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The Crisis in Financial Reporting

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by
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[Introductory note: Rick Antle, senior associate dean and professor of accounting at the Yale School of Management, is an expert on many facets of accounting. His academic research has encompassed such diverse topics as auditor independence, the reporting of business income, the use of information in capital budgeting decisions, the compensation of corporate executives, the incentives of auditors, and the structure of CPA firms. He recently published a book with Stanley J. Garstka, *Financial Accounting* (South-Western, 2002), for the first course in accounting. Mr. Antle has served as a consultant in matters involving auditor independence, compensation, the proper application of accounting methods, auditing standards, and capital budgeting for such clients as the AICPA, the Big Six/Five/Four accounting firms, and several large corporations. Professor Antle has often been cited in the press and has provided commentary about accounting and the profession several times on national television.

Thank you very much for inviting me to give the Emanuel Saxe lecture this evening. I am extremely pleased to speak at an event named for such a distinguished alumnus of and contributor to your school of business.

It is probably safe to say that no other speaker in this series has had access to as much raw material as I have. We have seen in recent months accounting failures of virtually every sort. Some of these fiascos remain allegations and others have moved to criminal indictments, guilty pleas, and one conviction. Further, these debacles have brought harsh criticism to every aspect of the process of financial reporting. Just go down the following list and see if you can find any piece that has been spared:

- Government regulators;
- Private-sector standards setters, particularly the Financial Accounting Standards Board (FASB) and the Emerging Issues Task Force (EITF);
- Management;
- Boards of directors; and, let us not forget
- The accounting profession

I cannot possibly cover the entire set of issues raised and all the parties involved in this crisis in financial reporting. What I will do instead is skip lightly around the territory, trying to touch upon some prime morsels for our early evening consumption.

What do you call them?

A difficulty one faces very early in preparing remarks about the crisis in financial reporting is what to call the problems of Enron, WorldCom, Global Crossings, Homestore, Qwest, Xerox, Tyco, Adelphia, and - let me just stop there. You might have noticed that I have already used several descriptors: failures, fiascos, and debacles. I started with *debacle*, as it is commonly used to describe Enron. Perhaps because I have an undergraduate degree in accounting, I am often somewhat cautious in my use of particular words, so I looked it up. According to my online source,(1) a debacle is "a sudden, disastrous collapse, downfall, or defeat; a rout." The second definition of debacle is my favorite: "a total, often ludicrous failure." A *fiasco* is "a complete failure."

A failure is simply "a cessation of proper functioning or performance." Whether the failures of financial reporting in Enron, WorldCom, etc., were "complete" as is required to label them fiascos, or "sudden, disastrous collapses" as is required to label them debacles, it seems there is little question that they were at least failures. Clearly, there was a "cessation of proper functioning" of at least one, and often more, of the components of the process of financial reporting. But which one or ones failed? How did they fail, and why did they fail?

Management

One component that seems to me to have ceased its proper functioning in all of these failures is management. Call me old-fashioned, but I thought the management of a public company has a fiduciary duty to its shareholders. As I recall from my undergraduate class in business law, a fiduciary duty is a pretty high standard. To be sure about this (I got a B in business law), I again went to the dictionary. What I found was revealing. A *fiduciary* is "one, such as an agent of a principal or a company director, that stands in a special relation of trust, confidence, or responsibility in certain obligations to others."

There are two aspects of management's role in financial reporting that I would like to focus on tonight. First, even before the recent SEC requirement that executives "sign off" on their firms' accounting, there has long been a statement of management responsibility in financial reports. That statement said that the financial reports were the responsibility of the company's management -- not its accountants, or even its auditors -- its *management*. Enron's Form 10-K for its fiscal year ended December 31, 2000 was signed by, among others, Jeffrey K. Skilling, president and chief executive officer of Enron. So my first point is that management bears the ultimate responsibility for financial reports, and if those reports contain material errors or omissions or are otherwise misleading, management must bear the responsibility.

My second point is a bit more subtle. I recall Mr. Skilling, in his testimony before Congress, defending himself by saying something like, "I am not an accountant." Robert Friese, Attorney for Peter Tafeen, former Homestore vice president for business development , said in defense of his client, "Mr. Tafeen was a businessman, not an accountant."(2) Mr. Skilling presided over the creation of, or perhaps was the architect of, some of the numerous special purpose entities that Enron is alleged to have used to cover its losses and hide its debts. Mr. Tafeen is the Homestore vice president accused of inflating revenues using improper "round-trip" transactions.

The "I am not an accountant" defense is based on the undoubtedly truthful proposition that no one can know all the details of the generally accepted accounting principles used by a large, complex business. I resort to a similar defense when asked for tax advice by relatives or acquaintances. "I am not a tax accountant," I say. I go on to explain that I hire a CPA to do my taxes.

It is true that I sign my tax returns and I am ultimately responsible for them. But reporting to the government for the purpose of determining your tax bill and reporting to your shareholders are different things. There is widespread acknowledgement that the tax laws form a set of rules within which we are expected to do everything legal to minimize our tax payments. Reports to your shareholders are supposed to provide a basic progress report on your management stewardship.

Let me try this another way. One of the basic distinctions in accounting is between income and capital transactions. We are interested in income because we are interested in whether an entity produced value. The basic idea of income is that it is an increase in the net assets of an entity from sources other than ownership transactions with its shareholders.

The purpose of a for-profit corporation is to earn income so that its shareholders can earn a return on their investment. Surely, anyone who is in charge of a for-profit organization has to know whether the transactions he or she is creating are adding value for shareholders or consuming shareholders' investments. "I am not an accountant" is no defense for failing to understand whether you have created value for shareholders.

Economic concepts and accounting conventions

Understanding whether value has been created goes beyond generally accepted accounting principles. We all know that accounting income measurement is imperfect when it comes to capturing additions to shareholder value. But I think it is useful to dig a little deeper into the imperfections. In fact, I think it is useful to go all the way back to the beginning.

What do financial reports do? They use *economic concepts* and *accounting conventions* to accumulate and report financial information. They do so in a rich *institutional context*. The economic concepts contain our aspirations - what we are trying to measure. Economic concepts guide our structuring and presentation of data. Take the balance sheet, for example. We want to portray the entity's wealth at a point in time. We frame the presentation in terms of listing its assets, then subtracting its liabilities. Assets, liabilities, and equities are all economic concepts. This fact is underscored by the recognition that our familiar tool: Assets = Liabilities + Equities is in fact an *identity*. It holds by definition. When teaching, I usually rewrite the fundamental accounting identity as: Assets - Liabilities = Equities. This highlights the fact that the accounting identity is really a definition of equity as the difference between assets and liabilities.

The first step in applying this identity is to decide the entity to which it refers. Whose assets and liabilities and equities are we talking about? Mine? IBM's? Enron's? Chewco's?

The identity itself does not help us make this decision. The decision about what entity is the focus of the identity's application is a matter of *convention*. This is where generally accepted accounting principles (GAAP) come in. GAAP are required if we are to apply economic concepts to any practical situation.

The identity also does not help us decide where to draw the line on what to include in it. What exactly are we going to count as assets and what are we going to count as liabilities? For example, one balance sheet that always balances is to define assets to always be equal to zero and liabilities to be equal to zero. By definition, equity will then be zero:

$$0 - 0 = 0$$

I could be perhaps even a step cleverer. I could define assets as always equaling five and liabilities as always equaling three. By definition, equity will be two:

$$5 - 3 = 2$$

While these definitions preserve the accounting identity (i.e., the balance sheet balances), they are not very useful. GAAP come into play here by providing *recognition criteria* that guide our determination of when to count something. For assets, these criteria begin by looking at whether an item has a future benefit that is owned or controlled by the entity and that arose from a past transaction or event. For liabilities, they begin by looking at whether an item entails an obligation to make a probable future sacrifice of resources by an entity as the result of a past transaction or event.

The economic concept of income is another example. Income (loss) is the increase (decrease) in net assets arising from sources other than raising resources from or returning them to owners. The first step in determining whether to recognize income is to determine whether net assets have increased or decreased. Therefore, the calculation of income is tied to the recognition criteria for assets and liabilities.

A simple example

Now we are ready to examine a straightforward example that illustrates some of the defects of accounting in capturing increases in shareholder wealth. Suppose ABC Co. owns a building that originally cost $6 million and on which it had recorded accumulated depreciation of $4 million. So the book value of the building is $2 million. Now suppose ABC Co. sells the building for $3 million.

From the point of view of the accounting records, the transaction is clear. $3 million was received for an asset with a book value of $2 million. Therefore, net assets have increased by $1 million, and we will record a Gain on Sale of Building for $1 million.

But here is the key question: Did the sale of the building for $3 million actually increase the wealth of ABC's shareholders? Suppose we discover that the building was really worth $10 million, and that the chief financial officer of the company arranged to have it sold to his wife for $3 million. Then this transaction actually was a theft of shareholders' wealth, not an increment to it. The defect in the accounting here is its failure to record the opportunity cost of selling the building.

On the other hand, suppose $3 million was a fair price for the building. Why did ABC's accounts report a gain? They did so because the book value of the building was out-of-line with its market value at the instant of the transaction. Many aspects of accounting have been pointed to as causing this, from our beginning with historical cost, to our algorithmic depreciation methods, to our failing to "mark-to-market" for all assets. The bottom line is that the amount of the gain is as much a correction of the book value as it is a signal that value has been created for shareholders.

I do not think there is much confusion about this among senior executives, or even freshly minted business school graduates. Nor do I think that this simple example illustrates some basic flaw in the way we keep accounts. We start out recording an asset at its cost because the cost is the best estimate of value we have. As long as some firms have economic assets that are not readily tradable in markets with lots of buyers and sellers, complete mark-to-market adjustment will not be available. Accounting methods for making adjustments, such as depreciation algorithms and LIFO/FIFO inventory methods, will be required.

As long as adjustment processes are imperfect, there are bound to be times when differences arise between economic and book values. The accounts will reflect "gains" and "losses" when these differences are closed in a transaction, but these do not translate directly into increases or decreases in shareholders' wealth. For example, several years ago after interest rates had gone up sharply, some companies retired their debt early and borrowed to do it. The only thing this accomplished, except for enhancing the wealth of investment bankers, was the reflection of a "gain" on the income statement. The questionable nature of this gain is why gains on early retirement of debt must be reported as extraordinary items on income statements.

Now I want to reconsider the "I am not an accountant" defense. Is this really an admission that the effect on accounting income was the criterion by which decisions were made? We got rid of that notion in financial accounting research a long time ago when the functional fixation hypothesis for equity markets was debunked. It seems to me that the "I am not an accountant" defense is really a claim of the functional fixation of management.

It does not seem credible to me that sophisticated people could confuse the aspirations of accounting measurements and the practical results of its conventions and techniques. There is a lot of evidence for this claim. In the 1970s when many companies were switching from FIFO to LIFO to economize on taxes, there were a great many people able to explain why such a shift would add to shareholder wealth, even though reported net income was going to be lower. For a more recent example, every day it seems that some management is explaining that income was low because of non-cash charges, and that shareholders have not really lost as much as what is reported on the income statement. It seems that no one has much trouble explaining why some charges and losses are not so bad for shareholders. But for some reason, it appears tougher to identify when gains have not really enhanced shareholders' wealth.

Standards setters

We could go on talking about management all night, but let us move on to talk about standards setters. I believe standards setters are the products of their environment. This is particularly true with the FASB because of its elaborate due process requirements. If the rules are too detailed, it is because some interested party has a desire for the details. If there are loopholes in the rules, it is often because some interested party has the clout to keep them open.

In preparing my remarks, I read several of the previous Saxe Lectures. Robert Swieringa discussed his term on the FASB in one of the 1996 lectures. A quote from his lecture illustrates my point:

> "Another very frustrating standard was Statement 123 on stock-based compensation. �The development of other standards has reflected political behavior. However, the focus of the stock-based compensation project increasingly was on Washington as the project progressed. People decided to go around the Board's due process." (3)

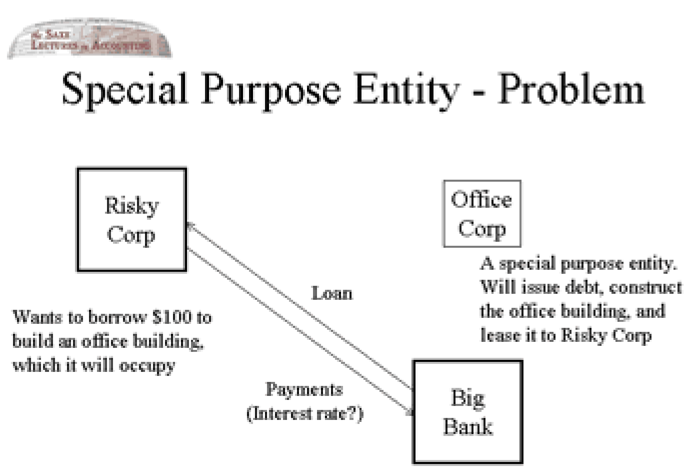
You can tell that I am sympathetic to the plight of the standards setters. I would like to highlight some of the difficulties they face by going through a particular case that might be currently of interest: special purpose entities.

Special purpose entities

Suppose Risky Corp is in the business of speculating on gold futures. It wants to build for its own use an office building that costs $100, and it wants to arrange financing to do so. One thing Risky Corp might do is to approach Big Bank and ask for a loan.

In deciding on an appropriate interest rate, Big Bank must consider the uncertainties involved in Risky Corp's business. Big Bank is likely to seek a relatively steep interest rate from Risky Corp because speculating in gold futures is a risky business.

Risky Corp would like to borrow money from Big Bank in a way that shields Big Bank's loan from Risky Corp's general business risk. Shielding the loan from Risky Corp's general business risk should allow Risky Corp to get a lower interest rate on its loan. After all, Risky Corp simply wants to construct and use an office building. It is not borrowing the money to use in its speculation.



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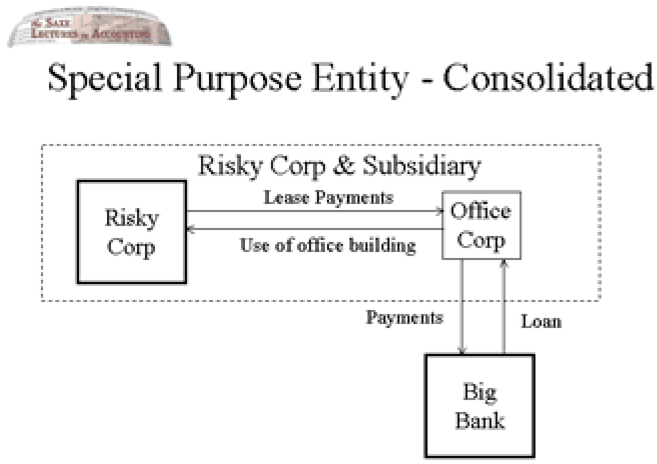
One way Risky Corp could shield the loan from its general business risk is to set up a special purpose entity, say Office Corp. Office Corp would borrow the money from Big Bank, construct the office building, and rent it to Risky Corp. A straightforward arrangement would be to make Office Corp a wholly owned subsidiary of Risky Corp. As a consequence, Risky Corp and Office Corp would be consolidated for financial reporting purposes. The office building and the loan would show up on the consolidated balance sheet. Depreciation on the office building and the interest payments to Big Bank would be reflected in the income statement.



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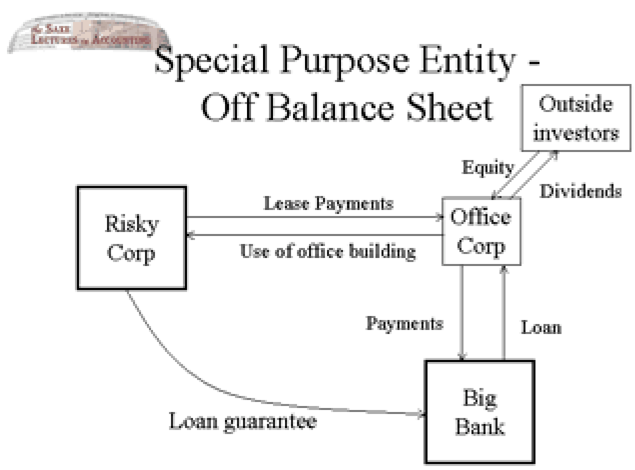
Now the real fun starts. If Office Corp was a completely separate corporation from Risky Corp, Office Corp would not be consolidated into Risky Corp. Neither the loan from Big Bank or the office building would show up on Risky Corp's balance sheet. Risky Corp would show rent payments on its income statement, but not depreciation on the office building or interest payments to Big Bank.



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To establish Office Corp as a separate corporation, Risky Corp needs to make sure that it does not own too much of Office Corp's stock. Risky Corp needs to find some outside investors that will own Office Corp. Of course, the holders of Office Corp equity will require a return on their investment, but if the reduction in interest is very large, Office Corp's shareholders can be paid some dividends and everyone will win as a result: Risky Corp gets its office building, and finances it more cheaply than it could have without setting up the special purpose entity. Big Bank is happy because it has lowered the risk on its loan. Office Corp's shareholders get a return on their investment.

So Risky Corp needs to find some outside equity holders to own Office Corp. How much of a problem is that? Office Corp does not need equity because it is going to borrow all the money to construct the office building from Big Bank. It will have the building as collateral and its lease with Risky Corp as a source of money from which it will repay the loan. Therefore, Office Corp needs only a miniscule amount of equity.

It seems a bit extreme to try to set up Office Corp with no equity at all. But Risky Corp has incentives to make the amount of equity as small as possible. You might imagine this dialogue between Risky Corp's executives and its accountants. "How about $0.01 of equity for Office Corp? Not enough to keep Office Corp from being consolidated into Risky Corp? How about $0.02? Still not enough? Ok, you tell me, how much equity is enough?"

Accountants and standards setters have only two choices. First, they can refuse to answer the question of how much equity is enough. Second, they can pick a number. Pre-Enron, that number was $3, now I believe it is $10.

Refusing to answer does not seem feasible. After all, you would just get this dialogue: "Let's go another way. How about $100 of equity? That will do it? Then how about $99? That's ok, too? Then how about $98?"

My point is that accounting standards setters have to answer the question of how much equity is enough for a special purpose entity. The answer will very likely be some level of equity, or at best a rule for determining a cut-off level of equity. Once there is a cut-off level or a rule for determining one, transactions' engineers will take only a few days to learn how to bend, shave, and otherwise maneuver around to get the results they want.

If the special purpose entity situation stopped here, it might not create too many problems. But I have left out an important piece. Suppose, in an attempt to further lower the interest rate on the loan from Big Bank, Risky Corp offers to guarantee Office Corp's debt. The guarantee might have a large or a small chance of coming into play. It might get really difficult to tell whether Risky Corp has much of a likelihood of having an obligation to Big Bank that we would feel should be recorded as a liability on Risky Corp's books.

In the case of Enron, there were two more pieces. Enron set up special purposes entities to hold all kinds of assets, not just buildings it was constructing for its own use. Apparently, some of these "assets" were Enron's own stock. Further, once a special purpose entity is not consolidated into its creator, the creator can book revenues from transactions with the special purpose entity.

Classification problems and principles-based standards

The difficulty presented by special purpose entities goes all the way back to the first judgment we have to make in applying the accounting identity: To what entity is the identity to be applied? Special purpose entities complicate this judgment. In accountant-speak, they make more difficult the choice of the proper level of consolidation.

This illustrates a basic difficulty faced by any accounting system. It is hard to construct an understandable accounting system in which Office Corp could be half-in and half-out of the proper consolidated entity for Risky Corp. Just as it is hard to construct an understandable accounting system where a particular financial instrument is half debt and half equity. We make a useful accounting system by classifying thousands of transactions and events into a finite set of bins and aggregating them. An accounting system with fuzzy categories is not likely to be as easily understood and useful as one with clearly defined categories, whether the categories of interest are the entities, assets, liabilities, equities, revenues, expenses, or extraordinary items.

If we are going to have categories, there have to be some rules for determining what goes in them.

Those rules could be either explicit or implicit, and they could be either uniform or varied. Our approach now is to try to make uniform, explicit rules. The proposal for principles-based accounting would leave the rules implicit and subject them to varied interpretation on a case-by-case basis. Without a substantial change in current institutional arrangements in which management is responsible for financial reports and auditors express an opinion on them, some combination of management and auditors would have to make the decisions about how to apply principles-based standards. Two issues arise here. One is that their decisions are likely to vary across otherwise similar circumstances. Second is that the demand for detailed rules and guidance(4) in our current standards came from auditors and managers. I simply do not understand how refusing to give guidance will work without radical changes in the relations between clients and auditors and in auditors' legal liability.

The accounting profession

I would be remiss in discussing the crisis in financial reporting if I omitted the accounting profession. In the current environment, I do not think the public will be keen on a proposed solution that gives auditors more leeway in determining what goes into financial reports. In a word, the credibility of the profession is shot. Executives are the only ones with a worse problem, probably because auditors have not as yet been implicated in some of their fiascos, such as getting caught trying to evade sales taxes and insider trading.

There is only cold comfort, however, in the refuge of "misery loves company." The profession must find proactive ways to recoup its status. An important first step, I believe, was taken last September 4 by Barry Melancon, president and CEO of the AICPA, when he publicly acknowledged the profession's role in creating some of its own problems.(5) He outlined some steps the profession is taking to rebuild its image. But it is a big job that will require an extended, concerted effort.

One of the difficulties the profession faces is that it has been the focus of criticism for some time now. Judge Stanley Sporkin, in the Saxe Lecture on September 22, 1993, had this to say:

> "During the recent past, however, the profession has not always lived up to its duties and responsibilities. �Because of the growing list of substandard audits, the profession is slowly losing its credibility�. We have seen too many recent instances of flawed accounting reports that simply have been chalked up to the overworked explanation that a certain amount of poor financial reporting is inevitable." (6)

Judge Sporkin also quoted Abraham Briloff, who at the time was the Emanuel Saxe Distinguished Professor Emeritus:

> "We are not confronted with a liability crisis. We are instead confronted with an identity crisis. We don't know for what, to whom, and the when of our responsibility."

These criticisms have a new sting in light of the Andersen failure. I had long been fond of Andersen. It was the firm that gave me summer jobs when it knew I was going on to graduate school to become a professor. I held, and still hold, in very high esteem two of my former undergraduate professors, Elba (Bud) Baskin and G. Michael Crooch, who left academia to work for Andersen. Through Mike Crooch, I came to know a little about Andersen's Professional Standards Group. It always struck me as a collection of the very best of the profession's highly talented, hard-working, and honest members.

Revelations that the advice of the Professional Standards Group was overruled in the Enron audit shocked me. I was further shocked by Andersen's lack of, or failure to deploy quickly, an emergency response team. I can only imagine that if GE caught wind of a major problem involving accounting in one of its divisions, a "SWAT" team would be dispatched immediately and those suspected would find their keys no longer fit the locks to their offices. They would certainly not be given access to documents that they could commence shredding.

I expect the new Public Company Accounting Oversight Board will assure that the remaining Big Four have procedures in place to prevent such things from happening in the future. I would like to see the Big Four act now to fortify their emergency response procedures. I would like to see them do it in a very public way, and I would like to see them do it on their own, without waiting for the Public Company Accounting Oversight Board to require it. This is very likely to be especially important at a time when Andersen's former clients have been dispersed to other firms.

I am confident that each of the Big Four are taking and have taken steps to minimize the likelihood that it will be the next Andersen. But their efforts have not received much attention from the financial press or the world at large. I hope the profession steps up its efforts to rebuild its image by proactively taking and publicizing strong action. Because you cannot build credibility by being forced into it, I believe the profession needs to respond ahead of requirements that the Public Company Accounting Oversight Board is likely to impose.

Conclusion

If I have done nothing else in this lecture, I feel I have fulfilled my promise in the introduction to skip lightly around the territory of the crisis in financial reporting. I have touched on the role of management, economic concepts and accounting conventions, the difficulties faced by standards setters, and the accounting profession's credibility problems. I left boards of directors and government regulators for another day.

Whatever comes out of this crisis, and I do believe it is a crisis, perhaps it has caused us to think a little more deeply about financial reporting - about what makes it work, how valuable and important a trustworthy system is, what its strengths and weaknesses are, and how we may help fashion a culture that relies on its strengths without taking advantage of its weaknesses. I believe that the system of financial reporting has tremendous strengths that we often take for granted and, unfortunately, have too often not defended rigorously enough, both in academic circles and in practice.

Footnotes

(1) All dictionary definition in this lecture are from *The American Heritage Dictionary of the English Language*, 4th Edition, HoughtonMifflin Company, 2000, as reflected on Dictionary.com in October, 2002.

(2) Kirkpatrick, David D., "From 'Piranha' At Homestore To Key Role In U.S. Inquiry," *The New York Times*, Friday, September 27, 2002, pages C1 and C3

(3) Robert Swieringa, "FASB in My Rear View Mirror," *The Saxe Lectures in Accounting*, April 22, 1996. Available at http://newman.baruch.cuny.edu/digital/saxe/saxe_1996/swieringa_96.htm

(4) Katherine Schipper aptly laid out the issue of guidance in applying standards in a speech before the American Accounting Association in Augst 2002.

(5) Barry Melancon, "A New Accounting Culture," speech before the Yale School of Management at the Yale Club of New York, September 4, 2002. Video available online at http://www.aicpa.org/video/New Culture/.

(6) Stanley Sporkin, "The Time Has Come: A Call to the Accounting Profession to Join the Fight Against Financial Fraud," *The Saxe Lectures in Accounting*, September 22, 1993. Available at http://newman.baruch.cuny.edu/digital/saxe/saxe_1993/sporkin_93.htm