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FUNDAMENTAL CAUSES OF ACCOUNTING DEBACLES: SHOW ME WHERE IT SAYS I CAN'T

by Roman L. Weil

Enron bet the farm and lost. It's OK to gamble, but shareholders should know about the size and risk of bets undertaken as well as how the nature of bets changes over time. Why didn't the accounting for Enron's activities do a better job of alerting shareholders to the risks and changes in them?

The Fundamental Problem

The fundamental problem arises when accounting *rules* trump accounting *principles*. From my historical perspective (other observers might choose a different start), accounting rule makers took the first step on the road to the Enron accounting debacle in 1980. At that time, Congress passed legislation de-regulating the granting of trucking rights, effectively giving any trucker the right to carry any commodity between any two points. Prior to that de-regulating legislation, Congress, acting through the Interstate Commerce Commission, had limited those rights. The issued rights traded in the market place and, once purchased by a trucking firm, appeared on the firm's balance sheet at cost. When Congress effectively destroyed the value of those rights by allowing any trucker the right to carry the goods previously protected by monopoly rights, what did the accountants at trucking firms do? They wrote off the value of the trucking rights then remaining on the balance sheet, recognizing an amount of loss equal to their then-current book value.

Did the trucking company accountants need a specific accounting rule telling them to write off the book value of those trucking right assets? You wouldn't think so, would you? But the Financial Accounting Standards Board (FASB) felt compelled to pass a rule (Statement of Financial Accounting Standards No. 44, 1980) saying just that. This was the first step toward the Enron debacle.

Since the early 1980s, an aggressive company's management engages in a transaction not covered by specific accounting rules, accounts for it as it chooses, and challenges the auditor by arguing, "Show me where it says I can't." The auditor used to be able to appeal to first principles of accounting. Such principles suggest, for example, that post-deregulation trucking rights are no longer assets. Now, the aggressive management can say,"Detailed accounting rules cover so many transactions and none of them covers the current issue, so we can devise accounting of our own choosing." And they do.

Accounting rule making has become increasingly detailed as both the SEC and auditors plead with standard setters for specific rules to provide backbone: "Dear FASB or EITF (Emerging Issues Task Force, created by the SEC and the FASB), Give us a rule for this new transaction."

So, Enron transfers assets, reporting current profit and debt, then challenges its auditor to "Show me where it says I can't." The auditor can't. The auditor considers nixing the profit recognition but simultaneously considers the consequences of saying, "No" to aggressive management: "We might lose this client."

The near majority of the board members of the rule setting FASB have come from high-powered audit practices. These members bring to the Board a mindset that the accounting profession needs and wants specific guidance for specific transactions. Three of them can meet privately and can effectively, if not formally, guide, perhaps even set, the agenda for the

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ACCOUNTING DEBACLES

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Board. A minority of the Board has spent careers dealing with fundamental theory. This minority, with more faith in the conceptual basis for accounting, appears to prefer to derive broadly applicable rules from first principles of accounting, which the FASB developed in the early 1980s in its conceptual framework. The majority, the members from auditing practice, less interested in deriving rules from conceptual principles, appears to win most of the battles.

The emphasis on specific rules for specific issues gets more pronounced over time. I concede that these specific rules for specific issues leads to more uniform reporting of the covered transaction — all else equal, a good thing. That uniformity comes at a cost: practicing accountants have less need for informed intelligence and judgment. Part of the pressure on standard setters for specific rules for specific transactions comes from the current litigation environment and from the SEC. Auditors, in a rational pursuit of a full purse, want unambiguous rules to stand behind in the event that accountant judgments and estimates, made in good faith, turn out to miss the target.

That some benefit results from specific rules for specific transactions doesn't make such rules a good idea. These rules have a cost: "Show me where it says I can't," demands management. "Give me more rules for these new transactions, pleads the auditor, so I can combat aggressive management or plaintiffs whose stock has dropped in value." This cycle continues: the increasing number of specific rules for specific transactions strengthens aggressive management's belief that if a rule doesn't prohibit it, then it's allowed. This, in turn, increases the auditor's dependence on specific rules.

What to Do?

I want accountants to rely on fundamental, first principles in choosing accounting methods and estimates. I want accountants not to hide behind the absence of a specific rule. Whatever the detailed rules accountants write, smart managers can construct transactions the rules don't cover.

You might now think about the parallels of the above with our tax collection system, where principles alone cannot suffice. The principle: tax income. The principle requires thousands of pages of tax code, regulations, and court decisions to implement. Can financial accounting be different? I think *yes*. The tax collector and the taxpayer play a zero-sum game — what one pays, the other gets. Financial accounting doesn't have that property and in addition has the auditor to interpret the rule book.

What else, besides more spine in the auditor, do we need to reduce the likelihood of more accounting debacles?

Congress: Keep Out of Accounting Rule Making

Several times in my professional lifetime, Congress has written rules, or taken steps to influence the rules, with bad outcomes for reported financial results. Moreover, these incidents call into question the wisdom of complaining to Congress. The first occurred in the legislation for investment tax credits in the 1960's. The most recent disaster was in the mid 1990's when Congress pressured the FASB to pull back on its proposals for the expensing of stock option costs. I can think of no offsetting, good outcomes.

Reduce Conflicts of Interest

In recent weeks, we have heard about reducing two key conflicts of interest: the opportunities of the auditor to do consulting and to go to work for the audited company. The basic conflict occurs because the audited pays the auditor and, in practice, selects the auditor. In my opinion, everything else has lesser effect.

Auditor Term Limits

Congress, in the recently enacted Sarbanes-Oxley Act of 2002, mandated the rotation of the lead partner on the audit every five years. I endorsed an even more stringent rotation — where the audit firm, not merely the auditor, must change. Firm rotation would let the auditor know that, no matter what, another auditor will take over the job in a few years and will have the incentive to expose a predecessor's carelessness (Talk about professional peer review. This will be *real* peer review, not the pap we get now.) Mandatory auditor term limits have a cost — audit costs might triple. Not just the actual audit bills, but the costs the audited company incurs to show the new auditor where the inventory records lie in the second file drawer of the cabinet two to the left of the green door in the third room on the right of the outside corridor.

I imagine that known term limits will induce the Audit Committee to begin the search for the subsequent auditor 18 months or so before the engagement will start and will be able to bring that new auditor into on-board, learn-from-observation mode early in the process. Those who argue against mandatory auditor rotation adduce large transition costs. Suddenly changing auditors does cause surprise costs that anticipated, orderly transitions will reduce.

Prod the Audit Committee

Then, we need audit committees to exercise the power Congress and the SEC has given them. Thirty years ago, Rod Hills, then Chairman of the SEC, conceived the powerful modern audit committee. He has written that the audit committee's most important job is to make the independent, attesting auditor believe that the auditor's retention depends *solely* on the decision of the audit committee. Most often, it doesn't work that way.

Most audit committees consist of independent, smart, but financially illiterate, members, with rarely more than one financial expert. (How do I know they are often illiterate? Because I teach them in Directors' College classes where I start with pop quizzes.) Audit Committees usually depend on management to recommend the independent auditor and changes in the auditor. The auditor learns to take its guidance from management, not from the audit committee. Congress and the SEC has provided power to the audit committee; now, it can help empower the audit committee by having the audit committee report on its independent search to find the replacement and its independent contacts with the auditor after engagement.

Consulting Conflicts

Management typically views audits as adding no value, purchased merely because regulation requires them. Hence, management typically wants the most cost-effective job it can get to satisfy the regulations. This doesn't mean the cheapest audit. Capital markets will guide a company in the S&P 500 not to hire me to do its audit, but to hire one of the Big Four, because the resulting savings in the cost of funds more than offsets the higher invoice cost. Once that firm decides it needs a Big Four auditor, its Chief Financial Officer will prefer to spend less, not more, for the service. The audit committee worries less about reducing the audit bill.

The audit committee could say, "We're going to pay top dollar for a high quality audit." To the auditor it could say, "Make a decent profit on the audit; don't count on consulting fees to make up for thin margins on the audit." This will drive up the cost of both the audit and the consulting services, because the outside consultant will not have the head start in understanding the client's specifics that the auditor has. Management will not like this. The audit committee, charged to be concerned primarily with the audit, should be unconcerned about the higher cost of consulting fees. When did you last hear of an audit committee asking for a higher-priced audit? I think audit committees should ask what extra work they might get from the auditor for a 20-percent increase in fees and should consider such a purchase.

Does this require a regulation forbidding the auditor from consulting? No, we already have regulations empowering the audit committee to act, independent of management. Now, we need the audit committee to act.

In the current environment, it's heresy to suggest that we need not forbid auditors from also providing consulting services. Indeed, the new statute limits the ability of a firm to provide both auditing and consulting service. I suggest, however, that mandatory auditor rotation, with auditors chosen and beholden to the audit committee, will solve the conflict of interest problem. Forbidding the auditor from all consulting will not produce high quality audits nor deal with the problem of malleable GAAP.

While the new statute prohibits firms from providing audit services contemporaneously with many non-audit serves, the new statute also allows for limited exceptions to the prohibition on consulting. The statute would allow the audit firm to prepare tax returns, for example, if approved in advance by the audit committee. I, and others, see no need to waste resources by having firms different from the auditor do the tax return. Where to draw the line? Let's don't mandate one, but let the audit committee decide. I can imagine that the auditor will prefer shorter terms to longer because the sooner the audit is done, the sooner it can undertake consulting engagements.

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