

**TESTIMONY****THE COMMITTEE ON GOVERNMENTAL AFFAIRS  
UNITED STATES SENATE****OPENING STATEMENT BY ARTHUR LEVITT****JANUARY 24, 2002**

Mr. Chairman, Senator Thompson, Members of the Committee:

Thank you for the invitation to share my thoughts on the failure of Enron and its implications for our financial markets.

Today, there is an emerging crisis of systemic confidence in our markets. What has failed is nothing less than the system for overseeing our capital markets. We have an opportunity to repair trust in those on whom investors depend, and in the process, trust in the numbers that are the backbone of our capital markets. But our response must be comprehensive. Healthy and resilient financial markets depend on the accountability of every one of its key actors – managers, auditors, directors, analysts, lawyers, rating agencies, standard setters, and regulators.

Enron's collapse did not occur in a vacuum. Its backdrop is an obsessive zeal by too many American companies to project greater earnings from year to year. When I was at the SEC, I referred to this as a "culture of gamesmanship" –

...a gamesmanship that says it's okay to bend the rules, tweak the numbers, and let obvious and important discrepancies slide...

...a gamesmanship where companies bend to the desires and pressures of Wall Street analysts rather than to the reality of numbers...

... where analysts more often overlook dubious accounting practices and too often are selling potential investment banking deals...

...where auditors are more occupied with selling other services and making clients happy than detecting potential problems...

...and where directors are more concerned about not offending management than with protecting shareholders.

Any reforms must recognize the importance of gatekeepers in safeguarding the interests of investors and the fundamental need to preserve and enhance these gatekeepers' independence. These steps are certainly not a panacea, but we must begin to reinvigorate the financial checks and balances.

First, we must better expose Wall Street analysts' conflicts of interest. For years, we've known that analysts' compensation is tied to their ability to bring in or support investment banking deals. In early December, with Enron trading at 75 cents a share, 12 of the 17 analysts who covered Enron, rated the stock either a hold or buy.

Two years ago, I asked the New York Stock Exchange and the National Association of Securities Dealers to require investment banks and their analysts to disclose clearly all financial relationships with the companies they rate. That rulemaking -- still not finalized -- should go further and mandate that analysts disclose how their compensation is affected by their firm's investment banking relationships. And Wall Street's major firms -- not its trade group -- need to take immediate steps to reform how analysts are compensated. As long as analysts are paid based on banking deals they generate or work on, there will always be a cloud over what they say. Analysts also should not be allowed to trade the stock of any company for which they have issued a recommendation in the last 30 days.

Second, company boards often fail to confront management with tough questions. Stock exchanges, as a listing condition, should require at least a majority of the directors on company boards to meet a strict definition of independence. That means no consulting fees, use of corporate aircraft without reimbursement, support of director-connected philanthropies, or other seductions. In Enron's case, at least three so-called independent board members would have been disqualified under this test of independence.

Third, many accounting rules need to be updated to better reflect changing business practices to give investors a better understanding of the underlying health of companies. Because the Financial Accounting Standards Board is funded and overseen by accounting firms and their clients, its decisions are agonizingly slow. This well-meaning group must defend itself as well from congressional pressure, which is often applied when powerful constituents hope to undermine a rule that might hurt their earnings. FASB's funding should be secured not just through the accounting firms and corporations, but also a number of market participants -- from the stock exchanges to banks to mutual funds. And the Financial Accounting Foundation, which chooses FASB's members, should be composed entirely of the best qualified members -- not merely those representing constituent interests. The FASB should then be able to focus more on getting the standards right, and avoiding delays and compromises that ill serve investors.

Let me turn briefly to probably the most urgent area of reform. Like no other, the accounting profession has been handed an invaluable, but fragile, franchise. From this Federal mandate to certify financial statements, the profession has prospered greatly. But as an edict for the public good, this franchise is only as valuable as the public service it provides, and as fragile as the public confidence that gives it life.

It's well past time to recognize that the accounting profession's independence has been compromised. Two years ago, the SEC proposed significant limits on the types of consulting work an accounting firm could perform for an audit client. An extraordinary amount of political pressure was brought to bear on the Commission. We ended up with the best possible solution -- given the realities of the time.

I would now urge -- at a minimum -- that we go back and reconsider some of the limits originally proposed -- namely a prohibition on the auditor designing or installing information technology systems and performing the internal audit. Auditors should also be barred from consulting on how to structure transactions, such as the kinds of Special Purpose Entities that Enron engaged in. This type of work only serves to help management get around the rules.

I also believe that the audit committee – not company management – should pre-approve all other consulting contracts with the audit firm. Such approval should be granted rarely, and only when the audit committee decides that a consulting contract is in the shareholders' best interests. Lastly, I propose that serious consideration be given to requiring companies to change their audit firm – not just the partners -- every 5-7 years to ensure that fresh and skeptical eyes are always looking at the numbers.

More than three decades ago, Leonard Spacek, a visionary accounting industry leader, stated that the profession couldn't "survive as a group, obtaining the confidence of the public...unless as a profession we have a workable plan of self-regulation." Yet, all along the profession has resisted meaningful oversight. We need a truly independent oversight body that has the power not only to set the standards by which audits are performed, but also to conduct timely investigations that cannot be deferred for any reason and to discipline accountants. And all of this needs to be done with public accountability – not behind closed doors. To preserve its integrity, this organization cannot be funded, in any way, by the accounting profession.

The rise of the baby boom generation, changing retirement patterns and markets that sometimes defied the laws of gravity brought more and more first time investors into the markets. These are our friends and neighbors, whose hopes and aspirations became inextricably linked to the health and resiliency of our markets. We assault those dreams if company executives sell out shareholder faith and if those purporting to be independent are anything but. Enron, like every other financial failure before it, proves that investors bear the ultimate cost. It's time to repair what has been lost.

Thank you very much.

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