reason why it is not
5 | being done is that we can't get a bigger fee. When
6 | you go in this year, your idea is to hold the line on
7 | the budget, have a minimal expansion; you're paying
8 | your people more to do it. If you do that division
9 | really quickly, that comes out to fewer hours and
10 | lower costs.

11 | So my feeling is, the SEC has got a lot of
12 | people on the staff who have experience in public
13 | accounting and could tell you, given a public company
14 | the size of Monster.com or Phillip Morris, a
15 | reasonable audit fee would be X. As I said, you can
16 | argue from that, but my third step would be to go to
17 | the SEC to arbitrate.

18 | MR. WILLIAMSON: Well, that was the second
19 | question I had. Why does the Enforcement Division get
20 | the expertise on this to be the mediator here?

21 | MR. VAN BRUNT: The Enforcement Division
22 | claims expertise to arbitrate every dispute that I'm

1 | aware of that's outside.

2 | MR. VAN BRUNT: Charlie Nemeyer* would be
3 | more than happy to get involved in an argument between
4 | his clients and your auditor as to how much auditing
5 | was appropriate to do, and how much it would cost to
6 | do it.

7 | MR. COCHRAN: My respectful response to
8 | anybody who would suggest government-set auditing fees
9 | is that no one would make it. Who has ever attended a
10 | rent stabilization hearing here in New York?

11 | (Laughter.)

12 | AUDIENCE PARTICIPANT: Scott said that the
13 | audit committees were really doing a pretty good job.
14 | Look at the audit committee charter for the top
15 | hundred companies, all of which say that the audit
16 | committee will make recommendations annually about how
17 | they could improve their job.

18 | No audit committee this year has any
19 | recommendation that I'm aware that says if conditions
20 | are any different now or that they should do anything
21 | differently now -- and at least 68 of the proxy
22 | statements out there say something to the effect that

1 | we've only looked at what management told us. We
2 | haven't looked at anything beyond management, we're
3 | not experts, we don't claim to be. So, in the context
4 | of whether or not footnotes are comprehensible, are
5 | the audit committees doing a good job?

6 | MR. UNIVER: I don't think I said that I
7 | believe most audit committees are doing a good job,
8 | although for all I know, they are. I think I said
9 | that I don't know how you get anybody to serve on
10 | them. There are some reforms going on, and I think
11 | those reforms are good.

12 | The stock exchanges have set new standards
13 | for financial sophistication of audit committee
14 | members, the number of meetings that have to be held,
15 | other kinds of rules -- and rules are not necessarily
16 | the answer here. I think this is another area where
17 | the market is taking care of the problem because of
18 | the threat of the class action litigation that I
19 | mentioned; 483 suits last year. If you're on a board,
20 | especially on an audit committee, you've got to be
21 | aware of that factor.

22 | I've noticed many law firms that have gotten

1 | into the business of providing special advisory
2 | services to audit committees and are happy to hold
3 | seminars, provide private counseling and draw up plans
4 | suggesting what these people should be doing just to
5 | keep their shirts.

6 | PANELIST: Ollie Gregory at Weil Gotshal.

7 | MR. UNIVER: Many fine lawyers will tell you
8 | exactly what you should be doing on an audit
9 | committee. I think the market is taking care of that,
10 | too.

11 | AUDIENCE PARTICIPANT: I'm unhappy about
12 | this resistance to the notion of throwing out GAAP.

13 | (Laughter.)

14 | AUDIENCE PARTICIPANT: One fellow said,
15 | "throwing out the baby with the bathwater". Here we
16 | have a situation where major companies report that on
17 | Tuesday, they have a \$50 billion asset on the books;
18 | on Wednesday, that asset is gone, and they have
19 | followed the rules. How can that be? An investor
20 | sees a \$50 billion asset and invests, thinking they
21 | have that asset and the next day it turns out there's
22 | no asset there, how can the rules be okay, and how can

1 | the rules possibly be salvaged?

2 | MR. COCHRAN: It's because we're in
3 | transition. You know, you can fool some of the people
4 | -- one of my scholars has a saying about that. It
5 | says, you can fool some of the people all of the time
6 | and all of the people some of the --

7 | PANELIST: All of the people some of the
8 | time.

9 | AUDIENCE PARTICIPANT: -- and that's good
10 | enough.

11 | (Laughter.)

12 | MR. COCHRAN: I just think we're in
13 | transition and this is part of the transition and
14 | paradigms to it. Maybe the last transition into the
15 | information age, is the accounting. And I don't think
16 | we can throw out GAAP at this point, but you add
17 | another tier of information disclosure and see what
18 | happens in the next 10 or 20 years. By the way, the
19 | next Chairman of FASB, Bob Hertz*, until this past
20 | couple of weeks ago a partner at PWC, was co-author of
21 | the book *The Value Reporting Initiative*, and
22 | contributed to the sequel that's coming out in July.

1 He's going to take that to FASB, and it will be very
2 interesting to see what happens there.

3 He's good friends with Bob Herdman, the
4 Chief Accountant of the SEC, who also agrees with some
5 of this. We're very much in transition in the economy
6 and in accounting. These are going to be rather
7 interesting times for attorneys counseling their
8 clients on what to put in. We are going to see the AK
9 go from 30 pages to I don't know how many pages,
10 unfortunately.

11 PANELIST: -- in less time.

12 PANELIST: One last close, just to
13 demonstrate the maturity of growth since the '33 and
14 '34 Acts were passed. One of the first accounting
15 series releases that the SEC published in its infancy
16 stages on the subject of accounting said, "Good
17 disclosure does not cure bad financial statements."
18 What I'm hearing suggested right now is that good
19 disclosure will pretty much cure bad financial
20 statements, and that, I would suggest, is a 180-degree
21 turnaround.

22 MR. DONLON: I promised I'd close it off,

1 | and we're only a few minutes past our stop time, but I
2 | need to ask each one of our panelists to respond to a
3 | sort of summing-up question. I hate to be a Johnny
4 | One-Note, but if the Federalist Society convenes this
5 | panel a year from now, is the average investor who got
6 | burned not just on Enron but all the other companies
7 | we've been talking about going to be more or less
8 | confident and trusting than he or she is today?

9 | MR. UNIVER: He will be more confident
10 | because that's not saying much, according to a survey,
11 | which I've got right here in my folder, ESTA ranked
12 | the biggest challenges to the U.S. investment climate.
13 | Eighty-four percent cited the accounting controversy,
14 | compared with 61 percent last year. So, being
15 | confident does not help much. What I think is more
16 | important than that is that the average investor will
17 | be richer because we will overcome these problems.
18 | That's my answer.

19 | MR. DONLON: Andy?

20 | MR. COCHRAN: Same answer.

21 | (Laughter.)

22 | MR. DONLON: Ed?

1 MR. WILLIAMSON: I don't know. I think the
2 investor will be confused because I think we're going
3 to see things coming out of both Congress and the SEC
4 that will promise them solutions and that aren't
5 really solutions. Whether it will be obvious by this
6 time next year may not be so clear. But I say the
7 investor's still going to be scratching his or her
8 head.

9 MR. DONLON: Roy.

10 MR. VAN BRUNT: I think if the changes that
11 are being discussed are going to eliminate the self-
12 regulation aspect of the accounting profession in
13 favor of a public accountability board, then one year
14 from now is not a sufficient passage of time in which
15 any change in investor confidence will be perceived
16 one way or the other. While the PAB or the proposals
17 that are in legislation are certainly well grounded,
18 there are very many down-to-earth, practical problems
19 with implementing them.

20 MR. DONLON: Thank you very much.
21 Panelists, I want to thank you for your distinguished
22 remarks. I'd also like to thank Dean Reuter and the

1 | Federalist Society for holding this very exciting
2 | seminar, and thank you for coming.

3 | (Whereupon, the panel was concluded.)