Problems Related to the Accounting Industry and Accounting Standards: Evaluation of Proposed Reform Measures

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The growing epidemic of accounting fraud

When Enron announced that it would file for bankruptcy protection, the largest case in US history with $62.8 billion in assets[1], this past December, investors were baffled at how the once seventh-largest company on the Fortune 500 could have spiraled into financial ruin so quickly. There were earlier indications of financial trouble that sent the company's stock price falling, yet no one outside of the company could have possibly imagined the future magnitude of Enron's dilemma. Not until these past couple of months have investors truly understood the events that led up to the energy giant's downfall.

According to recent investigations, the events that eventually led Enron to file for bankruptcy can be categorized into two key issues. Among the reasons for the firm's demise is the simple fact that the company's operations were not as profitable as they seemed. Despite the fact that Enron had reported 20 straight quarters of increasing income over the past five years, its operating margin told a different story. The firm's operating margin had plunged from around five percent in early 2000 to under two percent by early 2001, and its return on invested capital hovered at just seven percent, a figure that did not include Enron's substantial off-balance-sheet debt.[2]

Secondly, Enron invested in projects that generated great losses for the company. Some of these bad investments include interests in pipelines and power plants in such countries as India and Brazil. Enron's decision to broaden its trading activities beyond energy derivatives by creating new financial instruments developed for the broadband industry was another unsuccessful venture for the company.

These trading and investment activities forced Enron to take on massive amounts of debt during the mid to late 1990s. Toward the end of summer 2001, concerns regarding the company's credibility were raised and the price of Enron's stock began to fall – from a high of $80 a share at the beginning of the year to around $40 a share by mid-August.[3] Despite the fact that Enron's share price had decreased significantly from the beginning of 2001 to the middle of the year, and taking into account the impact that the recession and the terrorist attacks on September 11 had on the financial markets, the price of Enron's shares remained relatively high in respect to the company's financial performance.

The reason why the firm was able to keep its stock price inflated while enduring financial troubles was because it did not disclose certain information reflecting its true market value and hid many of its losses through partnerships. For example, on October 16, a few months before the firm filed for bankruptcy, Enron announced that it had taken

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[1] "'Nervous' employee warned Enron CEO," CNN.com January 15, 2002.
[2] Bethany McLean, Janice Revell, and Jessica Sung, "Why Enron Went Bust," Business 2.0 December 2001.
[3] Business 2.0 December 2001.

on a $618 million loss for the third quarter. However, it did not reveal to the public that it had also written down shareholders' equity by $1.2 billion, a substantial amount totaling nearly twice the amount of the losses it had declared earlier.[4] As for the partnerships, Enron executives established shell companies, such as Chewco and JEDI, that allowed the firm to exclude hundreds of millions of dollars in debt from its financial statements.[5] LJM2, another one of the company's partnerships, helped Enron by purchasing some of the company's under-performing assets. This allowed Enron to eliminate certain assets and liabilities from its balance sheets and improve its debt position, which made it easier for the firm to borrow money.[6]

It was through these types of activities that Enron was able to deceive its shareholders and investors and artificially inflate its market value. The company, though, did not act unilaterally and was aided by numerous parties, consisting of both insiders and outsiders of the organization. Among those involved include the company's audit committee, board of directors, lawyers, investment bankers, and stock analysts. Much like Enron, these entities profited a great deal through the establishment of the partnerships. Those on Wall Street, for instance, were rewarded with hundreds of millions of dollars by aiding Enron in the creation of the joint ventures. Through underwriting fees alone, the investment banks earned $214 million, in addition to several million more in lending, derivatives trading, and consulting fees from Enron.[7] As for the company's law firm, Vinson & Elkins also had much to gain from the partnerships as well, primarily in the form of legal fees earned from the creation of the shell companies.

Of all the parties involved, with perhaps the exception of Enron's top executives, Arthur Andersen, the firm's independent auditor, has received the most media attention. The accounting firm is perhaps most notably known for shredding memos and documents related to Enron's financial statements. On October 12th, Arthur Andersen's lawyers circulated a memo to company employees directing them to destroy a large portion of the audit material – including thousands of e-mails and electronic and paper files – related to Enron.[8] Besides the reports of shredding, there is another reason why Arthur Andersen has received a lot of exposure. Since the company was responsible for the firm's auditing and accounting, it had a direct role in the formation of Enron's financial statements, the same documents that mislead investors in believing that the energy giant was more profitable than it actually was. Whether Arthur Andersen knowingly took part in the scandal has yet to be determined, though the evidence brought against the accounting firm overwhelming favors the case of federal prosecutors.

In the past, there have also been allegations brought up against the accounting industry for fraud resulting from audit failures. For example, this past June, Arthur Andersen was fined $7 million by the SEC for its auditing of Waste Management's financial statements that were reportedly false and misleading. Just last year, the firm also agreed to pay $110 million to reconcile a class action suit that accused Arthur Andersen of committing similar fraudulent activities on Sunbeam's statements. Ernst & Young LLP is another accounting firm that was involved in a situation where Cedant, one of the firm's clients, agreed to pay shareholders $2.83 billion for accounting indiscretions stemming from a merger with CUC International. In another attempt to artificially boost

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[4] Business 2.0 December 2001.
[5] Daniel Kadlec, "Who's Accountable," Time January 21, 2002
[6] "Wall Street firms earned millions from Enron," CNNmoney January 14, 2002
[7] CNNmoney January 14, 2002
[8] Time January 21, 2002

profits through accounting measures, MicroStrategy's executives were fined $350 million each and brought attention upon its auditor PricewaterhouseCoopers.[9]

Cases of financial deception are not new to the corporate history of the United States, where celebrated cases such as the savings and loans of the 1980s and the near bankruptcy of LTCM come to mind. However, the more recent examples appear to characterize a growing trend of accounting scams rather than isolated instances of fraud. SEC data shows that federal regulators investigated 112 cases in 2001, an increase of 41 percent from 1998.[10] The next two sections of this paper will focus on some of the reasons for the increasing cases of deception, in particular those originating from the accounting industry and current accounting standards.

Reasons to question the integrity of external auditors

In the business world, the measure of a company's performance is usually defined by the profits it can generate. For instance, the stock value of a publicly traded company is often times determined by the quarterly earnings of the firm. If a company manages to exceed profit estimates, its share price tends to increase. In contrast, if the firm's earnings are sub-par, the price of its stock generally falls. This measure, though, is not solely restricted for investor purposes. Companies that manage to bring in profit amounts greater than that of their competitors are also more appealing to employees and potential employees. They can afford to compensate their workers with higher wages and more benefits, which helps to retain valuable human capital. Furthermore, such companies can also attract skilled workers away from other firms with the prospect of larger salaries. Higher earnings also allow for greater growth opportunities. Profits can be reinvested in firms to purchase capital and to fund expansion. An advantage resulting from larger operations is that companies can reduce their unit costs through economies of scale. Given the importance of corporate earnings, it should be of no surprise that the pressure to remain profitable impacts practically all levels of the organization.

Divisions within a company, for instance, are evaluated according to the profits they are able to produce for the firm. This appraisal technique, though, raises concerns regarding the ability of auditors, in particular, to effectively perform their jobs in the presence of earnings demands.[11] The problem with this specific situation is two-fold. The first issue is whether auditors can accurately assess the financial statements of client companies while at the same time maximizing the returns of their divisions. When performing an external financial audit, the process of determining the reliability and accuracy of financial statements by an objective and independent party, auditors must evaluate a firm's monetary position according to its assets, liabilities, and contributing capital. However, the accounting standards auditors must adhere to in order to calculate these amounts can at times be open to interpretation, a topic that will be discussed in more detail later on in the paper. As a result, a group of auditors reviewing the accounts of the same firm may each have different interpretations of the company's financial position. Some may have a more conservative interpretation whereas others may have a more liberal view.

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[9] CNN.com January 15, 2002
[10] CNN.com January 15, 2002
[11] For the remainder of this paper, "auditor" will represent "external auditor"

From the viewpoint of the party under review, the firm has an interest in having financial statements that reflect positively upon the organization. Credit agencies are more willing to lend to and investors generally favor companies with smaller leverage ratios. So when choosing among accounting firms, companies will be more inclined to conduct business with auditors that can interpret their financial positions favorably. This presents a dilemma for the auditor since there is a premium in assessing the reliability of financial statements with greater tolerance, which may not always provide investors and lenders with the most accurate view of the company's performance. In other words, auditors must balance between retaining clients and profits on the one side and upholding principles of integrity, quality, and professionalism on the other.

The second problem deals with the ability of auditors to effectively perform their duties despite pressure from other departments within the accounting firm. Although most of the larger accounting firms provide their clients with auditing services, many of these companies also offer their customers other valuable services, such as business and risk consulting and tax and legal advising. In fact, these auxiliary services account for a significant portion of the total revenue of many accounting firms. As illustrated in Table 1, the income generated from non-assurance services, including tax and legal, consulting, and information systems implementation, amount to more than half, and as much as two-thirds, of the entire revenue for four of the five Big Five accounting firms.[12] However, since many of the firms include revenue from outsourced internal auditing and advising services when computing total revenue from assurance, the percentage of revenue from non-audit services is most likely greater than the percentages indicate in Table 1.

Table 1. Revenue Amounts of "Big Five" Firms

Company	**Revenue in 2001 (in billions $)**	**Portion of revenue from non-assurance services**
Arthur Andersen	9.34	54%[b]
Deloitte & Touche	6.13	67%[b]
Ernst & Young	9.86	43%[b]
KPMG	13.5[a]	59%
PricewaterhouseCoopers	21.5[a]	61%[b]

[a] Represents revenue in 2000, since 2001 figures have not been released by these firms

[b] Companies that include revenue from advisory services when calculating revenue from assurance

Given the lack of detail in the corporate earnings reports of the Big Five firms, researchers have tried to obtain a more accurate view of the portion of non-audit fees paid to the large accounting firms. In a recent study conducted by Frankel, Johnson, and Nelson, the researchers collected data from the proxy statements of 2780 client companies filed between February 5, 2001 and June 15, 2001. They found that audit fees made up no more than one-third of the corporate revenue of the Big Five firms and that non-audit fees ranged from a low of 67 percent to a high of 75 percent of total revenue.[13]

[12] Derived from company websites

[13] Frankel, Richard M., Johnson, Marilyn F., and Nelson, Karen K., "The Relation Between Auditors' Fees for Non-Audit Services and Earnings Quality." http://papers.ssrn.com. Date Accessed: February 2002

Among some of the more elaborate cases reported in recent years include Delphi Automotive Systems paying Deloitte & Touche $6.6 million for audit services but $50.8 million for additional non-audit services, FleetBoston Financial paying PricewaterhouseCoopers $8.6 million for auditing work and $33 million for other services, and Wells Fargo awarding KPMG $4.2 million in audit fees while contracting $37.5 million for additional non-audit work.[14] Even in the recent Enron scandal, the former energy giant paid Arthur Andersen a reported $27 million in non-audit fees last year while contracting only $25 million in audit fees.[15]

Some experts estimate that accounting firms industry wide, in addition to the Big Five firms, also receive revenue amounts from non-audit services that are comparable to those received for audit services. Abbott, Parker, Peters, and Rama found that 96 percent of public companies buy non-audit services from their accounting firms and pay an average of $2.2 million, or 1.97 times the audit cost for non-audit services from the same firm.[16] These findings all illustrate the pressure that is placed on auditors to retain clients not only for proceeds from auditing services but also for the even greater profits generated from the purchase of supplementary services. Much like the need to maximize the profits of their divisions, the demand to satisfy clients that purchase consulting and advisory services provides auditors with another reason to review financial records in a more tolerant manner, albeit at the cost of investors and creditors.

Aside from corporate profits, another explanation for why auditors are sometimes tempted to compromise the integrity of their audits is that clients occasionally offer contracted auditors more attractive and well-paying positions at their own firms. Considering the limited promotional opportunities available at a single accounting firm and the rapport and access that auditors can have with the upper-level management of client companies, auditors sometimes feel inclined to match the results of their audits with the expectations of their clients in hopes of receiving potential job offers. In the Waste Management case, for example, all of the chief accounting officers of the company were chosen and hired directly from Arthur Andersen staff.[17] As for Enron, its chief accounting officer, Richard Causey, directed Arthur Andersen's audit team at the energy firm before he was later acquired by the Houston-based company. Interestingly, not only was Causey responsible for creating Enron's financial statements, but he also headed the office that reviewed and approved special partnership deals.[18] According to the Institute of Internal Auditors, Enron's chief audit executive was also signed from one of the Big Five firms, in this case PricewaterhouseCoopers. In addition, the IIA reported that a significant portion of Enron's accounting staff used to be employed by Arthur Andersen, in many cases immediately before working at the energy company.[19]

The inadequate standards set forth by some accounting firms also serve as an additional source of concern. Without a strict and disciplined set of policies to abide by, auditors may lack a sense of accountability in the work they perform. This can result in

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[14] Alan Levinsohn, "Fees Paid to Audit Firms Exceed Estimates," Strategic Finance August 2001

[15] "Enron paid one of largest audit bills to Arthur Andersen," Alexander's Gas & Oil Connections, Company News: North America Volume 7, Issue 24, December 19, 2001.

[16] Abbott, Lawrence J., Parker, Susan, and Peters, Gary F., "The Effectiveness of Blue-Ribbon Committee Recommendations in Mitigating Financial Misstatements: An Empirical Study," http://accounting.rutgers.edu. Date Accessed: March 2002

[17] CNN.com January 15, 2002

[18] Time January 21, 2002

[19] The Institute of Internal Auditors, http://www.theiia.org. March 18, 2002

financial record reviews that are not as meticulous as they should be and a greater acceptance of accounting irregularities. Under this scenario, accounting frauds and scams have an increased probability of success. One report by the Wall Street Journal describes how a jewelry seller managed to defraud Wells Fargo out of $14.5 million in 1996 using falsified financial statements that managed to successfully pass Ernst & Young's full audit procedure.[20] When asked to supply records of various receivables, payables, invoices, and bank statements for the audit, the jeweler created the documents himself and provided Ernst & Young with black and white copies. The auditors were reportedly satisfied with what the jeweler provided and never asked for original documents. Furthermore, when Ernst & Young appraised the inventory for market value, the seller managed to fool the auditors using deposit boxes filled with a mix of genuine and costume jewelry.

Although accounting frauds in the US, such as the example provided, are more prevalent among relatively small firms with assets below $100 million, a majority of these dishonest companies hire large accounting firms for auditing needs, according to research conducted by the Committee of Sponsoring Organizations of the Treadway Commission.[21] The study also found that financial statement fraud occasionally implicated the external auditor.

Regardless of the size of the firm under review, accountants have a responsibility to audit a company's financial statements with the highest degree of scrutiny and to provide third-party agencies with an accurate assessment of accounting records. However, when accounting firms fail to establish thorough procedural guidelines, separate areas of conflicting interests, reinforce the importance of ethical conduct, and enforce corporate policy by punishing violators, they jeopardize the independence of their auditors and must also bear a large part of the blame.

Flaws with several accounting standards

As mentioned earlier, accounting standards can at times be open to interpretation and can allow a firm to assess its financial position using a number of different means. Each approach, however, can potentially paint a different, and at times inaccurate, picture of the company's pecuniary status. The amount of maneuverability allotted to a company in how it can interpret its finances, in essence, permits the firm to determine how the public perceives it financially.

An example of an accounting principle that provides firms with a great deal of discretion is mark-to-market accounting. MTM is an accounting method that permits companies to include future profits from the trade of securities or commodities that they expect to receive as current earnings.[22] Accepted by the Financial Accounting Standards Board, MTM allows firms to estimate the value of these transactions partially based on their own assumptions of upcoming market conditions and risks. Since this accounting approach is mostly used at the end of fiscal quarters, when firms tend to have outstanding securities and commodities trades on their balance sheets, MTM introduces the risk of firms overestimating their future profits and inflating earning reports. Enron, for instance,

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[20] Jeff D. Opdyke, "Aspiring Midas Enmeshes Auditors in Gold Chain," The Wall Street Journal March 1, 2002

[21] Fraudulent Financial Reporting: 1987-1997 – An Analysis of U.S. Public Companies, http://www.coso.org. Date Accessed: March 2002

[22] Stephen Taub, "Question Mark to Market: Energy Accounting Scrutinized," CFO.com December 4, 2001

utilized estimated gains from MTM accounting to account for more than half of earnings in 2000 and approximately one-third of its income in 1999.[23] The use of this accounting method is part of the reason why Enron's operations appeared more profitable than they actually were. Dynegy, the firm that had plans of merging with Enron but ended negotiations shortly before the energy-giant went bankrupt, also used the technique to account for nearly half of its annual profits in 1999 and 2000. Other companies also known to have used MTM accounting to boost profit reports include American Electric Power, Duke Energy, El Paso, Entergy, Mirant, and Pinnacle West Capital.[24]

The ability of firms to exclude options as expenses is another accounting standard that may lead to an inappropriate perception of corporate finances and risk. Companies may use options as a means of compensating a business transaction or providing their employees with incentives without having to present cash or other company assets upfront. Part of the reasoning for why the International Accounting Standards Board chose not to consider options as an expense is because there is no exchange of assets at the time the option is issued and there is no guarantee that the second party will exercise the option.

The consequence of this decision, though, is that a company can issue as many options as it wishes without impacting the amount of its current fiscal period expenses. However, if a company does issue a large number of options in a short period of time, then the investor unknowingly faces a high degree of risk. If future market conditions are favorable for the recipient of the option, that party can then exercise its contractual right to assets promised by the firm. This in turn lowers corporate profits for the period in which the option is put into effect. Also, if the firm chooses to issue stock to payoff the obligation, then the monetary and ownership value of its shares is further diluted, depreciating the worth of the shareholder's investment.

Off-balance sheet transactions, especially those involving special purpose entities and related parties, have also been criticized as a result of recent events. There are currently no requirements for firms to report specific deals involving these parties on their financial statements. This means that companies can conduct business with these entities without having to disclose on their financial statements how the deals specifically affect their assets, liabilities, and contributing capital.

Similar to MTM accounting and the issuing of options, off-balance sheet transactions can also misinform the public of the effectiveness of a company's operations and place investors at great risk. They allow companies to transfer large sums of debt from their financial statements onto the records of subsidiaries and other firms. This enables them to improve their debt position on their balance sheet, despite the fact that many firms still bear the full-burden of their loans and credit obligations by having majority control and ownership in the partnerships.

Setting things right

Numerous regulatory agencies and federal legislators have proposed reform measures in response to the growing trend of accounting fraud. The proposals that have received the most attention include enhancing disclosure quality on corporate financial statements, prohibiting accounting firms from providing both consulting and auditing

[23] CFO.com December 4, 2001
[24] CFO.com December 4, 2001

services to the same company, mandating the rotation of audit engagements, and increasing federal funds to improve the performance of the SEC. Although each of these policies were created with the intent of preventing, or at the least minimizing, future cases of financial deception, not all of these reform measures seem appropriate for accomplishing such a goal. The remainder of the paper will focus on evaluating the effectiveness of each of the aforementioned proposals and how some of these policies will affect the rights of shareholders and firms.

1) Enhanced Disclosure Policy

Some regulatory officials feel that simply increasing disclosure requirements is insufficient and that greater emphasis should be placed on reforming current GAAP accounting rules set forth by the FASB. Changes in MTM accounting, inclusion of options as corporate expenses, and restrictions on off-balance sheet transactions via SPEs and related parities have all been considered as possible reform measures. However, implementing such change is not an easy task and the FASB may require several years to layout and agree upon a set of guidelines. As former SEC chairman Richard Breeden stated in his testimony to the US Senate, "the FASB has long had a tortuously slow process for writing accounting standards, somewhat comparable to the pace of a glacier trying to run uphill."[25] Given the urgent need for restoring investor confidence and faith, improvements for the accounting system cannot be prolonged and must be enacted as soon as possible.

Academic research indicates that some current disclosure requirements are sufficient. In a study by Aboody, Barth, and Kasznik, the researchers found that stock-based compensation that is disclosed but not included in the calculation of a firm's profits has a negative correlation with stock price.[26] Investors realize that that they are an expense on the firm and include potential option costs when assessing firm valuation. Thus, in regards to items such as stock options, changes in current disclosure requirements are unnecessary.

However, not all disclosures will provide adequate feedback to investors. In fact, some are misleading and can result in poor investment decisions. Market risk disclosures, estimates of market risk that can be calculated using one of three methods approved by the SEC, for instance, have the potential to deceive shareholders.[27] The reasons why market risk disclosures can at times be misleading is because: 1) they are based on unconfirmed assumptions rather than historical data and 2) management is allotted a considerable amount of discretion in choosing the estimates that are revealed and the methods used for risk calculation. Given these conditions for estimating risk, one should be concerned about how informative the disclosures really are. Some academic research provides evidence suggesting that there is good reason to be skeptical of market risk disclosures. A study conducted by Hodder shows that when managers are given greater

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[25] Breeden, Richard J., "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies," Washington, D.C., U.S. Senate Committee on Banking, Housing, and Urban Affairs. February 12, 2002

[26] Aboody, David, Barth, Mary E., and Kasznik, Ron, "SFAS 123 Stock-Based Compensation Expense and Equity Market Values," gobi.stanford.edu. Date Accessed: March 2002

[27] The three market risk calculation methods include tabular listings of financial instruments, sensitivity analysis, and value at risk.

discretion in predicting market risk, the reliability and relevancy of their disclosures decreases.[28]

In cases where companies are allowed to release profit and risk estimates based on assumptions that cannot be verified and/or are unreliable, such as market risk disclosures and MTM accounting, greater effort should be taken to ensure that assumptions are based on realistic forecasts rather than overzealous optimism. Furthermore, companies should not be given wide discretion when determining the type of information they wish to release. As for the case of off-balance sheet contracts and activities with related parties, any financial transaction that significantly changes a firm's accounts and cash flows should be disclosed to investors. However, the danger in implementing further disclosure requirements to improve the quality of financial statements is that firms may release greater information for the sake of quantity. The fear is that the potential excess of information will overwhelm investors and make it harder for them to evaluate the data in corporate financial statements.

Despite the concerns regarding information overload, the fact remains that investors are the ones who are responsible for understanding the financial performance of companies with which they have invested interests. If investors do not have the time to filter and extract data from corporate financial statements, then they should expend the resources necessary to hire individuals that can. So long as corporations disclose accurate and thorough information needed to assess the value of their firms, they have fulfilled their obligation of allowing investors to view their companies as seen "through the eyes of management."

2) <u>Prohibiting accountants from providing both auditing and consulting services</u>

As mentioned earlier, research has indicated that non-audit fees consisted of up to 75 percent of the total revenue of the Big Five accounting firms. Given the pressure placed on external auditors to retain clients that purchase consulting services, and the recent media attention placed on Enron and other related cases of accounting fraud, there is an urgent need to separate auditing units from consulting units in order to maintain the integrity and independence of the auditor.

The accounting profession has realized that certain non-audit services should not be performed for an audit client. Almost all of the Big Five accounting firms have already taken steps in response to the issue of auditor independence. Arthur Anderson, Ernst & Young, and KPMG have legally separated their consulting units from their audit units through contractual splits and spin-offs. As for PricewaterhouseCoopers, it has decided to separate from its consulting unit via public offering. Deloitte & Touche, the only Big Five firm that did not initially endorse the need for reform, also has plans to separate its accounting and consulting businesses by creating a spin-off firm.

Despite the concurring opinions of the larger accounting firms that a separation of auditing and consulting services is needed, not every accounting firm shares the same sentiment and is willing to take appropriate action. As a result, legislation that limits accounting firms to auditing services and audit-related services is needed. Auditing firms should be prohibited from providing services such as investment banking, business and risk consulting, legal service, and outsourced internal auditing to their clients. Congress

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[28] Hodder, Leslie, "Reliability and Relevance of SEC Market Risk Disclosures by Commercial Banks," diss., University of Texas, February 19, 2001

should take action and begin drafting a bill that formalizes the requirement to separate auditing units from consulting units.

3) Mandating the Rotation of Audit Engagements

In his testimony to the US Senate Committee on Banking, Housing, and Urban Affairs, Richard Breeden suggested that there should be mandatory limits on audit engagements within the time frame of five to seven years. He notes that if steps are taken to detach consulting units from accounting firms, then these firms will become substantially more dependent on audit revenue, which may further jeopardize the independence of auditors.[29] This once again raises the issue of whether auditors can form a balance between retaining clients and profits on one side versus upholding principles of integrity, quality, and professionalism on the other. Advocates of mandatory rotation also believe that forcing companies to switch accounting firms every so often will prevent them from forming close ties with their auditors. If firms realize that they will only be able to contract their auditor for a short number of years, then there is less of an incentive to invest the time and effort needed to develop a close business relationship.

Many of the arguments for mandatory rotation are predicated on the belief that limiting the engagement period between auditors and their clients can prevent accounting fraud. However, research by Walker, Lewis, and Casterella shows that the rate of audit failure is actually much lower in long-term relationships.[30] The researchers have also observed that the concern regarding new audit engagements may have more to do with the overall risk associated with the companies that choose to change auditors than with the risk of contracting a new auditor. As a result, even if companies are forced to contract a new auditor they may still engage in accounting fraud. These findings suggest that the implementation of a mandatory rotation policy may fail in reducing future counts of deception.

Current SEC chairman Harvey Pitt also believes that the mandatory rotation of auditing firms is unwise. He believes that accounting firms are not identical in the services they provide or the approach they take. One accounting firm may not necessarily have the resources to satisfy the needs of a business that another accounting firm has. Also, accounting firms have strengths that are unique to their own company, such as expertise in a certain industry or technology, which cannot always be provided by other firms.

Although not a primary reason for prohibiting the implementation of mandatory rotation, an added benefit of allowing firms to choose their own auditors is the cost savings associated with a long-term engagement. Knowledgeable audit teams tend to be more efficient and productive than teams that are unfamiliar with a company's operations. Nevertheless, the key issue remains that the mandatory rotation of audit engagements will not reduce accounting fraud. Because the majority of audit failures originate with the client firm rather than with the auditor, the frequency of accounting frauds will stay the same with or without the proposed policy. Mandatory rotation is inefficient as a preventive means and should not be enacted. The liberty to choose one's

[29] Breeden, February 12, 2002

[30] Walker, Paul L., Lewis, Barry L., and Casterella, Jeffrey R., "Mandatory auditor rotation: arguments and current evidence," Critical Perspectives on Accounting Conference, 1999

auditor should ultimately remain a right of the corporation and should not be restricted by government intervention.

4) Increasing SEC resources

In addition to creating rules governing the US securities markets and enforcing federal security laws, another function of the SEC is to review a firm's 10(K), a more detailed and unvarnished picture of a company's operations and situation than is found in its regular annual report, approximately once every three years. In Enron's case, however, the SEC was unable to investigate the firm's 10(K) in the year 2000 due to a lack of resources. Had the commission managed to conduct the investigation it is possible that Enron may have been caught deceiving its shareholders long before the firm declared bankruptcy at the end of 2001.

There are currently several suggestions on how to increase the SEC's resources in order to improve the agency's operations. One proposal is to increase the number of staff in the accounting area so that the commission can conduct more frequent reviews of new offerings and periodic filings. With more accountants, lawyers, and professional staff, the SEC will boost its ability detect irregularities in corporate financial statements which should help prevent future cases of accounting fraud.

Another suggestion is to provide full funding of pay parity. Under the pay parity system, the SEC professional staff would receive salaries that are comparable to those received by professional staff at federal banking agencies. Currently, the agency's staff earns 24 to 39 percent less than attorneys, accountants and examiners at banking agencies.[31] Equal earning bases should theoretically help improve staff moral and increase employee productivity. Some advocates also feel that pay parity will help retain professional staff and provide them with an incentive not to enter the more lucrative private industry. Over the past couple of years, the SEC has lost approximately 30% of its professional staff to private industry firms.

Although sound in theory, pay parity is not the best means of improving staff efficiency or retaining human capital. The reason why the SEC has been unable to keep pace with the growing security markets and rising volume of investors is not because its staff has under-performed relative to its potential capabilities. Rather, it lacks a sufficient number of personnel to match the emergent needs of the US financial markets. Furthermore, even with the implementation of a fully funded pay parity system, the agency will still face difficulties in convincing its professional staff not to enter the private industry. Much like other government agencies, such as the CEA and Federal Reserve, a large majority of the SEC's staff consists of visiting scholars, professors, and professionals who decided to join the agency merely to gain a few years of regulatory experience before returning to their institutions or reassigning to a higher paying position. This explains why the SEC has a turnover rate of approximately 30 to 40 percent every year.

However, high employee turnover is not necessarily a negative characteristic for the agency. After working for several years at the SEC, the excitement of working at the

[31] Unger, Laura S., "Testimony Concerning Fee Collections Required by the Federal Securities Laws," Washington, D.C., U.S. Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises. March 7, 2001

agency tends to wear off and a sense of routine begins to set in. New professionals and scholars, on the other hand, bring with them fresh innovative ideas for financial regulation and investor protection. In addition, the differing backgrounds and varying schools of knowledge that new agency employees bring to the SEC allow for quality debate and healthy discussion of regulatory issues.

Conclusion

Recent cases of accounting fraud such as the Enron and Waste Management scandals are characteristic of a growing epidemic of accounting fraud rather than isolated cases of deception. Part of the blame can be traced back to problems in the accounting industry. Auditors are expected to uphold principles of integrity and professionalism while facing profit and competition pressures from the auditing departments of other firms as well as from other divisions within the company that provide non-audit services to clients. The activities of auditors are also influenced by the prospect of higher-compensating employment from client companies and the inadequate standards set forth by some accounting firms. These factors severely affect the auditor's ability to remain independent.

Flaws in several accounting standards – such as mark-to-market accounting, market risk disclosure, option expenses, and the treatment of off-balance sheet transactions involving special purpose entities – also helped contribute to the emerging pattern of deception. These, among other current accounting rules, allow firms to have wide discretion in estimating future profits and risk, disclose and hide certain types of information from the investing public, treat options as non-expense items that have no impact on current fiscal period earnings, and exclude liabilities from corporate balance sheets even though the firm may still bear the full-burden of these obligations.

In response to the urgent need to restore investor confidence, federal regulators and lawmakers have proposed several new initiatives that they hope will remedy the situation. Some of their reform measures seem effective for preventing, or at least limiting, future cases of accounting fraud. These include enhancing disclosure quality, separating auditing and consulting units, and increasing the number of SEC professional staff. However, other suggested reform policies are ineffective and should not be implemented. For instance, mandating the rotation of audit firms will not aid in the reduction of future accounting fraud. As for pay parity, the full funding of this program will not help to significantly increase the efficiency and output of the SEC. Ill-advised proposals such as these will simply inhibit the ability of firms to operate efficiently and waste federal funds that could potentially support more productive government programs.