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ENRON PROVES IT IS TIME FOR TERM LIMITS FOR AUDITORS

The Enron case demonstrates that it is time to change the practice of a 'permanent engagement' between a public company and its auditors. What the financial community needs are **Term Limits** applied to all firms raising funds in the public capital market. Term Limits will guarantee continual **peer review** of public companies' audits. That will markedly raise the barrier against unexpected financial developments or outright fraud being hidden by complex accounting.

The incumbent auditor, knowing that it will be shortly succeeded, will be loathe to allow anything that might cast doubt on its motives or competence. The incoming auditor will want to be assured there are no financial land mines that could explode on its watch. The risks to both are substantial. Moreover, we might expect that the successor will require a 'shadow year,' during which it tracks the incumbent auditor prior to its full engagement. This may not prevent every financial fraud, but it will make the perpetuation of a continuing fraud more difficult and much riskier and it will put management on notice that transparent accounting is to be the rule, not the exception. That is precisely what a worldwide, public capital market should have.

Accounting companies and their clients may object to the likely rise in auditing costs, but higher costs should raise auditing standards. It will now be profitable for auditing companies to use highly valued partners on audits instead of consulting. It will encourage specialized auditing firms and allow their access to large accounts. Markets may produce some surprising savings and quality! Because auditing will be more expensive, the clients themselves will find it in their interest to tighten their own internal auditing process to insure that management is not surprised either by the incumbent auditor or the incoming auditor.

Previously, the SEC tried to separate audit and consulting functions carried on by a single accounting firm on the grounds that it represented a material conflict of interest. In the pre-Enron world, auditing appears to have been cross-subsidized by consulting, its more glamorous partner. With short, term limits, cross-subsidization will be a much less profitable strategy, particularly when peer review will force a higher quality of management to be used in the audit process.

Two major points need to be resolved initially: term length and term length's relation to corporate size; second, what special provisions should apply to private firms going public for the first time. The simplest version would be to choose a uniform term for all firms, say five years, and apply it to all firms that raise capital from the public in any form. Some thoughtfulness should be exercised in applying this standard to firms going public for the first time. This is a question of what risk is incurred if term limits did not apply prior to an IPO. The market may require it anyway once Term Limits become the norm. These details need study, but the principle of auditor rotation is sound and right for our times. It ought not to be delayed by excessive details.

The SEC should be able to implement this change immediately under its existing mandate but will surely want to throw open the issue to public hearings. As a preview, consider some of the objections that may arise. Firms will object that this raises their cost in acquiring public capital. Perhaps, but the provision of a public good requires the imposition of costs. The public has to pay for the costs of a financial disaster. It ought to get something back on its investments in regulation. The offset to this is that higher audit prices should stimulate far more probing audits. Legislators may object because they show a latent mistrust of using market incentives to do a job that legislators think that only they can do. Complex legislation doesn't stop fraud or

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chicanery or finding 'legal' ways around the restrictions. The IRS knows that even if Congress forgets it, repeatedly. Class action lawyers will object because class action securities fraud cases have become a big business. No matter that these case show only one real winner---the class action lawyers. If the lawyers object to term limits for auditors, consider that as a strong recommendation for the policy change.

In the end, we get what we pay for and the public does not get much from the current system of 'certification.' Some have argued that we should dispense with an auditing requirement completely and let the capital market differentiate 'good books from bad books' all on its own. The only objection to such a remedy is that it is highly unlikely that our regulatory society is prepared to de-regulate that far. In the meantime, term limits will be a huge improvement. It is time to move to a more transparent system of accounting information for an information age.

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