Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate

Statement by Michael H. Sutton

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Chairman Levin. Senator Collins. Members of the Subcommittee.

Thank you for inviting me to share my thoughts on the corporate governance and accounting issues raised by the failure of Enron.

First, let me comment briefly on my background and experience. I was Chief Accountant of the Securities and Exchange Commission from June 1995 to January 1998. Prior to holding that office, I was a senior partner in the firm of Deloitte & Touche, responsible for developing and implementing firm policy relating to accounting and auditing, and practice before the SEC. My career with Deloitte & Touche spanned from 1963 to 1995. As a retired partner, I receive a fixed retirement benefit from that firm. Presently, I undertake from time to time independent consulting and other assignments in the field of accounting and auditing regulation and related professional issues.

Effective oversight by boards of directors is at the heart of the financial reporting processes that serve and protect the interests of investors and the public. Without effective oversight, important checks on the integrity, judgment, and performance of management are compromised. Without effective oversight, critical safeguards of the rigor and objectivity of the independent audit are weakened. As we have seen in the case of Enron, failures of the corporate governance processes can be devastating, and the investing public, rightly so, is asking, “Can we rely on corporate governance processes – oversight by boards of directors and audit committees – to ride herd on management and see to it that auditors do their jobs?”

Today, you are examining the questions raised by Enron in a search for meaningful remedies. We would like to believe that Enron is an anomaly – that the governance issues raised are isolated to this case, but they are not. While Enron has become a “poster child” for a system out of control, the underlying concerns about the diligence of boards of directors and audit committees reach far more broadly into our corporate and capital market culture.

To help put the search for reform in perspective, I offer some essential views that I think all can agree on.

§ First, I think all will agree that our capital market system is a national treasure. It is vital to the success of the economy. Indeed, our exceptional standard of living depends on its vitality.

§ Accordingly, we all share a compelling common interest in assuring the strength and liquidity of our capital markets.

§ This compelling common interest must shape our policy goals and guide our thinking as we search for solutions.

§ Finally, the most critical, yet intangible, ingredient of a successful capital market system is the confidence of investors that the markets are fair – confidence that the information they depend on is trustworthy – confidence that they can make informed decisions and will not be misled.

As we look at the issues today, it should be abundantly clear that there is no higher goal for financial reporting than providing useful and reliable information that promotes informed investment decisions and confidence in the system. It also should be abundantly clear that, without diligent, probing directors and audit committees and dispassionate independent auditors, the quality of financial reporting can be, and will be, systematically undermined. Without adequate checks that must come from effective governance, conflicts of interest can, and will, go unchallenged.

One of the most practical and effective steps in reforming the financial reporting system would be to immediately revisit and rewrite our corporate governance policies and guidelines to clearly break the bonds between management and the independent auditor, and to unmistakably spell out the responsibilities of boards of directors and audit committees to shareholders and the investing public. Management should be the subject of, not the manager of, the independent audit relationship and process. The ultimate responsibility for full and fair disclosure to shareholders, and the direct responsibility for the independent audit relationship and the quality of the audit process, should be clearly fixed with the board of directors and its audit committee. The audit committee should be made up entirely of independent directors.

As we consider reforms, it is important to keep in mind that investor confidence is influenced by both the fact and the appearance of the independence of the auditor. At the end of the day, governance of the financial reporting process should provide comfort to the investing public that the financial statements they receive have been subjected to an effective and truly independent audit.

For independent auditors, I believe that a brighter future begins with full acknowledgement of the reality that seems so clear today. Failures in our financial reporting system are more than aberrations. They seriously undermine investor confidence in the institutions that are supposed to protect them. They "poison the well."

Pleas that the vast majority of financial reports are sound, that most audits are effective, and that failures are few miss the point. In capital markets, a single financial reporting failure can be a disaster in which losses can wipe out decades of hard work, planning, and saving. In that context, debates about how many failures can be tolerated are not only not productive, they are nonsense.

To restore and maintain confidence in the independent audit, I believe that the auditing profession will need to do three things:

§ First, it will have to embrace a role that is fully consistent with high public expectations. In public capital markets, insiders have an advantage over public investors, and in that arena independent auditors are expected to balance the scales by assuring investors that financial reporting gives them a fair presentation of the economic realities of the business.

§ Second, the auditing profession will have to tackle fraudulent financial reporting as a distinct issue, with a distinct goal – zero tolerance. We understand that, in life, "zero defects" are almost never realized. Nevertheless, the public expects that the profession will pursue that end.

§ Third, it will have to accept and support necessary regulatory processes that give comfort to the public that the profession is doing all that it can do to prevent future episodes of failed financial reporting.

Regulatory processes that will build confidence in the auditing profession will be truly independent; they will be open; they will actively engage, inform, and involve the public; they will be adequately resourced and empowered to accomplish their mission; and they will be adaptable to changing conditions.

With respect to accounting standards, we simply can't tolerate financial reporting that "hides the ball." And, we can't tolerate processes that are not responsive to critical financial reporting needs. Current rules for accounting for SPEs, for example, are nonsensical – they can only be explained by accountants to accountants. More broadly, outdated rules governing consolidation and off-balance-sheet financing have become recipes for masking a company's true economic risks and obligations. We have a right to insist that accounting standards clearly reflect the underlying economics of transactions and events. And, it is not acceptable to sit by while market innovations outstrip the development of needed guidance.

Criticism of US standards is beginning to focus on the fact that they have become increasingly detailed, and arguments have been made that they should be broader statements of principle, applied with good judgment and respect for economic substance. I have sympathy for the desire to break the cycle of the mind-numbingly complex accounting rules that have become the norm, but to do that I think we have to confront realistically the reasons why our standards have evolved the way they have.

Here are some of the underlying pressures at work:

§ Business managers want standards that provide the greatest flexibility and room for judgment. They want to be able to manage reported results, but yet be able to point to a standard that assures the public that they are following the rules.

- § Dealmakers and financial intermediaries want standards that permit structuring transactions to achieve desired accounting results – results that could obscure the underlying economics. In that world, creative transaction structures are valuable commodities.

- § Auditors are pressured to support standards that their clients will not take issue with, and they often are restrained in their expected support for reporting that is in the best interests of investors and the public.

- § Others, including some legislators, too often lose sight of the fundamental importance of an independent and neutral standards-setting process. Without independence and neutrality, standards setters cannot effectively withstand the myriad of constituent pressures that it inevitably will face and make the tough decisions that inevitably are required.

- § And then, standards setters too often seem to pull their punches – perhaps because of a perceived threat to the viability of private sector standards setting – perhaps because of the sometimes withering strain of managing controversial change – perhaps because of a loss of focus on mission and concepts that should guide their actions.

As we re-examine our processes, the issue and debate should not be about whether accounting standards should be detailed or broad, but rather about what formulation of standards and standards-setting approaches best accomplish the goal of providing capital markets with reliable and decision-useful financial information.

We need to re-energize our standards-setting processes and the commitment of capital market participants to support a fully effective, independent standards setter. We should provide independent funding for the FASB – funding that does not depend on contributions from constituents that have a stake in the process. We also need a more independent governance process to replace the current foundation board. The leadership for these changes should come from visionaries of unquestioned objectivity and demonstrated commitment to the goals of financial reporting and the public interest.

At the outset, I suggested that the common interest in preserving and maintaining healthy capital markets far outweighs the concerns or goals of any particular group or special interest. We have to keep focusing on that fundamental tenet and on the goal of assuring that confidence in our capital markets is preserved and that confidence in our financial reporting and disclosure system is restored. Only a continuing commitment to that goal will guarantee that we continue to enjoy the best capital markets in the world.

Thank you again for inviting me. I would be pleased to respond to your questions.