

SEC List of Accounting-Fraud Probes Grows

By MICHAEL SCHROEDER, Staff Reporter of THE WALL STREET JOURNAL
 WASHINGTON—The Securities and Exchange Commission's list of companies under change investigation for possible accounting fraud is growing longer, just as the agency's limited resources are being stretched more than ever before.

SEC officials say they have nearly 260 accounting investigations under way, a big jump from recent years. They aren't just small firms—the chief focus of the SEC's enforcement actions historically. Some 15% of the probes, or about 40, are focusing on companies that are among the nation's 500 biggest.

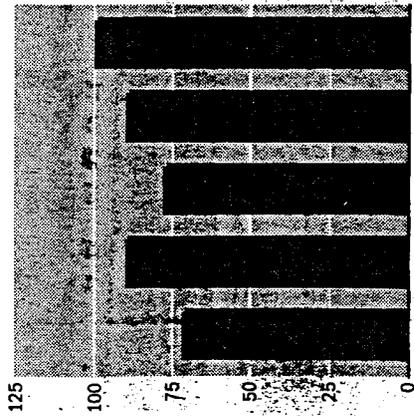
"If we had nothing else to do, the accounting investigations alone could keep us busy for the next five or 10 years," Richard Walker, the SEC's enforcement chief, said in an interview. "The size and magnitude are crushing."

The drumbeat of headline-grabbing accounting scandals, at firms led by Centiant Corp., Sunbeam Corp. and Rite Aid Corp., is also getting attention on Capitol Hill. Lawmakers are beginning to call for more SEC resources to combat fraud. The SEC's division of corporation finance has the staffing to review only a tiny fraction of earnings statements filed by public companies, and until this year it has been swamped by the huge crush of technology initial public offerings of stock.

The current crackdown on accounting misdeeds began in mid-1998. The SEC's then-chairman, Arthur Levitt, beefed up policing efforts, approved new auditor-independence rules and issued new accounting guidance to curb bookkeeping practices used to inflate revenue. Last year, the regulator brought 100 financial-fraud actions, and there has been a 28% increase in accounting-related cases in the past three years.

The most visible indicator of improper accounting—and source of new investigations—is the growing number of restated financial reports. Restatements ballooned to 233 last year, twice the number in 1997,

Finding Fraud
 Financial-fraud actions by the Securities and Exchange Commission



*The SEC brought an unusually large number of actions in smaller accounting matters in 1997
 Source: SEC. For fiscal years ended Sept. 30.

according to a recent study by Arthur Andersen LLP. Of those, only 9% resulted from new accounting methods required by the SEC.

Xerox Corp. is an example of the major companies being scrutinized. In recently restating its results for the past three years, Xerox conceded it had "misapplied" a range of accepted accounting rules in a variety of ways, including improperly using a \$100 million reserve to offset unrelated expenses. To correct the reserve error, Xerox cut its 1998 and 1999 pretax profit by \$100 million, while adding \$6 million to 2000's pretax figure. Xerox's acknowledgment of problems hasn't dissuaded the SEC from conducting a broad inquiry into its accounting practices.

Recently, ConAgra Foods Inc. said its restatement is the subject of an SEC inves-

SEC's List of Probes Of Accounting Fraud Is Growing Longer

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been absorbed during the last two years by the hot IPO market, leaving little time for more random selection of annual reports and other filings," said Robert Bayless, the division's chief accountant.

Accounting-fraud cases, which typically take at least a couple of years to prepare, often rest on complicated and hard-to-prove allegations. The largest cases are handled by the SEC's special accounting-fraud unit staffed by eight attorneys and seven forensic accountants. An additional 60 accountants in Washington and the regional offices also work on cases. Because of limited resources, the SEC doesn't pursue scores of less egregious cases involving violations caused by negligence.

Rep. John LaFalce (D., N.Y.), ranking member of the House financial-services committee, said recently that his panel will look into the accounting-fraud issue and has called for a 200% to 300% increase in the SEC's enforcement staff to bolster oversight. Such an increase would boost the SEC's total \$423 million annual budget this year by as much as \$400 million.

Critics also complain that the SEC would also be less burdened if the accounting industry did a better job of policing auditors, ostensibly the first line of defense in the fight against fraud. Last year, the SEC worked with industry groups to improve self-regulation and the disciplinary peer-review process, but progress has been slow.

At the request of Rep. John Dingell, (D., Mich.), the General Accounting Office, an independent research arm of Congress, has agreed to study whether the various accounting regulatory groups should be replaced by one full-time self-regulatory organization.

—Jonathan Weil
 contributed to this article.

Congress of the United States
House of Representatives
Washington, DC 20515

January 17, 2001

The Honorable David M. Walker
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

In September 1996, the General Accounting Office (GAO) released a seminal two-volume report, The Accounting Profession – Major Issues: Progress and Concerns (GAO/AIMD-96-98), in response to my request concerning the status of recommendations made to the accounting profession over the prior two decades by major study groups to improve accounting and auditing standards and the performance of independent audits under the federal securities laws. GAO's principal finding was that, while the accounting profession had been responsive in making changes to improve financial reporting and auditing of public companies, the actions of the profession had not been totally effective. The most significant weaknesses were found in the areas of auditor independence, auditor responsibility for detecting fraud and reporting on internal controls, public participation in standard setting, the timeliness and relevancy of accounting standards, and maintaining the independence of FASB.

Recent events, in particular last year's bitter fight over maintaining auditor independence, suggest that GAO needs to take another look at the accounting profession. The AICPA's move to block funding for the Public Oversight Board (POB) to conduct the special reviews requested by the Securities and Exchange Commission raises a number of troubling questions about the integrity and effectiveness of the profession's current governance system. Critics also contend that the peer review process is too clubby and too slow and that disciplinary actions are inadequate and ineffective. This is difficult to judge since the process is not transparent, thereby compounding the growing suspicions about ineptitude and collusion.

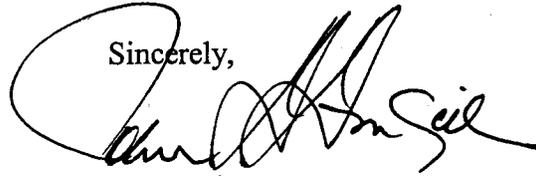
In 1998, the POB appointed a panel of eight members, charging it to thoroughly examine the audit model. In his remarks to the panel at its public hearings, SEC Chairman Levitt asked: "has the accounting profession become so big and complex that perhaps we need a full-time SRO [self-regulatory organization]? Are the alphabet of regulatory bodies ... really workable?" The Panel on Audit Effectiveness (the so-called O'Malley Panel) submitted its report and

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recommendations on August 31, 2000. I am transmitting Chapter 6 – Governance of the Auditing Profession, and requesting that GAO answer Chairman Levitt's question by reviewing the current governance structure, the Panel's proposed system of governance (which appears to call for retention of the current list of entities reporting to an enhanced POB), the status of the profession's response to the Panel's recommendations, and the likelihood that the reforms, if implemented, will be effective.

This is a matter of great importance affecting the reliability of financial statements, and I thank you for your prompt attention to my request.

Sincerely,

A handwritten signature in black ink, appearing to read "John D. Dingell", written over a large, stylized circular flourish.

JOHN D. DINGELL
RANKING MEMBER

Enclosure

cc: The Honorable W. J. "Billy" Tauzin, Chairman
Committee on Energy and Commerce



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May 23, 2001

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
United States House of Representatives

Subject: Auditing Profession's Governance System

Dear Mr. Dingell:

We previously met with your staff to gain a further understanding of your needs concerning your request for a GAO study of the auditing profession's governance system. It was agreed that we would proceed with a design phase given the number of components of the auditing profession's governance system and the broad range of the Panel on Audit Effectiveness' recommendations affecting the governance system. A design phase will enable us to obtain a more complete understanding of the governance system and will allow for the time we will need to access the various senior representatives of each of the system components. The purpose of this letter is to set forth the study objectives and provide you with a completion date for the design phase. We agreed with your staff that the overall objectives of our work will be to:

- obtain an understanding of the structure and operation of the auditing profession's current governance system;
- obtain an understanding of the governance system proposed by the Panel on Audit Effectiveness and how it addresses limitations identified by the Panel;
- determine whether the Panel's recommendations have been accepted, how the system components are working together to implement reforms, their current status, and timeframe for implementation; and
- obtain views of the Panel and senior representatives of each system component regarding critical factors to successful implementation of recommended reforms and any gaps in the recommended reforms.

The design phase will be completed by August 2001. We will remain in contact with your staff, and at the end of the design phase, we will provide you with a projected completion date for the total study. If you should have any questions, please contact Cheryl Clark at (202) 512-9377 or clarkce@gao.gov, or Robert Gramling at (202) 512-6535 or gramlingr@gao.gov.

Sincerely yours,



Jeffrey C. Steinhoff
Managing Director
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ONE HUNDRED SEVENTH CONGRESS

U.S. House of Representatives
Committee on Energy and Commerce
Washington, DC 20515-6115

W.J. "BILLY" TAUZIN, LOUISIANA,
CHAIRMAN

June 7, 2001

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The Honorable David M. Walker
Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Walker:

I am writing to acknowledge receipt of your letter of May 23, 2001, agreeing to my January 17, 2001, request for a General Accounting Office (GAO) study of the auditing profession's governance system. I am generally comfortable with both your study objectives -- some specific comments are set forth below -- and the August 2001 timetable for completion of the design phase of GAO's work.

Under my chairmanship, the Committee on Energy and Commerce's Subcommittee on Oversight and Investigations held over 30 hearings on the accounting profession. The GAO's two-volume 1996 report, The Accounting Profession (GAO/AIMD-96-98), prepared in response to my March 1994 request, remains one of the most-requested reports in GAO history and has made a major contribution to the public debate on important accounting issues. Therefore, I retain my interest in these matters, despite the fact that the Committee on Energy and Commerce no longer has a direct role in them. As you know, a recommendation by House Rules Committee Republicans and the House GOP Conference to shift most of the Committee on Energy and Commerce's historic jurisdiction over securities and exchanges to a newly created Financial Services Committee was narrowly approved by the House earlier this year. I believe that decision was unwise, but these important responsibilities have been shifted. Therefore, I am copying the Chairman and Ranking Member of the Financial Services Committee on this letter as I am sure that they will be interested in your report. On January 20, 2001, Speaker Hastert inserted in the *Congressional Record* at H67 a memorandum of understanding (MOU) to clarify this jurisdictional situation. Among other things, the MOU spells out that the Committee on Energy and Commerce will retain jurisdiction over the issue of the setting of accounting standards by the Financial Accounting Standards Board, thus requiring the two committees to work closely on accounting issues and ensuring that the Energy and Commerce Committee's considerable expertise will continue to be brought to bear on these issues.

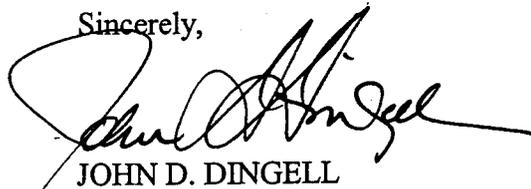
While I am satisfied with the general objectives set forth in your letter, I also request that these specific critical issues be addressed in your report within those objectives:

- The adequacy and effectiveness of the Securities and Exchange Commission's (SEC) oversight of the profession's governance system. *See, e.g.,* enclosed February 9, 2001, letter from SEC Chief Accountant Lynn E. Turner to Public Oversight Board Chairman Charles A. Bowsheer.
- The adequacy and effectiveness of the response of the governance system to the recent string of major accounting debacles, using Livent, Waste Management, MicroStrategy, Cendant, Sunbeam, Rite Aid, and Xerox as case studies.
- The adequacy and effectiveness of the response of the governance system to the sharp increase in misleading and fraudulent accounting. Please update your February 4, 2000 letter report, Review of Reporting Under Section 10A. Given the level of accounting chicanery in the five years since 10A went into effect (1996), one might expect auditor's fraud reports to be piling up at the SEC. However, GAO reported that only six such reports had been filed through December 14, 1999. Are auditors still missing in action?
- The adequacy and effectiveness of the response of the governance system to complaints that "going-concern" clauses, in which auditors raise substantial doubt about a company's ability to stay in business for at least 12 months, were rare among the dot-com companies that shut down or filed for bankruptcy last year. *See, e.g.,* enclosed article " 'Going Concerns': Did Accountants Fail To Flag Problems at Dot-Com Casualties?" Wall Street Journal, Friday, February 9, 2001. The Financial Services Subcommittee on Capital Markets is conducting an inquiry into the Wall Street shills who passed themselves off as "independent" analysts and how their heavily compromised research and recommendations hurt retail investors -- an investigation that I strongly support -- but Wall Street analysts are not the only expert sentries who were asleep at their sentry posts or abandoned them altogether.
- The adequacy and effectiveness of the response of the governance system with respect to oversight, review, and reporting on the quality control systems that accounting firms are supposed to have implemented to ensure compliance with SEC and firm independence regulations. *See, e.g.,* enclosed article "Opening the Books on Corporate Auditors," Washington Post, Sunday, June 3, 2001, on the thorny issues that continue to cast a shadow over the integrity of the profession and its audit function. The SEC's new disclosure requirements are making a tremendous contribution to the public debate on how best to maintain auditor independence in order to safeguard the integrity of our financial reporting system. How has the governance system responded?

The Honorable David M. Walker
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Thank you for your cooperation and attention to my request. The importance of this work cannot be overstated. I look forward to hearing back from GAO at the end of its design phase, and I thank you for the significant contribution that GAO makes to the public interest and the protection of investors.

Sincerely,



JOHN D. DINGELL
RANKING MEMBER

Enclosures

cc: The Honorable W. J. "Billy" Tauzin, Chairman
Committee on Energy and Commerce

The Honorable Michael G. Oxley, Chairman
Committee on Financial Services

The Honorable John J. LaFalce, Ranking Member
Committee on Financial Services