The University of NSW
School of Accounting

SEMINAR
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Why Have the Recent U.S. Corporate Collapses Captured the World's Attention?

presented by

Stephen Zeff

Rice University

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Why Have the Recent U.S. Corporate Collapses Captured the World's Attention?

Their sheer size and number (Enron, WorldCom, Global Crossing, Qwest, Dynegy, CMS Energy, Tyco, Adelphia, Peregrine, Sunbeam, Baptist Foundation of Arizona, Waste Management, Xerox, etc., etc.)

The involvement of high-flying companies in two high tech industries: energy and telecommunications

The tragedy of so many Enron employees losing not only their jobs but also their life's savings

That Enron and its CEO had been contributing large sums to many national political figures of both parties – also, Enron ran a major lobbying operation in Washington

The arrogance of so many top corporate executives, and their contemptuousness toward their fiduciary responsibilities to shareholders and other stakeholders

The central role of one Big 5 accounting firm, Andersen LLP, in so many of the failures

The shredding of documents by Andersen employees at the time of a Securities and Exchange Commission inquiry

How can Enron be described?

A systemic failure in performance by

- **Senior management**
- **Board of directors, especially the audit committee**
- **External auditor**

'individual and collective greed in an atmosphere of market euphoria and corporate arrogance'

- C.W. Thomas, *Journal of Accountancy*, April 2002

Three Major Transgressions by Enron

1. Engaged in transactions that had no business or economic purpose – to create an illusion of greater revenues and profitability

2. Mis-used 'special purpose entities' to increase revenues, hide losses, and keep debt off its consolidated balance sheet – many of its 'special purpose entities' were not independent of the company

3. Cloaked the true nature of these practices from public view through obtuse and incomplete disclosures – a lack of transparency

Enron was abetted by the following parties:

1. An external auditor that apparently did not exhibit sufficient professional skepticism and objectivity

2. An audit committee that failed to exercise proactive oversight

3. A law firm that did not provide objective advice

4. Financial analysts and a business press that refused to believe that the company was too good to be true

5. Investment banks that helped structure, financed, and richly profited from the questionable 'special purpose entities'

Who Are the Culpable Parties in the Enron Affair?

The senior management of Enron

Andersen's Enron audit team

Enron's board of directors, especially its audit committee

Vinson & Elkins (Enron's law firm)

Financial analysts

Credit-rating agencies

Investment banks

Business press

Self-regulatory structure overseeing the audit profession

Accounting standard-setting body (FASB)

Securities and Exchange Commission

The Congress

Accounting educators

Instances of Improper Financial Reporting

Under-reported liabilities

Improper use of 'special purpose entities' (Enron)

Manipulated earnings

Overstated revenues

Treating short-term rentals of products as long-term leases (Xerox)

'Channel stuffing' (Sunbeam)

Nominal swapping of energy or telecommunications capacity (Qwest, Global Crossing, Enron, others)

Overstating the cost of expenditures so as to hype revenues (Adelphia, Tyco)

Understated expenses

Improperly classifying operating expenses as capital assets (WorldCom)

What Were the Causes of the Systemic Failure?

Pressures on companies for short-term revenue and earnings performance

Engagement partners and/or audit firms unwilling to stand up to corporate clients

Boards of directors dominated by the CEO

Top executives afflicted by ‘infectious greed’ and blind ambition

Rules-based v. principles-based accounting standards

Selected Reforms in Sarbanes-Oxley Act of 2002

Code of Ethics for Chief Financial/Accounting Officers

Under the Act, the 'code of ethics' should include 'such standards as are reasonably necessary to promote-

(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed by the issuer; and

(3) compliance with applicable governmental rules and regulations.'

Improper Influence on Auditors

No officer or director may 'take any action to fraudulently influence, coerce, manipulate, or mislead' the external auditor.

CEO's and CFO's Assurance of 'Fair Presentation'

CEO and CFO must certify that the financial statements 'fairly present in all material respects the [company's] financial condition and results of operations' and that the quarterly or annual report 'does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements…not misleading.'

Audit Committee

All members must be independent of the company. It is to be responsible for the appointment and compensation of the auditor, as well as the oversight of its work, and pre-approval of all of its audit and non-audit services. It shall have the authority to engage independent counsel or other advisers. Each company must disclose whether at least one member of the audit committee is a 'financial expert', and, if not, why not.

New York Stock Exchange Proposed Reforms

'Non-management directors must meet without management in regular executive sessions.'

'Every listed company must have an internal audit function.'

Desirable Reform not in Sarbanes-Oxley or NYSE

The CEO may not also be the chairman of the board of directors.

Other Reforms in the Wake of Enron et al.

Sarbanes-Oxley Act of 2002

Establishes an 'accounting oversight board' with investigative and disciplinary powers to regulate the auditing profession – under direct SEC supervision

Provides that the oversight board and the Financial Accounting Standards Board be funded by an 'annual accounting support fee' levied on issuers in proportion to their market capitalization

Requires rotation of the lead partner on an audit engagement every 5 years [since expanded by the SEC], and instructs the US Comptroller General to study possible mandatory audit firm rotation

Prohibits audit firms from offering eight types of non-audit services for their audit clients, including internal auditing and installing information systems

Prohibits an audit firm from serving a company if any of its senior officers were, in the year prior to the audit engagement, an employee of the audit firm and participated in the audit of the company

Requires the CEO and CFO to forfeit certain bonuses and profits when the financial statements are restated due to misconduct

Imposes more serious penalties for various types of securities and other fraud

Instructs the SEC to secure the adoption of rules to address securities analysts' conflicts of interest

Requires companies to disclose off-balance sheet transactions in annual and quarterly reports

Requires that 'pro forma figures' not contain an untrue statement, not be misleading, and be reconciled with GAAP presentations

Instructs the SEC to develop rules 'setting forth minimum standards of professional conduct' for attorneys who represent securities issuers

Instructs the SEC to conduct a study on the adoption of a 'principles-based' accounting system

Instructs the SEC to conduct a study of the 'role and function' of credit rating agencies

Instructs the US Comptroller General to conduct a study on 'whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition'

Other Reforms Already Adopted

Heighten SEC scrutiny of registrants' annual and quarterly financial reports

Streamline the Financial Accounting Standards Board, with more vigorous oversight by the SEC

Disallow audit partners from being compensated for the cross-selling of consulting services

Accelerate the disclosure of corporate officers' and directors' transactions in the company's shares

Accelerate the deadline for filing quarterly reports (45 days to 35) and annual reports (90 days to 60)

Likely Reform

Require listed companies to have an internal audit function (recommended by the NYSE for SEC approval)

Doubtful Reform

Mandate the periodic rotation of audit firms

‘Audit Committee Financial Expert’
under Sec. 407 of the Sarbanes-Oxley Act
(as modified by the SEC, effective 3 March 2003)

Each company must disclose whether at least 1 member of its audit committee is a ‘financial expert’, and, if not, why not; and whether the ‘financial expert’ is independent of management.

A ‘audit committee financial expert’ is a person who has, ‘through education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions’, and who possesses—

(1) ‘An understanding of generally accepted accounting principles and financial statements’;

(2) ‘The ability to assess the general application of suchprinciples in connection with the accounting for estimates, accruals and reserves’;

(3) ‘Experience in preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable’ to those of the company’

(4) ‘An understanding of internal controls and procedures for financial reporting’; and

(5) ‘An understanding of audit committee functions’.

Prohibited Non-audit Services in Regard to Audit Clients
(under Sec. 201(g) of the Sarbanes-Oxley Act)

‘(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

(2) financial information systems design and implementation;

(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

(4) actuarial services;

(5) internal audit outsourcing services;

(6) management functions or human resources;

(7) broker or dealer, investment adviser, or investment banking services;

(8) legal services and expert services unrelated to the audit; and

(9) any other service that the [oversight board] determines, by regulation, is impermissible.’

Wisely Aligning Incentives to Encourage Professional Behavior

<u>Companies</u>

De-emphasize the ‘short term’ in executive/director compensation

- **Stock options**
  - **Link the options to meeting certain goals or to the length of executive tenure**
  - **Lengthen the period between the grant and vesting dates**
  - **Bar executives from selling their shares until after a longer period following exercise**
  - **Index the exercise price to general stock market performance indicators**
- **Link executive bonuses to indicators of long term company performance**

Audit firms

Protect engagement partners from bearing the cost of standing up to clients on accounting issues

Firms should be prepared to 'walk away' from clients that fixate on manipulating earnings

Public Company Accounting Oversight Board appoints 2 key staff officers

George H. Diacont, director of registration and inspection

- **formerly acting SEC chief accountant, chief accountant of the SEC's enforcement division, and chief accountant, listing investigations, at Nasdaq**

Douglas R. Carmichael

- **accounting professor at Baruch College (CUNY), formerly vice president-auditing of the AICPA, leading auditing textbook author, and frequent expert witness for plaintiffs suing audit firms**

Sources of Documentation and Coverage of Enron, Andersen and Related Matters

U.S. House of Representatives' Committee on Energy and Commerce (Powers report and numerous internal Enron and Andersen documents): http://energycommerce.house.gov

C-SPAN (video and audio recordings of many Senate and House hearings, plus many other useful sites and hyperlinks): http://www.c-span.org

Text of the Sarbanes-Oxley Act of 2002 - downloadable from www.iasplus.com Summary of the Act: www.fei.org

Other Web sites and subscription services (search under 'Enron' or 'Andersen' under Google, Yahoo! or msn.com):

***Financial Times* (news.ft.com)**
CNN (www.cnn.com)
***The Wall Street Journal* (Dow Jones Interactive, by subscription)**
***The New York Times* (www.nytimes.com)**
***The Washington Post* (www.washingtonpost.com)**
American Institute of CPAs (www.aicpa.org)
New York State Society of CPAs (www.nysscpa.com)

Consult http://thomas.loc.gov, the Web site for the U.S. Congress, for the prepared testimony in hearings during the first half of 2002 (Senate Committee on Banking, Housing & Urban Affairs, House Committee on Energy and Commerce, and the Senate Committee on Governmental Affairs)

Selected articles and books:

C.W. Thomas, 'The Rise and Fall of Enron,' *Journal of Accountancy*, April 2002.

G.J. Benston and A.L. Hartgraves, 'Enron: What Happened and What We Can Learn from It,' *Journal of Accounting and Public Policy*, Summer 2002.

J.K. Brazelton and J.L. Ammons (editors), *Enron and Beyond: Technical Analysis of Accounting, Corporate Governance, and Securities Issues* (Chicago, IL: CCH Incorporated, 2002) (http://tax.cchgroup.com) US$75.

Other Web sites:

www.sec.gov (Securities and Exchange Commission)
www.pcaobus.org (Public Company Accounting Oversight Board)
www.pcaob.com (a forum of current articles on auditing and accounting, as well as the rules and announcements from the PCAOB – Web site is run by a private firm)