CFA Consumer Federation of America

Testimony of
Travis Plunkett, Legislative Director
Consumer Federation of America

Before the
Subcommittee on Consumer Affairs, Foreign Commerce and Tourism
of the Senate Committee on Commerce, Science and Transportation

Regarding the Consumer Impact of State Pension Fund Investments
in Enron Corporation

May 16, 2002

Good afternoon. I am Travis Plunkett, legislative director for the Consumer Federation of America. CFA is a non-profit association of more than 290 organizations founded in 1968 to advance the consumer interest through advocacy and education. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is one of our top priorities.

I would like to thank Chairman Dorgan, Ranking Member Fitzgerald and the other members of the Subcommittee for the opportunity to offer our comments on this extremely important issue. When Enron suddenly collapsed last year amid allegations of accounting fraud and misleading financial disclosures, the magnitude of the damage was difficult to comprehend. As the dust has begun to settle, it appears that investors have lost roughly $93 billion dollars.[1] To put that in perspective, this one case has caused losses that are nearly equal to the estimated $100 billion in investor losses resulting from faulty, misleading, or fraudulent audits over the previous six years.[2] And that six-year total dwarfs similar losses in previous years. It is no wonder, then, that the Enron-Andersen fiasco has prompted Congressional, regulatory and judicial investigations into what went wrong and how to prevent such a debacle in the future.

Early attention focused on the tragic cases of the Enron employees and retirees, who saw their 401(k) account balances dwindle nearly to zero because of their heavy concentration in company stock. It soon became clear that many mutual funds and pension funds had also invested heavily in Enron. As a result, workers who never heard of the energy giant had their retirement savings put at risk by Enron's practice of hiding debt and inflating earnings and Arthur Andersen's willingness to let them.

Among the victims were public and private pension funds. One media account put the total of Enron losses in just 31 public retirement funds at a little over $1.5 billion.[3] Others have estimated that total losses in state pension funds are closer to twice that amount.[4] Pension managers, while outraged at the losses and at the apparent fraud that led to them, have nonetheless been quick to assure the public that pension benefits are not at risk. Diversification rules have guaranteed that, in most cases, losses

---

[1] "The Accountants' War," by Jane Mayer, *The New Yorker*, April 22 - 29, 2002, pg. 64.

[2] Ibid. The article cites an estimate by former SEC Chief Accountant Lynn Turner.

[3] "Enron's Many Strands: Fallout; The Enron Scandal Grazes Another Bush in Florida," Leslie Wayne, *New York Times*, January 27, 2002.

[4] "The Enron Wars," by Marie Brenner, *Vanity Fair*, April 2002.

totaled less than one percent of fund holdings, though concentrations are somewhat higher at certain individual funds.

An unknown portion of those losses resulted from the practice of index investing which is common among pensions, and which nonetheless remains a sound strategy for reducing risk. Of greater concern are the funds whose private money managers invested considerable fund assets in Enron stock, even after signs had emerged that this was a company in serious financial distress. Money managers who are paid with taxpayer money to manage public funds have a responsibility, arguably greater even than the fiduciary duty that all money managers owe their clients, to ensure that they make prudent investment decisions based on thorough and sound research. It is certainly appropriate for Congress to explore whether those standards were met in this case.

Still, just about everyone appears to have been fooled by Enron's false picture of financial health--from the media, which sang its praises, to the bankers, who loaned the company money, to the research analysts, who touted the stock, to the professional money managers who bought it. While Enron was clearly a speculative investment once the stock price had entered freefall, those who bought during its astronomical rise had little reason to think they were taking undue risks.

There are many lessons to be learned from Enron. Lessons about the fundamental dysfunction of a system that rewards top executives with millions or even billions of dollars in profits while rank and file workers and shareholders are taken to the cleaners. Lessons about the dangers of relying on private accounts to fund retirement and the need to enhance protections for those accounts. Lessons about the failure of securities analysts to provide reliable research, particularly when their firm has, or hopes to have, an investment banking relationship with the company being analyzed. Lessons about the gross inadequacy of Securities and Exchange Commission resources to police the nation's financial markets.

But the central, inescapable lesson from Enron is that the market can't function without reliable information. As this committee's investigation today makes clear, even the most sophisticated institutional investors can be duped when corporate executives use financial disclosures to mask, rather than reveal, the true financial condition of the company. When the professionals can so easily be duped, the average retail investor doesn't have a chance.

The beauty of our system of investor protections, of course, is that it was designed with just this potential for misleading behavior in mind. It was designed to protect investors, not just when corporate executives are honest, forthcoming and aboveboard, but also when they are greedy, unethical and deceptive. That's why we have standardized rules that govern what companies have to disclose and how. It's why the SEC reviews financial disclosures for accuracy, completeness, and compliance with appropriate accounting rules. It's why rating agencies pore over massive amounts of information to determine the creditworthiness of companies that issue debt. It's why corporate boards have audit committees, made up primarily of independent board members, to supervise the audit. And, first and foremost, it is why we require an outside, independent auditor to review and approve a company's financial statements.

In the Enron case, as in others before it, all of those safeguards failed. The accounting rules failed to produce an accurate picture of Enron's finances, even where the company complied with the rules. The corporate board failed to ask tough questions, challenge questionable practices, or require more transparent disclosure. The auditors signed off on financial statements that clearly presented a misleading picture of company finances. The SEC had not reviewed the company's financial statements in several years. The credit rating agencies and securities analysts that investors rely on for an expert assessment of the company's prospects failed to provide any advance warning of possible trouble.

All of these issues deserve congressional and regulatory attention. But none is more crucial than the failure of the independent audit to serve its public watchdog function. Independent auditors are our first line of defense against misleading disclosure and accounting fraud. But as the rising tide of audit disasters in recent years makes clear, the system of independent audits is broken. It seems to work fine when companies are honest, and it is our good fortune that so many companies today maintain their commitment to providing investors with full and accurate information about their operations. But when the independent audit is really needed, when the company is both intent on deceiving investors about its true financial condition and powerful enough to assert itself, some auditors are all too willing to appease the client, devise justifications for the misleading disclosures, or, worse, earn millions helping to design structures and transactions with no purpose but to hide the company's true financial condition.

Investors burned by the Enron collapse and witness to a rising tide of failed audits are understandably skeptical about the ability of the system to produce reliable information. That doubt imposes costs on the system that harm not just those companies that engage in misleading disclosure, but all companies that raise capital in the securities markets. Unless Congress fixes this central problem, investors will continue to harbor those doubts, and with good reason.

A number of bills have been introduced with the intent of restoring integrity to the outside audit by enhancing the independence of auditors, improving regulatory oversight of audits, and improving the ability of corporate boards to supervise the audit. Just last month, the House passed a bill, H.R. 3763, that claims to do all that, though frankly it is in our view a waste of the paper it is printed on. At best, it codifies the status quo. At worst, it would actually make it harder for the SEC to create an effective independent regulator for the auditing profession.

Hopes for real reform now rest with the Senate. Several bills have been introduced or are being drafted which could provide for truly independent audits, effective oversight of the audit by corporate boards, and a strong new regulator to set and enforce standards for the conduct of those audits. On auditor and corporate board independence, the gold standard is S. 2056, a bill introduced by Sen. Bill Nelson and Sen. Jean Carnahan. In addition, Sen. Paul Sarbanes and the Banking Committee will soon be marking up legislation that would, among other things, create a very strong, effective, independent new regulatory body for auditors, enhance the independence of the Financial Accounting Standards Board, and establish additional corporate governance reforms. Taken together, these two bills would provide a very strong package of reforms.

The remainder of this statement describes in more detail what we view as the key steps needed to restore integrity to and confidence in the capital markets, how these and other legislative proposals would address these issues, and the changes we recommend to make the legislation more effective.

I. Restore real independence to the independent audit.

The whole point of requiring public companies to obtain an independent audit is to ensure that outside experts have reviewed the company books and determined that they not only comply with the letter of accounting rules but also present a fair and accurate picture of the company's finances. Auditors have profited handsomely over the years from performing this important public watchdog function. Unless the auditor is free of bias, brings an appropriate level of professional skepticism to the task, and feels free to challenge management decisions, however, the audit has no more value than if the company were allowed to certify its own books.

A. The independent audit has never been more important.

The independent audit is arguably more important today than it has been at any time since the requirement was first imposed in the 1930s. More than half of all American households today invest in public companies, either directly or though mutual funds. They do so primarily to save for retirement. As a result, their financial well-being later in life is dependent on the integrity of our financial markets.

At the same time, corporations today are under great pressure to keep their stock prices on a smooth upward trajectory. As one writer has noted:

> No longer is a higher stock price simply desirable, it is often essential, because stocks have become a vital way for companies to run their businesses. The growing use of stock to make acquisitions and to guarantee the debt of off-the-books partnerships means, as with Enron, that the entire partnership edifice can come crashing down with the fall of the underlying stock that props up the system. And the growing use of the stock market as a place for companies to raise capital means a high stock price can be the difference between failure and success.[5]

Both because they will be judged by the company's success and because much of their compensation often takes the form of stock options, corporate managers have a strong incentive to

[5] "Deciphering the Black Box: Many Accounting Practices, Not Just Enron's, Are Hard to Penetrate," by Steve Liesman, *Wall Street Journal*, January 23, 2002, pg. C1.

manage their earnings in order to present the picture of steadily rising profitability that Wall Street rewards. And, as the Enron case clearly illustrates, murky accounting rules that rely on numerous subjective judgments make it easier than it should be to construct a false picture of financial health. The Enron case also makes it abundantly clear that an auditor whose independence is compromised may be all too willing to sign off on financial statements that conceal, rather than reveal, the company's true financial state.

B. Many factors undermine auditor independence.

Because of the central importance of the outside audit in upholding the integrity of our system of financial disclosure, the Supreme Court has stated that this "public watchdog function demands that the accountant maintain total independence from the client at all times.'[6] Unfortunately, accountants have been unwilling to accept the responsibility for maintaining their independence that goes with the privilege of performing audits. This lack of independence takes several forms.

Much of the debate over auditor independence has focused on their provision of consulting and other non-audit services to audit clients. Since the mid-1990s, most of the big firms have dramatically increased their sales of such services to audit clients, despite the clear conflict-of-interest that this creates. Today, virtually all big companies receive both audit and non-audit services from their accountants, and they typically pay between two and three times as much for the non-audit services as they do for the audit itself. In some cases, the disparity between audit and non-audit fees is far greater. Furthermore, consulting services increasingly drive the profitability of accounting firms. If an auditor's tough questioning of management were to threaten its more profitable consulting arrangement, that auditor might expect to face tough questioning of his own from higher ups at the firm.

Other factors also undermine auditor independence. The lack of independence starts with the fact that auditors are hired, paid, and can be fired by the audit client. This basic conflict is exacerbated by the general lack of client turnover. Auditors may reasonably expect to keep the same client for 20, 30, even 50 years. The prospect of such long relationships make it that much harder for the auditor to challenge management aggressively, not only because of the friendships that are likely to develop up between auditors and company management, but also because they risk losing this seemingly endless stream of future audit (and consulting) revenues if their tough stance on the numbers causes them to lose the client.

Another problem that clearly needs to be addressed is the revolving door that all too often exists between auditors an their audit clients. This was true at Enron, it was true at Waste Management, and it is a common feature in many failed audits. A constant flow of personnel from the auditor to the audit client helps to create an environment in which external auditors are viewed as just another part of the

---

[6] U.S. Supreme Court, *United States v. Arthur Young*, 1984.

corporate family. Such intimacy is not conducive to true independence.

C. Comprehensive reforms will be needed to restore auditor independence.

Legislation to restore independence to the audit must tackle all these issues. It must lessen the influence audit clients have by virtue of the fact that they hire, pay, and fire the outside auditor. It must limit the financial dependence of the auditor on the audit client that results from providing both audit and non-audit services to the same firm. And it must close the revolving door that all too often exists between companies and their auditors.

The Nelson-Carnahan bill provides just this sort of comprehensive approach to reform. S. 2056 would require mandatory rotation of auditors every seven years. It would strictly limit the non-audit services an audit firm may provide to those that are closely related to the audit and pose no conflict-of-interest. Tax consulting services are excluded from the ban, but would have to be pre-approved by the audit committee of the board. Finally, the bill proposes a one-year cooling off period before an audit firm employee could accept employment in a management or policymaking position at a company that is an audit client of the firm.

The mandatory rotation requirement is key to diminishing the basic conflict that exists because the auditor works for the audit client. First, an audit firm that knows it has a limited term of engagement has far less to lose by challenging management than one that expects to retain the client indefinitely. The knowledge that a rival firm will soon be evaluating the books should also provide an incentive to get it right. And the new auditor would have no reason to hesitate in setting past mistakes right. Some have argued against this requirement by citing research that shows a preponderance of audit failures occur in the first year of the audit, but it is an inescapable fact that investors have suffered their largest losses in audit failures in cases like Enron, Waste Management, Microstrategy, Cendant, Rite Aid, Sunbeam, Lucent, and others that involved ongoing, often very long-term audit relationships.

The Nelson-Carnahan bill would further lessen the auditor's financial dependence on a single audit client by strictly limiting the non-audit services they may provide. We strongly support this approach. The argument put forward by opponents of a consulting ban -- that providing consulting services makes auditors less financially dependent on the audit itself and, thus, more independent -- is absurd on its face. It assumes that the audit firm can challenge management to the point of losing the company as an audit client, but still retain the more lucrative consulting services. The real world simply doesn't work that way.

Our one suggestion for improving the bill in this area is would be to add a requirement that audit committees pre-approve all non-audit services. This would clarify that audit committees are directly responsible for determining what non-audit services are permissible based on a determination that they are "directly related to the audit" and pose no conflict-of-interest.

Finally, we support the cooling off period in the Nelson-Carnahan bill as a good first step, though we would like to see it strengthened. The bill effectively addresses the clearly inappropriate practice of members of the audit team applying for work at an audit client while engaged in conducting the audit. A further problem is the conflict that arises when certain high placed executives responsible for over-seeing the preparation of financial disclosures are former partners or employees of the audit firm. To address this problem, we advocate adding a requirement that a company change auditors if it hires an individual who has worked at its current audit firm during the past three years to fill certain key positions, such as chief executive officer, chief financial officer, or chief accounting officer.

Although it offers a less comprehensive package of auditor independence reforms than is contained in the Nelson-Carnahan bill and than we believe is needed, the draft bill being circulated by Sen. Sarbanes nonetheless offers some progress in this area. First, it would expand the list of prohibited non-audit services to reflect the definitions in the original SEC rule proposal under Levitt. All of those definitions were watered down in the final rules, not just those pertaining to internal audits and financial system design and implementation. In addition, the Sarbanes bill would require audit committee pre-approval of non-audit services. This would clarify that audit committees have the ultimate responsibility to ensure the independence of the audit. We can only hope that they have learned the lesson of Enron and other previous audit failures, that auditors who have millions of dollars at stake in consulting contracts are not the independent arbiters of financial disclosure that our system demands. The bill would also enhance the ability of audit committees to oversee the audit by requiring auditors to make separate reports on key issues to the committee.

Unlike the Nelson-Carnahan bill, the Sarbanes draft does not require mandatory rotation of audit firms. Instead, it calls for a General Accounting Office study of the issue and requires rotation of audit team members on a five-year basis. Like the Nelson-Carnahan bill, it would impose a one-year cooling off period. However, the cooling off period in the Sarbanes draft applies to only a few top positions at the audited company. We believe that provision should be expanded as outlined above.

Both Senate bills are significantly stronger than the House bill on the issue of auditor independence. The Nelson-Carnahan bill in particular offers the comprehensive package of reforms that we believe the current crisis of investor confidence demands.

II. Provide effective regulatory oversight of auditors.

Auditors' lack of independence makes them vulnerable to pressures to sign off on questionable accounting practices. This problem is exacerbated by the fact that they face relatively little fear of sanctions if they do so. Although a variety of groups including the SEC, state accountancy boards, and the AICPA all have power to discipline auditing firms and their employees for ethical and legal infractions, even serious violations typically receive little more than a hand slap.

A. The current "regulatory" system is under-funded, ineffective, and captive of the *industry.*

In theory, the real authority over auditors lies with the SEC. It has the power to bar individuals and firms from auditing publicly traded companies. It also has authority to impose potentially substantial fines. In reality, however, the agency does not routinely review how auditors perform their audits, and instead delegates that responsibility to the AICPA's SEC Practice Section and the Public Oversight Board. Furthermore, according to past agency officials, the SEC only has the resources to tackle the very worst cases of alleged accounting abuse, and it typically settles even those cases without an admission of wrongdoing. It took no action, for example, against a former Arthur Andersen managing partner whom the SEC said had allowed persistent misstatements on Waste Management's financial reports to go uncorrected.[7] Similarly, a PricewaterhouseCoopers partner ordered by the SEC in 1999 to cease and desist violating securities laws didn't even lose his position as lead partner on the audit in question.[8]

The AICPA sets audit standards, the Public Oversight Board (POB) oversees a peer review system to determine compliance with those standards, and the AICPA has disciplinary authority over its members for violations. According to former SEC chief accountant Lynn Turner, however, the audit standards adopted by AICPA are "so general that, as a practical matter, it's difficult to hold anyone accountable for not following them."[9] The POB,[10] which is responsible for overseeing the industry's peer review system and other ethics investigations, is notable for having never sanctioned a major accounting firm in its 25 years of existence, even when peer reviews have uncovered serious short-comings in a firm's audit procedures.[11] Furthermore, the POB can't act against a firm without the AICPA's cooperation. In one case where, at the SEC's prompting, the POB did attempt to investigate possible stock-ownership violations at the major firms, the AICPA refused funding for and cooperation with the investigation, which as a result went nowhere.[12]

Even if they had the will to act, the AICPA and POB are also hampered by a severe lack of investigative authority. They cannot subpoena evidence or compel testimony, for example, and as a

---

[7] "Deciphering the Black Box: Many Accounting Practices, Not Just Enron's, Are Hard to Penetrate."

[8] Ibid.

[9] "After Enron, New Doubts About Auditors," by David Hilzenrath, *Washington Post*, December 5, 2001, pg. A1.

[10] The POB recently voted itself out of existence in protest over SEC Chairman Harvey Pitt's proposal to create a new self-regulatory body for the accounting industry.

[11] "Peer Pressure: SEC Saw Accounting Flaw," by Jonathan Weil and Scot J. Paltrow, *Wall Street Journal*, January 25, 2002, pg. C1.

[12] The case is described both in a May 12, 2000 letter from Rep. John Dingell (D-MI) to the SEC Chairman Arthur Levitt and in a May 22, 2000 *Business Week* editorial, "Why the Auditors Need Auditing."

result are forced to rely on the public record in building a case. If the SEC settles a case confidentially, with neither a public ruling nor an admission of guilt, there is no public record the AICPA or POB can rely on in bringing its own enforcement actions. Where the AICPA does act, its maximum sanction is expulsion from the organization, which can have serious consequences, but does not prevent the individual from continuing to practice.

In reality, however, AICPA has shown itself to be a reluctant regulator. According to a *Washington Post* investigation, the AICPA took disciplinary action in less than a fifth of the cases in which the SEC imposed sanctions over the past decade. Even when AICPA determined that SEC-sanctioned accountants had committed violations, they closed the vast majority of ethics cases without disciplinary action or public disclosure.[13] The disciplinary action AICPA was most likely to take, according to the *Post* investigation, was issuing a confidential letter directing the offender to undergo additional training. Ethics committee member Dave Cotton has reported seeing "ethical lapses that resulted in millions of dollars of losses getting punished with as little as *16 hours* of continuing education."[14]

B. A complete overhaul of the system is needed.

There seems to be general agreement that a new, independent regulator is needed to oversee the auditors of public companies. We agree that such a body, operating under SEC oversight, could offer a vast improvement over the current system. To do so, however, it must be entirely independent of the accounting industry, be adequately funded, and have extensive rule-making, standard-setting, investigative, enforcement, and sanction authority.

As one former SEC official observed to *Business Week*, "The accounting profession is very creative at taking over every group that's ever tried to rein it in."[15] For a self-regulatory organization (SRO) to have any credibility, therefore, its independence must be unassailable. At a minimum, a super majority of board members must have no ties whatsoever to the accounting industry, and they must be subject to conflict-of-interest rules that prohibit ties to the industry for a significant period before they join the board, while they are on it, and after they leave it.

Just as important, funding for the organization must be totally free from threat by industry members. The AICPA and the Big Five firms have shown their willingness to use strong-arm tactics to head off potentially embarrassing investigations in the past. They must have no such hold over any SRO

[13] Ibid.

[14] "CPAs (and I'm One) Can Reverse Their Losses," by Dave Cotton, *Washington Post*, January 27, 2002, Op Ed.

[15] "Accounting in Crisis," by Nanette Byrnes with Mike McNamee, Diane Brady, Louis Lavell, Christopher Palmeri and bureau reports, *Business Week*, January 28, 2002, pg. 44-48.

that is created to provide enhanced oversight in the wake of the Enron-Andersen disaster. Funding must also be adequate to support an aggressive oversight program.

Once its independence is guaranteed, the new regulator must be endowed with full authority for overseeing the conduct of audits of public companies. This includes authority for setting auditing standards. Both the bill that has passed the House and the proposal put forward by SEC Chairman Harvey Pitt would leave authority for developing auditing standards with the AICPA. This is unacceptable. Rules on how to conduct audits clearly need to be strengthened and clarified. That is the job of an independent regulator, not an industry trade association. The AICPA, as a trade association, should have no government-recognized role in the regulatory process.

A new regulator to oversee accountants must also have the ability to conduct routine, thorough inspections of audit firms to determine their compliance with auditing standards. It must have extensive powers to conduct timely investigations of suspected abuses, including the power to compel testimony and documents from both auditors and the public companies they audit. And it must have the ability to impose meaningful penalties for violations.

C. The Sarbanes draft bill offers the complete overhaul that is needed.

The Sarbanes draft would create a single new regulatory body to which all accountants that audit public companies would have to belong. It would be overseen by a five-member full-time board whose members could include up to two current or past CPAs. The board would be funded through a combination of mandatory registration and investigation fees paid by members and a fee imposed on issuers. This should ensure a secure source of adequate funding that is free from influence by accounting firms.

The bill gives the board broad authority and the powers it needs to fulfill those responsibilities effectively. Specifically, the board would be responsible for: registering accounting firms that audit public companies; setting auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers; conducting inspections; conducting investigations and disciplinary proceedings; enforcing compliance with the act, the rules of the board, professional standards, and rules of the Commission; and, when appropriate, imposing sanctions on firms or individuals associated with a firm for violations.

Upon registering, audit firms must provide extensive information about their operations, which information is to be made available to the public. They must also consent to comply with requests by the board for documents or testimony and to obtain similar consents from firm partners and employees. Failure to comply is ground for suspension of registration, which costs the firm the ability to audit public companies. This gives the board the authority it needs to conduct effective investigations.

The board is also required to conduct routine inspections of firms on a regular basis. The bill specifies that inspections must include a review of selected audit engagements, which may include those subject to ongoing litigation. A written report detailing inspection findings must be provided to federal and state regulators and be made available to the public. The bill gives the board extensive sanction authority, including the ability to impose civil fines of up to $750,000 per person per violation and $15 million per firm per violation for fraud and deceit.

The bill includes a number of provisions designed to ensure the independence of the governing board in addition to the requirement that they serve full-time. Members would be appointed by the SEC, the Federal Reserve Board, and the Treasury Department. Members could not receive any compensation, except pension payments, from an accounting firm while serving on the board. This is a substantial improvement over the Oxley bill, which requires that two board members be current CPAs recently engaged in the practice of auditing public companies, permits an additional two members to be current or past CPAs, so long as they have not been associated with an audit firm for at least two years, and only requires that one member of the five-person board actually be free of ties to the accounting industry.

Nonetheless, we are concerned that the bill does not do enough to ensure the independence of the board. A retired academic who is a CPA but is otherwise free of ties to the accounting industry would be subject to limitations on his or her ability to serve. A non-CPA who has spent a career in the accounting industry would not. To avoid these inconsistencies, we believe a better approach would be to define strong independence standards for the board and to require that a super-majority of board members meet those standards. To accommodate that requirement, the board would have to be expanded to seven members. Despite this one concern, we believe the Sarbanes draft bill would dramatically improve the quality of regulatory oversight for auditors.

III. Reform private litigation laws to provide a real deterrent to wrongdoing.

Private litigation has long been viewed as an important supplement to regulation, since the threat of having to pay significant financial damages provides an incentive to comply with even poorly enforced laws. Even a reinvigorated system of auditor oversight would benefit from this support. In 1995, however, Congress passed the Private Securities Litigation Reform Act (PSLRA), which significantly reduced auditors' liability in cases of securities fraud.[16] It did so, both by making it more difficult to bring a case against accountants and by reducing their financial exposure where they are found to have contributed to fraud.

Under PSLRA, it is not enough in a securities fraud lawsuit to show that an auditor made a materially false statement. You must also show that the auditor acted with an intent to defraud or a reckless disregard for the truth or accuracy of the statement. PSLRA set pleading standards with

[16] PSLRA also all but guaranteed that Enron's victims will receive mere pennies on the dollar in any recovery.

regard to state of mind that create a Catch 22 for plaintiffs' attorneys. They must present detailed facts showing the defendant acted with requisite state of mind, and they must do this before they gain access through discovery to the documents they need to establish state of mind. If plaintiffs can't meet the pleading standards, the case is dismissed. One result is a dramatic reduction in the number of cases filed against secondary defendants. By the time victims of fraud gain access to discovery and uncover the evidence that would support their case against such defendants, the statute of limitations has often expired.

In addition to making it more difficult for securities fraud victims to bring private lawsuits against accountants, PSLRA reduced accountants' liability when they are found to have contributed to fraud. The primary way it accomplished this was by replacing joint and several liability with a system of proportionate liability. Thus, accountants who are found to have contributed to securities fraud no longer have to fear being forced to pay the full amount of any damages awarded should the primary perpetrator be bankrupt. Under proportionate liability, the culpable accountant cannot be forced to pay more than their proportionate share of damages. As a result, according noted securities law expert Professor John C. Coffee, Jr., accountants will rarely be forced to may more than 25 percent of the losses.[17]

PSLRA was also notable for what it didn't do. It failed to extend the federal law's very short statute of limitations for securities fraud of no more than three years from the time of the wrong-doing and one year from discovery. This rewards those who are able to cover up their fraud for the relatively short period of three years and guarantees, for example, that some claims against Enron and Andersen will be time-barred. It also, as described above, helps to keep cases against secondary defendants from being filed. PSLRA also failed to restore aiding and abetting liability under securities fraud laws, which the Supreme Court's 1994 Central Bank of Denver decision eliminated as a potential cause of action. Thus, accountants can only be sued as primary perpetrators of securities fraud, not for their role in aiding and abetting that fraud.

The result is that the threat of private lawsuits now poses a diminished deterrent to accounting fraud. Restoring reasonable liability for culpable accountants should be part of any overall reform plan. This should include provisions: to enable plaintiffs to gain access to documents through discovery before having to meet the heightened pleading standards regarding state of mind; to restore joint and several liability where the defendant recklessly violated securities laws and the primary wrong-doer is bankrupt; to restore aiding and abetting liability for those who contribute to fraud but are not the primary culprit; and to extend the statute of limitations for securities fraud lawsuits.

Sen. Richard Shelby has introduced legislation to restore this needed deterrent to fraud. In

---

[17] "The Enron Debacle and Gatekeeper Liability: Why Would the Gatekeepers Remain Silent?" Professor John C. Coffee, Jr., Adolf Berle Professor of Law, Columbia University Law School, testimony before the Senate Committee on Commerce, Science and Transportation, December 18, 2001.

addition, Sen. Patrick Leahy included a provision to lengthen the statute of limitations -- to five years from the wrongdoing and two years from discovery -- in legislation that was recently approved by the Judiciary Committee. We support passage of both those bills.

IV. The independent audit must be backed up by an aggressive, fully funded SEC.

In the wake of Enron's collapse, many have asked, "where was the SEC?" Given the SEC's responsibility for reviewing public companies' financial disclosures, why had the agency not detected the company's problematic accounting earlier? One answer is that the SEC had not reviewed Enron's financial disclosures since 1997. The reason is that the agency is so understaffed it is only able to review a small percentage of filings each year.

The General Accounting Office released a study earlier this year on the devastating effect that under-funding is having on the SEC's ability to perform its assigned tasks. That report looks at the growth in workload at the agency since the start of the 1990s, and documents the degree to which funding has failed to keep pace. It tells only half the story. The real damage to SEC funding occurred before the period covered by the report, in the 1980s, when staffing stayed virtually flat while the industry experienced dramatic growth.

In 1980, for example, there were just over 8,000 publicly traded companies filing annual reports, according to a report commissioned in 1988 by the Securities Subcommittee of the Senate Banking Committee,[18] and there were 710 new registration statements filed. Excluding the staff for electronic filing and information services, 420 staff years were devoted to disclosure matters. As a result, the agency was able to review all transactional filings.

In 2000, the number of staff years devoted to full disclosure (again excluding the staff for electronic filing and information services), had dropped to 356, according to the SEC's analysis of the president's proposed FY 2002 budget. As a result of diminished staffing, dramatic growth in the number of publicly traded companies, and increased workload associated with review of initial offerings, "the percentage of all corporate filings that received a full review, a full financial review, or were just monitored for specific disclosure items" decreased to about eight percent in 2000, according to the GAO report. Because of a dramatic drop-off in the number of IPOs in 2001, the SEC was able to complete "full or full financial reviews of about 16 percent, or 2,280 of 14,060 annual reports filed" last year, the GAO report found.

Among the financial statements that were passed over for review because of this staffing shortfall were the financial statements for Enron from 1998, 1999, and 2000. Although it is impossible

[18] *Self-Funding Study*, prepared by the Office of the Executive Director of the U.S. Securities and Exchange Committee, submitted in partial response to the request of the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs (S. Rpt. 100-105), December 20, 1988.

to know whether more regular, more thorough reviews would have nipped the accounting problems at Enron in the bud, it is reasonable to think they might have. Certainly, it is irresponsible to so grossly under-fund the federal regulators that they can't hope to fulfill the important responsibilities assigned to them.

Last year, Congress had a historic opportunity to fix this problem. A decision was made not to use SEC-generated fees to fund other areas of the government. As a result, the agency no longer had to compete with other federal priorities in justifying its budget. Instead of taking that opportunity to dramatically boost agency funding, however, Congress approved a budget that required additional staffing cuts and passed legislation to reduce agency imposed fees to reflect that inadequate budget. The Senate fought to provide a funding boost, but those efforts were ultimately unsuccessful.

The collapse of Enron has focused new attention on the issue of SEC funding. Because of Enron, most of that attention is focused on staffing issues related to full disclosure and enforcement. The Sarbanes draft, for example, would provide a significant funding boost for the agency targeted primarily at these two areas. These are important priorities that certainly deserve increased funding, but similar trends have affected all areas of SEC responsibility. Think of what has happened in that time in the area of mutual funds or financial planning since the beginning of the 1980s. Think of how many more households are now participants in the markets and thus vulnerable to wrong-doing.

The GAO report has helped to make the case for across-the-board significant funding increases for the SEC. That case is even more powerful when the numbers from the 1980s are taken into account. Congress must undo the damage of last year's fee reduction legislation and provide a budget for the SEC that is commensurate with its responsibilities. The Sarbanes bill, which also would authorize full funding for pay parity at the agency, offers an important step in this direction, but it must be followed up with a more thorough analysis of agency funding needs.

V. Study credit rating agencies to determine why they failed to provide an earlier warning of problems.

Another troubling aspect of the Enron collapse is the failure of credit rating agencies to provide an early warning of trouble. In fact, both Moody's and Standard & Poor's still had Enron at investment grade until just five days before it filed for bankruptcy. According to a Bloomberg News account, Moody's had decided to downgrade Enron to junk in early November, but backed down in response to lobbying from Dynegy, which was then negotiating a takeover of Enron, and its bankers.[19] Although this raises serious questions about the objectivity of the ratings, it is unclear that an earlier downgrade would have changed things for investors. A credit rating is not just an isolated measure of a company's financial health. A downgrade may not just reflect the company's worsening financial status, it can

[19] "Moody's Enron Rating Shows Lack of Independence," Mark Gilbert, Bloomberg News, November 15, 2001.

trigger further financial woes, as it did for Enron.

We strongly encourage Congress to conduct a further study of this issue to assess whether the operations of credit rating agencies are adequate to ensure accurate ratings and, if not, what should be done to enhance the quality of ratings. That study should examine the extent to which recently announced changes by the rating agencies are likely to provide the desired improvement. It should also examine whether lack of competition in the industry is contributing to the problem. We expect that a thorough review will identify areas in need of additional reform.

VI. Provide additional protections to prevent securities analyst conflicts-of-interest.

Credit ratings agencies were not alone in missing the warning signs. In early November, after the SEC had already announced it was looking into Enron's partnership transactions, ten of 15 analysts who followed Enron still rated it as a "buy" or "strong buy." One reason, as the analysts are quick to point out, is that they were not getting good information from Enron's financial statements. Another is that Enron was apparently actively and intentionally misleading analysts about activity on its trading floor, for example.

However, this offers only a limited explanation. Red flags were there for those who were looking. And many now looking back -- albeit with the benefit of 20-20 hindsight -- have been able to point out obvious danger signs. These included wide discrepancies between the company's reported earnings and its retained earnings, negative cash flow of $2.56 billion in 2000 once proceeds from asset sales and other one-time activities not part of its core business were deducted, and actual revenues on energy trading that were a mere fraction of those that accounting rules let the company claim.[20] Surely it is analysts' job to look for just such clues and to probe deeper than the surface of company disclosures.

Another reason analysts may have missed these signs is that they simply weren't looking. Institutional investors, who vote a key annual beauty contest ranking analysts, tend to frown on negative reports on stocks they hold in their portfolios. Even more important, negative reports don't attract investment banking business, and Enron was clearly seen as a huge potential source of such deals. Since investment banking business is far more profitable than the retail sales business for large Wall Street firms, it is hardly surprising that those firms use their research arms to support their investment banking business. In the process, their research has become so compromised by conflicts of interest that it has no real credibility.

Recently, new rules have been adopted to address analyst conflicts of interest. They do so by attempting to limit the investment banking department's influence over research, limit analysts'

---

[20] "How 287 Turned Into 7: Lessons in Fuzzy Math," by Gretchen Morgenson, *New York Times*, January 20, 2002, Section 3, page 1.

investments in pre-IPO shares of companies in the industry they cover, limiting their purchase or sale of securities during a window of time around the release of a new research report, prohibiting trades against their own recommendations, and requiring better disclosure of conflicts. We view these rules as a positive first step. However, we believe more should be done in several areas, including banning compensation for analysts that is tied in any way to investment banking profits, improving the clarity and relevance of required disclosures, and extending disclosure to recommendations by sales representatives to retail clients based on the company's research. We are cautiously optimistic that the investigation being pursued by New York Attorney General Eliot Spitzer, and somewhat belatedly by the SEC, will force additional reforms along these lines. Absent regulatory action, Congress should intervene to impose higher standards.

VII. Protect FASB's independence.

In the wake of Enron's collapse, Arthur Andersen has tried to blame inadequate accounting rules -- rather than its own poor performance as auditor -- for Enron's less-than-transparent financial disclosures. This ignores the fact that Enron's financial statements have been shown to contain several violations of existing rules.[21] It also ignores Andersen's responsibility as auditor to ensure not just that Enron's disclosures complied with the letter of existing rules, but also that they presented an accurate picture of Enron's overall financial status. However, this is not an either-or proposition. It is in fact the case that Andersen failed in its responsibility as auditor *and* existing accounting rules are inadequate.

One reason is the inability of the Financial Accounting Standards Board to produce strong rules in a timely fashion when faced with entrenched opposition from large corporations and accounting firms. It is difficult to criticize FASB for moving too slowly on improved accounting rules governing special purpose entities, for example, when their past efforts to pass similarly controversial rules -- regarding pooling of interest accounting for mergers, derivatives disclosures, and accounting for stock options -- have met strong resistance, not just from business, but also from members of Congress.

Something needs to be done to enhance FASB's independence. This is a difficult issue to tackle, since FASB is a private entity not subject to government oversight. The Sarbanes draft bill seems to offer a reasonable approach. It specifies that accounting principles recognized by the securities laws as "generally accepted" must be set by a private body, with a majority of independent board members and procedures to ensure prompt consideration. It also guarantees an independent funding source in the form of a fee imposed on issuers for the board. We believe this approach offers the possibility of real progress without exposing FASB to excessive risk of political interference. In addition, however, certain members of Congress must recognize that they have played a key role in undermining FASB's independence in the past and should refrain from interfering inappropriately in the

[21] In his January 24, 2002 testimony before the Senate Committee on Governmental Affairs, former SEC chief accountant Lynn Turner outlined four areas of noncompliance with existing rules.

future.

VIII. Improve corporate governance standards.

Enron's independent board members, and particularly the board audit committee, have come in for considerable criticism for authorizing some of the company's more controversial partnership deals and for failing to ensure clear, accurate financial disclosures. While it may be unrealistic to suppose that board audit committees will ever be equipped to closely scrutinize and challenge the outside auditor's work, steps can and should be taken to enhance the independence and expertise of independent board members.

The Nelson-Carnahan bill would impose tough new independence standards for both board audit and compensation committees. We strongly support those provisions of the bill. If audit committees are to bear greater responsibility for the oversight of the audit, as the Sarbanes draft bill proposes and we endorse, they must also have the independence and resources necessary to serve that function.

IX. Reduce incentives for managers to manipulate the numbers.

Although the above protections are designed to work even when managers are corrupt, reforms are most likely to be effective if corporate managers' incentives to manipulate the numbers are minimized. The Sarbanes bill includes several provisions to accomplish this goal, including: requiring CEOs and CFOs of public companies to certify in writing that financial statements present a fair and accurate picture of the financial condition of the issuer; making it a violation of the law to fraudulently influence, coerce, manipulate, or mislead the auditor; requiring forfeiture by CEOs and CFOs of bonuses and profits on sales of company stocks during the 12-month period before an earnings restatement resulting from material noncompliance with disclosure requirements; enhancing SEC authority to force disgorgement of salary, bonuses, stock option payments and other profits to corporate officers; and expanding SEC authority to prohibit certain individuals from serving as officers or directors of public companies. We support all these provisions.

We also support legislation introduced by Sen. John McCain and Sen. Carl Levin to require companies who claim stock option expenses on their tax filings to also show those expenses on financial statements to shareholders. The fact that corporate officers today earn a disproportionate share of their income in the form of stock option grants can give them a strong incentive to boost the company's share price. While that can be a positive incentive, within limits, it can also create an incentive to push the envelope on acceptable accounting. By lessening the incentive for companies to grant such outsized stock option compensation packages, the McCain-Levin bill should help to reduce those temptations. As such, we believe it is an important part of an overall reform package.

X. Conclusion

The collapse of Enron has provided a clarion call for reform. It has exposed gaping holes in the investor protections we rely on to keep corporate managers honest. Enron is not unique. These same shortcomings apply to all publicly traded companies. We are fortunate that so many company managers have remained committed to providing clear, accurate disclosures to investors. But we cannot rely exclusively on their integrity. We need a system that works even when company managers are greedy and overly aggressive, and we need a system that reduces their incentives to be greedy and overly aggressive. Congress can repair the gaps in the current system. It is of paramount importance that you do so.