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Financial Reporting: Past, Present, and Future

By Tad Howard

One of the surprising considerations apparently overlooked in the financial reporting scandals of the early 2000s was whether the financial problems percolating at Enron, WorldCom, and other companies had been adequately revealed in their financial reports to shareholders. Normally, when CPA firms have doubts about the continuing viability of a company, they convey these doubts in what is called a "going concern" opinion. Under this form of opinion, the auditor notes that they have reviewed the statements on the assumption that the company will remain a going concern and, accordingly, there have been no reserves for discontinued operations, asset write-downs, or extraordinary expenses that normally might be associated with such a dire state of affairs. In reality, the "going concern" opinion is an unsubtle way for the CPA firm to alert readers that there are considerable problems lurking in the operations of the company.

Therefore, it is important to review whether the CPA opinions rendered on these companies telegraphed in any way the impending problems that surfaced when many of them filed for bankruptcy. In fact, during the two-year period of 2001 through 2002, 12 of the largest 20 bankruptcy filings in the history of the United States occurred, and in each case the company had received an unqualified opinion from its CPA firm on its most recent financial statements issued before filing.

Director Summary: The "going concern" opinion, which in the past has alerted companies to a problem in the financial viability of an organization, was absent from companies that subsequently imploded. The author examines the condition of the going concern opinion in an environment with fewer CPA firms capable of auditing large public companies, increased congressional involvement, and the CPA firms themselves seeking to reduce their liability for inaccurate or incomplete audits.

There are several reasons that the CPA firms are reluctant to issue a going concern opinion when facing a troubled client company. First is the realization that there are other CPA firms that could audit the client company and garner the fees involved (as high as $52 million annually in the case of Enron). In a related issue, the firms are painfully aware that generally accepted accounting principles (GAAP) are so broadly defined, that different applications of GAAP can lead to dramatically different presentations of financial results that other CPA firms might certify. Third, the firms are extremely sensitive to the fact that bank loan and debt documents list various events of default that can be triggered by failure to show certain levels of financial performance, by a late date of certification and certainly by the issuance of anything but an unqualified opinion. Under this scenario, the demise of the company could be precipitated by the opinion of the CPA firm.

So what is the current status surrounding CPA opinions?

The Final Four

In the early 1970s, there were eight large accounting firms known, not surprisingly, as "The Big Eight." Companies had their choice of these large, well-known firms to audit their financial statements and/or to employ for financially related consulting services such as software selection/installation and appraisal/valuation engagements. Now, following a wave of consolidations and the demise of Arthur Andersen, we have what some ruefully refer to as "The Final Four." This funereal tag conveys the concern of many that the number of professional options has declined to an alarming level. At a May 23, 2005, meeting of The American Assembly (Columbia University) to discuss the future of the accounting profession, the blue ribbon panel deemed the loss of another of the four firms "intolerable." The panel suggested that such an event could lead to the end of the public accounting profession and prepare the way for the government to take over responsibility

for public company audits. Since there is this anxiety of dropping below the current array of four large CPA firms, recent events at KPMG reinforced the notion that our free market system would suffer with the demise of the current system of independent and non-governmental public company audits.

In the case of KPMG, the firm and some of its professionals were served with financial penalties for sponsorship of ill-advised tax avoidance schemes, but it escaped from the type of extreme measures that led to the disappearance of the Arthur Andersen firm. The underlying message to the profession was clear: CPA firms would be given more leeway before the authorities would pursue and penalize them aggressively and run the risk of reducing the number of options to three.

Directions with Mark Goulston

Complainers, Blamers, and Excuse Makers Need Not Apply

> Until you fully accept responsibility for where you are and fully take responsibility for what you need to do to get where you want to be, you will have no chance of getting there.
>
> —Lt. General Marty Steele (USMC Retired)
> President and CEO, Intrepid Sea Air Space Museum

In 1966, college dropout Marty Steele joined the Marines. Every day he still thinks of his mentor, Staff Sergeant Karl Taylor, who believed in Steele when he didn't believe in himself. Taylor was killed in action not just giving encouragement to others like Steele, but giving his life to save them. Taylor was instrumental and even fundamental to Steele's rise from corporal to lieutenant general in the Marine Corps 25 years later. Karl Taylor is the true north that continues to guide Steele even now. Steele's mission is to do unto others as Karl Taylor did unto him. He honors Taylor by helping leadership and character development, built on value-based behavior. This is behavior based on respect for oneself and one's fellow human beings. Steele also believes that one of the lynchpins to leadership, character, and respect for others and yourself is taking responsibility for your life with no excuses. One of Steele's values is to put into practice the words of the Bible "Heaven helps those who help themselves" by committing himself fully and only to those who help themselves by taking responsibility for their lives.

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Another worrisome sign was reported in *The Wall Street Journal* on November 28, 2005, when it revealed that auditing firms are inserting language to provide for "liability caps" on their work. Critics feel that this arrangement could diminish the pressure on audit firms and lead to less stringent reviews.

Cat and Mouse Games

To paraphrase Supreme Court Justice Potter Stewart's frustration with defining pornography in 1964, no one knows how to define GAAP, but we know it when we see it. The current approach to GAAP in the United States is to issue lengthy pronouncements on accounting for leases, corporate combinations, pensions, stock options, etc. No sooner have the standards been published then clever financial minds have developed ways to comply with the letter of the dictate and circumvent the intention of the release. Sometimes forgotten in the retrospective rush to criticize Enron is the acknowledgement that the company employed former staff of the Financial Accounting Standards Board whose primary mission was to ensure compliance with FASB guidelines while enabling Enron to report favorable earnings. In the escalating game of cat and mouse, the protagonist gears his next move to the previous move of the opponent.

Against this background, the SEC commissioned a study in July 2003 to delve into the possibility of adopting "principles-based" GAAP. In the opening section of the announcement, the SEC states the objective of avoiding specific tests that allow accounting engineers to achieve technical compliance with an accounting standard while evading the intent of the standard. In its most extreme and succinct form, principles-based GAAP could simply stipulate: Financial statements should reflect economic reality.

While the SEC's objective is noble, a more sober assessment suggests that we are already too far down the road in our embrace of rules-based GAAP. In our litigious society, it is difficult to imagine a retreat from the cat and mouse game we have set in motion.

Congressional Involvement

Part of the fallout from the financial scandals of the early 2000s was the widespread complaint that executive compensation derived from the issuance of stock options did not need to be treated as a company expense in arriving at reported earnings. While the Sarbanes-Oxley legislation did not directly address this criticism, there was pressure on senators and representatives to pursue this expensing recommendation or, in the case of the technology companies, to advocate the avoidance of such an approach.

In 2004, the Financial Accounting Standards Board (FASB) published FASB Statement No. 123 (revised 2004), *Share-Based Payment*. Statement 123(R) requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Staged implementation of the rule, which began with implementation by publicly traded companies, will be complete when non-public entities must comply as of the beginning of the first annual reporting period that begins after December 15, 2005. However, it is important to realize that none of the schemes for recognizing share-based payment provides for the lower valuation of options attributable to vesting and restricted transferability considerations.

Steel, automobile, and airline companies have increased the concern over the funding of defined-benefit pension plans. Because of the exposure of the Pension Benefit Guaranty Corporation (PBGC) to potentially under-funded plans, Congress has stepped into the situation with its views on adequately funding these plans. While their concern with minimizing the potential exposure of the PBGC is absolutely legitimate, there is little question that they will also delve into the methods of accounting for this corporate liability.

In an October 21, 2005, article in *The Wall Street Journal*, John Berlau, a fellow in economic policy at the Competitive Enterprise Institute (a putatively conservative organization), said that the biggest obstacle to the domestic production of avian flu vaccine was not the FDA, but the SEC. According to the article, companies would be unwilling to manufacture the vaccine because they would not be allowed to recognize the revenue on the vaccine until the product was shipped. Since this latter approach is the accounting convention that applies to almost all products, it is not clear why this is a problem. Nevertheless, Mr. Berlau recommended that Congress get involved and mandate that revenue be recognized when a firm order is received.

The Sarbanes-Oxley Act of 2002 produced two highly effective approaches to addressing the accounting scandals at Enron, WorldCom, and other companies. Section 302 (CEO and CFO certificates on responsibility for financial reporting) and section 906 (criminal penalties) sounded a clear signal that the abuses of the past would no longer be tolerated. Unfortunately, the hastily passed legislation also included section 404 (internal controls) that naively assumes that by scrutinizing the twigs in exhaustive detail, the branches, trees, and forests are all in good shape. Professors Solomon and Peecher of the University of Illinois have stated that "There's not a shred of evidence that the stringent new rules will protect the investing public."

No sooner have GAAP standards been published then clever financial minds have developed ways to comply with the letter of the dictate and circumvent the intention of the release.

Among the "Son of Sarbanes-Oxley" legislative remedies is the Protection Against Executive Compensation Abuse Act (HR 4291) proposed by Representative Barney Frank (D-MA). While primarily focused on more extensive disclosure of executive compensation arrangements, the bill could provide the first step along the road to greater congressional oversight of compensation levels and accounting treatments.

Summary

Following the financial reporting scandals of the early 2000s, one would expect that changes had been effected that would reduce the chances of a repeat of the problem. Instead, with the reduction in the number of large CPA firms, more leeway is being granted to the surviving four firms. In another indication of the pressure to produce facing these large firms, they are seeking to limit their liability for any poor audit work they perform. Also, by responding to a perceived deficiency in accounting and financial reporting, Congress is getting more involved with the specifics of financial parameters, and one must question the qualifications of this group to address issues that have eluded far more talented groups. Finally, in discussing the impact of Sarbanes-Oxley, SEC commissioner Cynthia Glassman opened the door to revising the bottom-up approach used in section 404 compliance work when she suggested in a recent speech that the "controls for controls sake" focus should be revisited. This would be a welcome step to reducing the time and money spent on section 404 compliance; time and money that many feel is not in the least bit effective. ■

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