

**Testimony of Robert K. Elliott, Chairman,
American Institute of Certified Public Accountants,
On Auditor Independence
Before the Securities and Exchange Commission**

September 13, 2000

Thank you, Mr. Chairman, for the opportunity to address the Commission at this public hearing on the proposed revisions to the auditor independence rules.

The American Institute of Certified Public Accountants, which I have the privilege of chairing, is the largest professional association of certified public accountants, with more than 340,000 members in business, industry, public practice, government and education. Its mission is to enable its members to provide value-added services that optimize clients', employers' and other users' decision-making effectiveness, ever mindful of the profession's covenant to serve the public interest with integrity and objectivity. The AICPA sets U.S. auditing standards and supplements the work of the Financial Accounting Standards Board on U.S. accounting standards. The AICPA also establishes and enforces ethical rules for its members and has developed a comprehensive set of rules governing auditor independence.

Auditor independence is a matter of paramount importance -- to the profession, to users of audited financial information, to the functioning of our capital markets and, therefore, to the public at large. I commend the Commission on soliciting the views of interested parties on the proposed rules. In that same spirit, I urge you to extend the all-too-brief 75-day comment period and extend these hearings so that you will obtain the fullest expression of views about the SEC's far-reaching and complex proposals. On behalf of the many members of the AICPA who are not

able to participate in hearings in Washington or New York, I would also propose that you conduct hearings in other regions of the country. Given the undeniable impact of your actions on the accounting profession and its clients, it is only appropriate that other parties be afforded the opportunity to present their ideas directly to the Commission.

I would like to focus my remarks on the impact of the proposed rule on the future of the profession and its ability to serve the public interest well into the 21st century.

It is, by now, a truism to say that we are in a period of transforming change. No one is smart enough to predict -- with confidence -- what that will mean in terms of the needs of public companies for new attestation and other professional services and the abilities of firms to meet those needs. No one is wise enough to pre-determine those choices in the confidence that the imperatives of the New Economy will be met and the public interest will be served. So, the better part of wisdom calls for caution and a sense of humility as the Commission considers rules which could shape the structure of the accounting profession well into the future. We need to do our best to come to terms with the law of unintended consequences and, as the medical profession teaches, "above all, do no harm."

That is not to say inaction is the policy of choice for the AICPA or the policy that we would recommend on independence requirements. As you will hear, we at the AICPA believe there is a great deal of useful and important work to do. Change is welcome. The regulatory framework must respond to the economy as it is today and as it is becoming. The new rules must not straight-jacket the future of the profession. That would ill serve the public interest. They must be based on the best information about the issue of auditor independence, and the likely

ramifications of particular policy choices. And they should have sufficient flexibility to accommodate the changing needs of the markets, while assuring fidelity to enduring principles. That is why the AICPA strongly favors a principles-based approach to regulating auditor independence grounded in a new conceptual framework.

Let me give you a concrete example of what I mean. We need to reinvent our 1930's-based model of financial reporting. We need to do that urgently, because the markets are telling us what we are doing doesn't work any more. When the most valuable assets of Microsoft, as reflected in its audited financial statements, are, first, its investment portfolio and, next, the buildings which house its intellectual capital, something is wrong. The fact is our audited financial statements simply are not measuring that which the markets value most, a shortcoming which has something to do with the high price-to-earnings (if any) ratios in New Economy companies.

To elaborate, the current financial reporting model is based on the assumption that profitability is driven by physical assets, like factories and machinery, and raw materials -- in other words, the tangible inputs needed to produce tangible products.

But the high tech companies of the information age are driven by intangible inputs financial statements mainly ignore -- from patentable ideas to marketing concepts, process design, computer programs, know-how, brand names, work-force expertise and training, quality controls, executive strategy, and organizational mechanisms to generate both quality improvements and innovation. These are the "intangibles" valued by the market but missed by the current SEC influenced accounting model.

There is a "gap" in GAAP. That is why I have called for the Commission to issue a concept release on the development of new GAAP for the New Economy. We need to replace the accounting model of the industrial age with a business reporting model for the information age.

The old financial reporting model needs to be reexamined from two perspectives:

- **what information is reported, and**
- **when information is reported.**

Six years ago, the AICPA's Special Committee on Financial Reporting both responded to and anticipated these trends by proposing a way to capture the "intangibles" that drive profitability in the New Economy in a new "business reporting" model. Today, the need to reexamine what information is reported is even greater. We are in a game of catch up -- and if we lose, our system of financial reporting will become irrelevant, with untold consequences for our capital markets.

The second challenge is rethinking when information is reported. We need more timely disclosure. In the Internet age, quarterly and annual reports are becoming dinosaurs. The relative absence of current information to assess corporate earning capacity helps explain the volatility of today's share prices. It also provides an insight into the behavior of Wall Street analysts and other market professionals who seek to obtain information from companies over and above what is reflected in their periodic filings. Real-time disclosure of relevant financial

information on the Internet is clearly foreseeable.

The FASB and the profession must work together to design and implement a 21st Century business reporting model. That presents new and very difficult conceptual and practical challenges. Accountants will have to become experts in e-commerce and all forms of rapidly evolving information technology. We will need to understand how "new" businesses are run, and how to evaluate "soft" business information. We will need to employ even greater arrays of "heavy duty" statistical techniques, engineering and technological skills to examine the integrity, quality and reliability of client-generated information. Accounting firms will have growing needs for specialists to provide critical audit support.

These resources are not optional -- they are core requirements. To meet them, we will need professionals with skill sets honed in sophisticated client work.

You may ask what this has to do with the proposed rule. Simply this – if adopted, the amended rule would go far to deny accounting firms what they will need the most to meet the challenge of "information age accounting" –

- people with highly developed technical skills and the capacity to analyze complicated business environments, and
- relationships with other businesses with complementary skills, which are increasingly necessary in an era where no firm, however large, can assemble all of the needed expertise under one roof.

As you know all too well, the profession is already experiencing considerable difficulty in its efforts to continue to attract the best and the brightest. If we constrict opportunities for talented young men and women with the qualifications and drive to work with cutting-edge information technology, accounting firms are going to be less attractive career embarkations for talented graduates. What will that mean for the ability of firms to audit complex public companies in the coming era of business reporting? In my view, the challenge of the future will not be met by imposing an "audit and tax-only" model on accounting firms - a model that has never accurately characterized the range of services offered by accounting firms and makes no sense today.

You may also ask whether the firms could just hire whatever talent they need or outsource their requirements to others? This is neither likely nor desirable. Young people with the skills to do what we need them to do have choices. Given the option of working for an accounting firm with a limited range of permissible services or signing up with the companies building the technology-driven projects of the future, is it likely they will choose auditing as a career or an accounting firm as the employer of first resort? And, if we outsource these projects, we will come to rely on people we have not trained, people who are not imbued with the culture of a professional accounting firm and people who are not bound by our ethical standards. It is hard to see how that would serve the public interest.

The new rule also would deprive accounting firms of the ability to leverage their assets through affiliations with innovators in the New Economy that are not audit clients. No single accounting firm is likely to have the resources to acquire, develop or produce all the

competencies needed to audit the new accounting model of the information age. But, the proposed rule would severely restrict the ability of accounting firms to enter into such relationships. Any entity with whom the accounting firm has virtually any meaningful commercial relationship will be considered, under the new rule, an "affiliate" of that accounting firm, and accordingly subject to the SEC's independence rules. If any entity provides any service to one of the audit clients of an accounting firm which has any equity interest in that entity, or has loaned it any money or with whom it shares any revenue, or has any direct business relationship with that entity, that entity would be deemed an "affiliate" and subject to the independence rules. This means an IBM, or Oracle, or AT&T could never enter a strategic alliance with an accounting firm. In short, accounting firms would come to be seen as pariahs.

Surely, these consequences are unintended. The Commission, I am confident, does not want to strip accounting firms of the resources they need to do the work the New Economy will demand. But, these consequences are not remote or conjectural – they are clearly foreseeable.

A new approach is needed. Rather than drawing up detailed new rules for a rapidly changing future, we should first get the concepts right. That means giving dual priority to a concept release on accounting for the New Economy and the ISB's ongoing initiative - to which the SEC pledged its support just three years ago - to develop a new conceptual framework for auditor independence.

In 1997, the profession and the SEC made a commitment to create a new principles-based framework for auditor independence. Since then, the ISB has made substantial progress on that critical project and, according to Chairman Allen, is within a year of producing an exposure draft

of a framework which would assess the risks of specified activities and prescribe safeguards carefully calibrated to protect auditor independence. I can't promise you that the outcome will be what we need - that remains to be seen - but the project is without a doubt a matter of first priority. Ideally, this reform will be similar in design to the revolutionary changes in audit procedures that occurred in the 1970's, when the profession adopted a risk assessment process as the basis of the audit model -- exactly the approach favored by the majority of participants in the second Earncliffe study. If we work together within the framework of the ISB, we should be able to arrive at the consensus that you, Chairman Levitt, have called for in support of a 21st Century system for regulating auditor independence.

It needs to be said that the AICPA fully supports modernization of the independence rules relating to financial interests and family relationships. We agree with the public members of the ISB that care should be taken to conform the technical language to the ISB exposure drafts.

However, with respect to the balance of the rule, let's not put the cart before the horse. Without first deciding what a 21st Century business reporting model should be, what skill sets will be required to perform an audit applying that new reporting model and without developing the new conceptual framework for the regulation of auditor independence, we would risk severe, adverse unintended consequences that could seriously damage the profession, and the public interest. There is no reason - and I have carefully studied the Earncliffe reports in this connection - for a rush to judgment on these critical issues. We have the time to get it right, and the public is entitled to nothing less.