

CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

BILL ANALYSIS

Assembly Bill 2970

Assembly Member Wayne (As amended 4/29/02)

Position:

Support, if amended (Staff recommendation)

Proponents:

CALPIRG, Center for Public Interest Law, Congress of CA Seniors, Consumer Attorneys of CA, Consumers Federation of CA, Consumers Union

Opponents:

None on File

SUMMARY

Assembly Bill 2970 prohibits a California-licensed external auditor for a publicly traded corporation from accepting employment with that corporation or its affiliate, within 24 months of performing an audit or issuing a financial statement on behalf of the corporation.

HISTORY

S. 2004 (Dodd-Corzine) among other things, requires a 2-year cooling-off period for an auditor to serve in a senior financial position for a client.

S. 2460 (Levin) prohibits an accounting firm from auditing its own work and from providing non-auditing services to a company during the course of its audit contract and for two years afterward.

BACKGROUND

As a major investor in domestic equity and fixed-income markets, the California State Teachers' Retirement System (CalSTRS) and its investment managers rely, among other things, on corporate financial statements and independent audits performed by outside accountants in order to make informed investment decisions. Accurate financial statements and reliable independent audits are also vital tools in assessing the true value of CalSTRS' investments.

The failure of Enron and the role their independent auditor, Arthur Andersen, played in it, exposed the inadequacy of safeguards to protect investors from questionable accounting practices and major conflicts of interest between auditors and their audit clients. While some former Arthur Andersen employees worked for Enron at the time of Enron's failure, the outcome of the accounting firm's work for another audit client, Waste Management, Inc., illustrates how the practice of auditors becoming employees of their former clients can call into question the accuracy of financial reports certified by external auditors.

In February 1998, Waste Management restated its pre-tax earnings, reducing them by \$1.43 billion for the period from 1992 through the third quarter of 1998 to correct a previous accounting error. A subsequent Securities and Exchange Commission (SEC) investigation found that Arthur Andersen had certified false and misleading audit reports of Waste Management's financial statements from 1993 to 1996. The accounting firm settled with the SEC in June 2001 without admitting any wrongdoing by paying \$7 million in civil penalties. While the settlement order alleged various abuses of generally accepted accounting principles, it also noted that until the time of the restatement, every chief financial or accounting officer in Waste Management's tenure as a public company had previously been an auditor for Arthur Andersen. In fact, 14 former Arthur Andersen employees served in key financial and accounting positions for Waste Management during the 1990's.

Responsibility for the oversight and setting of standards for auditors and the accounting industry is spread among numerous state and federal government agencies and professional organizations. The SEC sets disclosure requirements for securities that are bought and sold in U.S. markets and requires an independent accounting firm audit corporate financial reports annually. The SEC can fine and/or bar accountants from auditing publicly traded companies if they have violated SEC disclosure rules.

The SEC also has the statutory authority to set accounting rules. It has, however, delegated this task to the non-profit Financial Accounting Foundation (FAF). The FAF is run by 16 trustees, the majority of whom are accounting industry representatives. The FAF oversees, funds, and selects the members of the Financial Accounting Standards Board, a 7-member body that sets the rules for how public companies keep their financial records. The American Institute of Certified Public Accountants, a professional society, also performs a peer-review function through its ethics division and various oversight committees. However, the most severe disciplinary action imposed by the AICPA is to expel a member from the organization for unprofessional conduct.

Besides regulating most forms of corporate conduct, individual states license accountants and set practice standards. Through statute and regulations, the California Board of Accountancy determines what services an accountant or accountancy corporation licensed in the state may provide to a client, specifies what constitutes a conflict of interest, and establishes disclosure requirements and other rules of professional conduct. It also has the authority to strip an accountant of his or her license for violating these laws and regulations. Recently, the Board of Accountancy has made matters related to the audit of public companies a priority because the Members of the Board believe abuses in area represent the greatest danger to the consumer.

In April 2002, the Board of Accountancy released its Report and Recommendations on Audit Standards and Practices, which addressed four key areas: 1) record retention and working paper documentation; 2) the influence of non-audit services on auditor independence and objectivity; 3) auditors becoming employees of their clients; and 4) auditor's responsibility to detect and report errors and irregularities. The report included proposed legislation that would prohibit accountants from taking a job with a former audit client if they had performed auditing work for

the client within the last two years, depending on the extent of their involvement in the audit and the nature of the position offered.

According to the Board's report: "As technically skilled audit personnel become exposed to their client's business operations through the audit process, they become potentially valuable employees to the client. These relationships may lead to lucrative employment opportunities in positions such as Controller or Chief Financial Officer." The report went on to note that conflicts arise when an auditor's objectivity is compromised by promises or expectations of obtaining a high-level job with the audit client, or out of consideration for a former coworker that now works for the audit client.

Proposals dealing with issues of investor protection, accounting oversight and corporate governance continue to circulate in Congress, state legislatures, the SEC, and self-regulating industry groups. According to CalSTRS' Washington counsel, a consensus on the proper elements of a new regulatory framework has not formed, and the prospects for passage of reform legislation at the federal level remain unclear.

DISCUSSION

Assembly Bill 2970 prohibits a state licensed accountant who performs independent auditing services for a publicly traded corporation from accepting employment with that company or its affiliate within 24 months of issuing a financial statement, if the accountant:

- Participated in the audit process in a position ranging from the person in charge of fieldwork through the partner managing the engagement.
- Would be able to exercise significant authority over the corporation's accounting or financial reporting.

According to the author, AB 2970 would protect an external auditor's independence and serve consumers' best interests by creating a "cooling-off period" that would prohibit employment with a former audit client for 24-months following any significant involvement in providing audit services.

In effect, this bill authorizes the California Board of Accountancy to discipline a licensed accountant who violates the terms of the employment ban. While the Board of Accountancy recommends a two-year ban, the task force it charged with drafting the original report recommended a one-year cooling-off period. The Board rejected that proposal, concluding that two years would provide greater consumer protection. Because any accountant or firm that works in California or serves California clients must obtain a license from the Board of Accountancy and a licensee working for a California client in another state must continue to follow California law, AB 2970 applies to any accountant who works in California or audits a California company. It does not affect, of course, the activities of companies and auditors operating outside of

California. As a result, adoption of this proposal at the federal level would be of more widespread effectiveness.

With the significant change in the role of external audit firms, and internal audit/financial reporting, the CalSTRS Investment Committee and its Subcommittee on Corporate Governance has approved an extensive plan to promote financial market reforms, including strengthening standards related to corporate audit committee accountability, external auditor independence and disclosure. CalSTRS supports a one-year cooling-off period regarding the employment, as either Staff or a Member of the Board of Directors, of persons on the companies' external audit team or senior management of the external audit firm. The Investment Committee has amended the CalSTRS Statement of Investment Responsibility to reflect the change, allowing CalSTRS, as a shareholder, to vote against the selection or retention of an external auditor or board member that violates this policy.

The two-year ban imposed by AB 2970 is more restrictive than CalSTRS policy and would limit employment opportunities for those auditors affected. A one-year cooling-off period is consistent with employment restrictions placed on former state officials, which prevent them from receiving compensation for communicating with their former agency in an attempt to influence agency decisions. A similar one-year ban is placed on legislators and other elected state officers.

FISCAL IMPACT

Benefit Program Costs – None

Administrative Costs – None

RECOMMENDATION

Support, if amended to limit the “cooling-off period” to one year. This is consistent with the CalSTRS Investment Committee’s position, as well as the System’s implementation plan regarding financial market reform. It would, within California, help maintain an independent auditor’s duty to investors that need reliable information on the financial state of publicly traded corporations without unreasonably restricting career opportunities for accountants. A federal limitation, however, is a preferred approach.