deAccountant

ARTHUR LEVITT:

'There is a role for an audit only firm'

Arthur Levitt (1931) was chairman of the United States Securities and Exchange Commission (SEC) from 1993 to 2001. At present he is senior advisor to the Carlyle Group and, among other things, co-chairman of the Advisory Committee on the Audit Profession (ACAP), which was installed by the Treasury last year. Tom Nierop, chief editor of 'de Accountant', interviewed Levitt on May 13th in New York.

Mr Levitt, having seen and witnessed a number of financial crises over the last decades, including the present subprime crisis, could you give me the two or three root causes at the base of our apparent collective blindness that causes us not to see - or even not want to see - disaster coming?

Levitt: "I think that all financial crises seem to have some common factor. These crises are a result of animal spirits, greed, regulatory failures, lack of transparency and runaway bull markets that regulators are unable to keep up with innovations, with the developers of new products, new systems, and new techniques. They always come in after the crisis has developed.

In the United States it is only a crisis that motivates Congressional action, when for a very short period of time Congress is willing to defy the power of campaign contributors from the business community that have kept them in a deregulatory mode for some years. They then develop regulations that could never otherwise have existed. For instance during the nineties we went through a deregulatory period, until Enron. Enron started a series of regulatory actions culminating in the Sarbanes-Oxley bill. What occurred then was a period of business bashing by the media, by the Congress, which was playing to their retail constituents at that point, rather than their corporate constituents. And three years after Enron, Congress came back to their normal mode of being subservient to their business patrons, and we had an administration that was determined to defang all regulators and appointed individuals regulatory positions who served as custodians at best, and destroyers in some instances, emasculating the regulatory mechanism.

When that took place it coincided with the Federal Reserve's loose money policy. Alan Greenspan threw fuel onto the fire encouraging the use of highly speculative, highly leveraged products, most of which were unregulated and not listed on any exchange. And that witches' brew is playing out today in terms of a mortgage meltdown, aided by highly conflicted rating agencies. What we have here is the failure of regulators, legislators, ratings agencies, and accountants of investment banks that knew exactly what they were doing by taking the risk away from its originators and parcelling it out to retail investors, in ways that destroyed any oversight capability. And the triggering mechanism of today's failures of course was this house of cards that was based upon real estate values continuing in one direction."

Why didn't oversight bodies, accountants and others see this coming? Because anyone could see.

"Oh, I think there was the usual number of people who saw the danger. But the leverage of power remained with the Federal Reserve Board, the Security and Exchange

Commission, the Treasury. And with the standard setters that were so inapt they allowed mechanisms to develop that enabled businesses to disguise their true financial condition. So the failures were pretty broadly distributed. But the oversight is a function in my judgement in an administration and a congress that was committed to deregulation at any cost."

The climate wasn't right?
"It couldn't have been worse."

This is a pattern you see in other crisis as well?
"Yes it is. And it will happen again."

What can we do about it?
"I think public awareness is the best antidote. It is only through public humiliation and embarrassment that we can address these issues. I think regulatory solutions are short term solutions that the business community can manage to work their way around. But you have got a power structure in this country, with the Chamber of Commerce and the Business Roundtable having had a greater measure of effectiveness than in any time in their history. This created a reaction to SOx and everything that surrounded it. Today the business arguments have been largely invalidated and they are now in a defensive mode. I think that this election will involve some of these economic characteristics, with the Democrats probably favouring a more vigorous regulatory environment and the Republicans continuing to wave the banner of deregulation. The proper answer, for this or any other society, is balanced regulation and balanced oversight. And we have lost that balance."
Greed and politics are the root causes. We will never solve it completely. Every time we come up with a solution we think: Aha this is the solution! But oversight, regulation and governance are a moving target. What may be absolutely perfect for today may be very imperfect for a year from today. The lesson that is to be learned is that to deal with a rapidly changing business environment, you need a rapidly changing oversight environment. Not at all static, but very dynamic."

With an appropriate budget.
"Yes. That's another phenomenon, that there has been a systematic starvation of the overseers of our system."

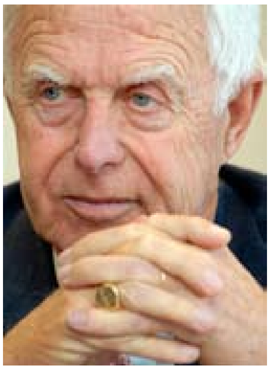
Some people criticize fair value accounting for derivatives. This sounds like shooting the messenger?
"I think it is. I think that we have been very lax in terms of valuations. The whole notion of 'marked to the market' is being fought strenuously by institutions that are not mandated to do that. I very much support telling it as it is, reporting it in al its rawness, whatever that may be. And I am not at all sympathetic to the notion of moving away from fair, accurate valuations."

'The political climate couldn't have been worse.'

As a chairman of the SEC you encountered similar opposition against fair value accounting.
"It is an ongoing process. It is a repeating pattern, and it will always be."

Auditors look in the kitchen of their corporate clients. Could they have played a more extensive role in preventing this crisis, or signalling the risks?
"I don't think that, unlike the crises of the nineties when the auditors were seriously conflicted, they were at the head of the pack of wrongdoing. They were participants, but if you compare their failures to those of the standard setters, who enabled the auditors to come up with numbers that turned out to be fictitious... Or the rating agencies that were totally conflicted and really co-conspirated in terms of coming up with plans and schemes that they accorded favourable ratings to, that turned out to be totally fictitious. Or, for that matter, the regulators, including the SEC and the Federal Reserve Board. The Fed served as the 'bankers protective association' rather than the banking regulator. And the SEC was so starved for resources and risk management was simply such a minor part of their activities that they were very late to the table."

In November 2005, 'de Accountant' published a paper written by Jules Muis and his former Worldbank-colleague Dipankar Gosh (A shorthand survival kit for accountants and auditors in a turbo derivative world), in which they warned accountants and auditors for precisely the systemic risks with credit derivatives that now substantiate on a large scale.
"Jules tends to be on the right side of these issues, over and over again. I simply feel that the failure was so broad this time, that I would not say that they were the leading factor. Accountants were part of the total fabric that was filled with holes. They were participants. Were they better or worse than the rating agencies? I wouldn't say that at all. Were they better or worse than the FASB? I wouldn't say that either. Were they better or worse than the Federal Reserve Board and the SEC? I wouldn't say that either. They were players in a drama that was very destructive."



'There has been a systematic starvation of the overseers of our system.'

Could you mention two or three measures that are crucial to improve the present situation?
"The first thing you need to do in my judgement, is to convene a high level presidential commission to examine precisely what went wrong and who was to blame. We wouldn't be sitting here discussing the role of the accountants if we had a clearer picture as to exactly what they did or didn't do. I think we have to come off with a new regulatory structure. Paulson floated a plan, but it was just a blueprint. And that is going to be picked apart in typical Washington fashion, with every agency fighting to preserve their turf. Every member of Congress that receives contributions from a partisan particular agency will fight very hard to keep the turf precisely as it is as we sit here today.
But this experience is not over. Whether it will be bank failures or problems with hedge funds or continuation of the mortgage meltdown, I think Congress is going to be pushed to some sort of action. At the very least these obscure products, these derivatives, the various forms of synthetic investment vehicles, should be subjected to a common clearance facility or exchange facility, with some sort of oversight, that it presently lacks. We simply cannot go along using free market principles and assuming that the market will make all of these things right. We need to provide the regulators with the resources that were taken away from them during the past eight years. Namely the SEC and the CFTC. I think we should merge those two agencies. And I think Paulson's notion of a new agency that is geared to the protection of investors, makes a great deal of sense. Whether that includes the SEC or replaces the SEC is too early to tell."

Can we really avoid a next financial crisis without fundamentally assuring some sort of 'ownership at the top' for the proper systemic functioning of the markets?
"The lines of responsibility should be more clearly defined. I don't believe in principles based regulation, I believe in enforcement based regulation. Except as to when it deals with systemic risk. Systemic risk is so evasive that I think you need the flexibility of some sort of prudential oversight. But certainly not with respect to certain kinds of market structures.
And what role a central banker should play in this, remains to be seen. Their failure has been profound. Every step in the way. Yet if they are providing the money to bail out investment banks, they clearly have to have had some responsibility in overseeing them."

As to the effects of the present credit crisis: have we had the worst?
"No, I think it will continue for a while. Real estate values will continue to decline. I think we will see some bank problems, clearly more corporate problems similar to AIG."

In the Netherlands, but internationally as well, some in the business community are warning not to make the 'mistake' of implementing new regulation. New rules are supposed not to be the solution for the problems we face.
"More rules won't provide the answer, but more transparency will. And you don't get transparency by pleading for it. You get it by mandating."

Mr Levitt, you are presently co-chairman of the Advisory Commission on the Audit Profession (ACAP). In May a discussion paper was published. The recommendations included, among other issues, a 'strengthening of auditing firms' fraud detection and prevention skills' and 'creating a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms'. Could you clarify these ideas?
"It is just a discussion paper, but we are to recommend undoubtedly a custodial arrangement whereby if a major firm gets into trouble the PCAOB will have the ability to take it over and, almost in a bankruptcy mode, run the firm in an orderly way. With respect to the failure of an accounting firm this is probably the most significant recommendation that will come out of this."

What would it have meant in a case like Arthur Andersen?
"Andersen failed and was thrown to the winds. That wouldn't happen here. The PCAOB knows the firms intimately, would take it over in an orderly fashion."

It is difficult to imagine what it really means.
"It means an orderly transition of leadership - not necessarily leading to the dissolution of the firm."

You have a history in fighting for reform of the audit profession. When you compare the present situation with that in the nineties, have the reforms been enough?
"No, I don't think so. The profession is better managed today than ever before. But once again: this is a moving target. The firms are aggressively getting back into consulting services. I think there is a role for an audit only firm. We don't see them but I think it would be very helpful to have a firm which just did audits. We also need greater transparency, to understand what condition a firm is in. We need the firms to provide fully documented audits of their own operation. They don't do it at the present time, but I think that clearly is coming."

You mean literally 'an' audit only firm, next to the others?
"Yes. Or firms should be given the choice. That if they choose audit only, they will be treated in a certain way. If they take on other services, they will be treated in a different way."

For example? They would not be allowed to audit public companies?
"Not necessarily."

What about strengthening fraud detection and prevention skills?
Smiling: "I'm a supporter."

In your book you repeatedly mentioned the harmful effects of 'a web of dysfunctional relationships'.
"They still exist. When the business community is able to command the intention of the legislators that oversee and fund the regulators that is a very bad situation. There are very few reformers in Congress that are willing to stand up to protect the regulators, and for that matter to protect the public interest. That hasn't changed. It all goes back to the way politicians are funded. And it takes extraordinary leadership to make a difference. And those extraordinary leaders don't come along very often. Paul Volcker I consider one of the world's foremost apostles of good governance. A great regulator can make a difference. Not by the rules, but by speeches that he of she makes, by announcements. The only way the system can flourish and the investors can have a seat at the table is as coalitions form that have that common interest. Coalitions such as the Council for Institutional Investors, the American Association of Retired People, the labour unions. International coalitions are especially important, coalitions of investor supportive institutions; you have several in Holland, also in the UK. They are going to become increasingly important."

This influence is already visible in the discussion on compensation and bonuses for top management.
"The only way I can think of to address those issues is public embarrassment. The media is quite important there. And the strengthening of independent boards, compensation committees, and organisations like ISS, of

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which I am a director. And there are other organisations that will have an affirmative impact. It is not something you simply can address by a rule."

Why is an extra financial incentive, next to regular compensation, necessary at this level of management?
"Because a board is fraternal board rather than a sceptical board. Compensation committees lack the backbone to do something about it. But the boards are becoming more sceptical because they don't want to see their names in the papers. And they don't want to have a negative vote form the ISS-s of this world."

So you are an optimist?
"I am a cautious optimist. I think boards have changed; transparency is greater and an organisation such as ISS is giving a level of accountability that didn't exist before. I expect the next chairman of the SEC will push through what this chairman was not able to do, in terms of shareholder access to the proxy. That is not going away. There are reasons for some optimism." □

NOTES:

- A Dutch version of this interview is published in 'de Accountant' (June 2008), the monthly magazine of NIVRA, the Royal Dutch Institute of Registeraccountants. See www.accountant.nl.
- Download the 2005 article by Jules Muis and Dipankar Gosh ('(A shorthand survival kit for accountants and auditors in a turbo derivative world').

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