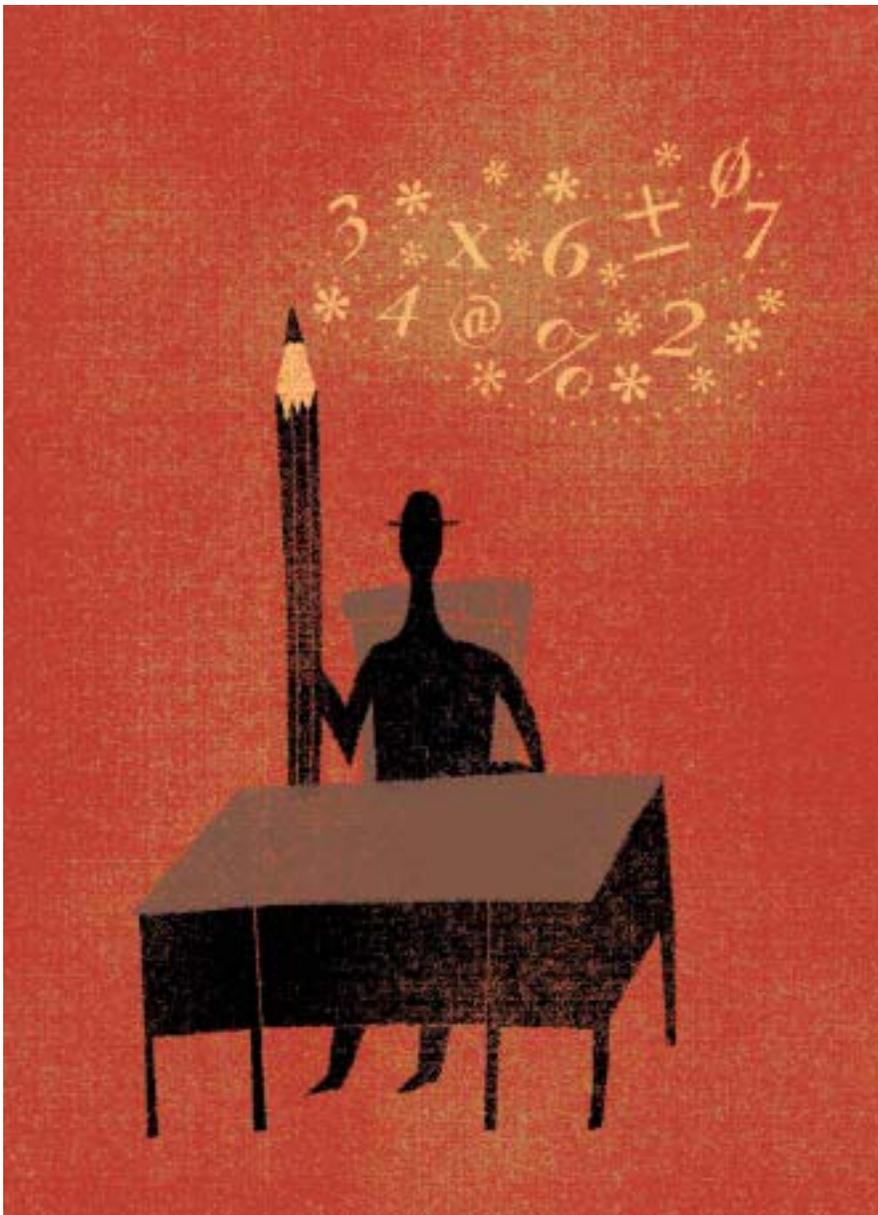


# Held Accountable

**RESPONDING TO ACCOUNTING DISTORTIONS AND  
AUDIT FAILURES IN CORPORATE AMERICA**



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*by Itzhak Sharav*

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Using his bully pulpit as SEC chairman, Arthur Levitt pointed out in September 1998 the importance of “transparent, timely and reliable financial statements.”

America was in the midst of a roaring bull market and a good three years away from the Enron debacle and other disclosures of accounting distortions and audit failures. Levitt warned, “If a company fails to provide meaningful disclosure, the bond between shareholders and the company is shaken: investors grow anxious, prices fluctuate for no discernible reason and the trust that is the bedrock of our capital markets is severely tested.”

We know now all too well of companies that failed notoriously the test of “meaningful disclosure” and of the punishing blows they suffered as a consequence in the marketplace, to the point of bankruptcy and imminent extinction. Investors, concerned about future bad news, wonder whether the last shoe has fallen. And since we have read about earnings restatements by such companies as AOL Time Warner and Xerox, questions have been raised regarding the validity and usefulness of our accounting model.

That model is the collection of U.S. generally accepted accounting principles (GAAP), which these companies claimed to have followed in the preparation of the financial reports—now subject to revision. And these reports were attested to and blessed at the time by auditors from the Big Five accounting firms.

We are facing a problem, no doubt. But it should be

approached from a proper perspective. Most public companies in the United States have been submitting to the SEC and their stockholders periodic informative financial reports based on GAAP that contain useful data and are free of any taint of scandal.

We should also realize that audit failures are not necessarily proof of faulty accounting standards. In the cases of Waste Management and Enron, the Arthur Andersen auditors first either objected to or expressed serious reservations regarding their clients' improper accounting treatment and lack of disclosures of certain transactions—in other words, their violation of GAAP. But they yielded to clients' pressure for fear of losing the account.

As a result of the Sarbanes-Oxley Act of 2002—assuming it will be faithfully enforced—chances are that such crass pressure on auditors will lessen substantially and might indeed become a thing of the past (since CEOs and CFOs will have to certify SEC-mandated reports under the threat of both civil and criminal sanctions).

The accounting firms, restricted to a very limited menu of non-audit services to their audit clients, will be overseen for the first time by an oversight board with “real teeth.” The board will be authorized to impose penalties reaching \$15 million and to ban firms from auditing public companies altogether. Intentional violation of auditing standards in this new, as yet untested, environment may be tantamount to a professional *hara-kiri*.

There is no question, however, that the recent accounting scandals exposed several shortcomings and weaknesses in our

accounting model. Two of the major ones are (1) overstatement of revenues and earnings, often accompanied by a rampant manipulation of income and cash flow from operations, and (2) understatement and lack of full disclosure of actual and potential liabilities a company might be exposed to, having guaranteed another party's obligation or having engaged in various off-balance sheet financing arrangements, such as the creation of special purpose entities. (The Enron SPEs are an extreme case in point.)

The good news is that the Financial Accounting Standards Board (FASB) has been moving on these fronts. It is likely to tighten the rules and provide guidelines for a comprehensive and consistent approach to revenue recognition. Also, two recently issued exposure drafts, upon final approval, should limit significantly the opportunities for exclusion of liabilities and their nondisclosure in the financial statements.

We should also learn from the fact that political intervention has occasionally affected our accounting model, at times with negative results—as in accounting for employees' stock options. These should and would have been deducted as an expense on the income statement but for a wrongheaded Senate action, spearheaded by Senator Joseph Lieberman almost a decade ago, that rejected an FASB resolution to that effect.

The tide has now turned in reaction to public revulsion. It is no longer a novelty to hear an announcement by one company or another (Procter & Gamble, General Electric, Coca-Cola) that it

intends to deduct employees' stock-option expense on its income statement. The International Accounting Standards Board had already passed a draft resolution to that effect, and the FASB has taken preliminary steps in that direction as well.

It may turn out that the accounting scandals, a companion to the stock market upheaval, had a silver lining after all: these scandals have become a catalyst for change and improvement in financial reporting by public companies. This is not surprising—the same had happened in the aftermath of the stock market crash in 1929. The more things change, the more they remain the same.

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