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The Numbers Game: Manipulation of Financial Reporting by Corporations and Their Executives

Manuel A. Rodriguez

THE NUMBERS GAME: MANIPULATION OF FINANCIAL REPORTING BY CORPORATIONS AND THEIR EXECUTIVES

MANUEL A. RODRIGUEZ, CPA*

I. THE IMPORTANCE OF ACCURATE FINANCIAL REPORTING

Accounting failures have become rampant and more pervasive, undermining the credibility of the accounting profession and the inherent reliability of the financial reporting model as an evaluative tool in shaping investor confidence and awareness. The financial statements, comprised essentially of the balance sheet, the income statement, and the statement of cash flows, purport to transmit the financial data of an entity or group of entities into a proscribed format that stakeholders of that entity can use as a means of evaluating the financial health and viability of that entity. The various stakeholders could include shareholders, management, creditors, bondholders, regulatory agencies, and other interested parties, which may have an interest in the corporation. These interests can be economic, social, or regulatory in nature. The information presented in financial statements is both quantitative and qualitative. Quantitative information can include the core financial statements, supplementary statements, and footnote disclosure. Qualitative information is principally contained in the Management Discussion and Analysis section of the financial statements of a Securities and

* J.D., May 2002, University of Miami School of Law; B.S., 1987, Barry University. CPA: Florida, 1995; Alabama, 1993. The author wishes to thank his family for their patience and support.

Exchange Commission (SEC) registrant, but can also be contained in the footnotes to the financial statements, which act as explanatory comments to the financial statements. Several self-regulating accountancy bodies, described in detail in the following section, prescribe the format of the financial statements. The regulations that govern the methodology used in developing the quantitative amounts and qualitative disclosures in the financial statements and their presentation in them are called *generally accepted accounting principles*, typically known as GAAP. The regulations governing audit methodology, and the techniques that must generally be followed in the conduct of the audit, are known as *generally accepted auditing standards*, better known through the acronym GAAS.

Financial statements must be able to accurately and faithfully convey the economic substance of a transaction, over a period of time, and as of a given date. The balance sheet captures financial data as of a particular point in time; the income statement captures that data over a period of time, usually the fiscal year of the entity. Financial information presented in these statements must be able to be accurately compared to financial statements of other entities. These other entities may or may not be within the same industry as the target company. The financial statements must convey the economic substance of the transaction rather than merely the economic form of it. This *substance over form* doctrine has been widely accepted as the prevailing standard in evaluating the nature of a transaction. Transparency and comparability have been the *goalposts* towards which the accounting profession and the SEC have driven to. Comparability between financial statements ensures that creditors and investors will make meaningful investing decisions based on financial statements that faithfully convey the underlying economic position of the entity. If comparability does not exist, either because of intentional misapplication of accounting standards or through misinterpretation of the standards, the financial statements and any assessments derived from them are meaningless and will convey fiction rather than truth. Misleading financial statements can potentially wreak havoc on investors, creditors and lenders, and undermine the credibility of the capital markets. If financial statements and the results derived from their analysis cannot be relied upon, to whom may the third parties turn to for reliable and accurate assessments of entity performance? Special interests may attempt to manipulate financial statements to derive conclusions and outcomes favorable to their interests.

The accounting regulatory and standard setting model fashioned by the SEC has consistently displayed ineffective policies in addressing its primary accounting oversight goals of standard setting and auditor regulation. The SEC has failed to curb creative accounting and earnings management by public corporations through its oversight of the private Financial Accounting

Standards Board (FASB) and the FASB's issuance of extensive and detailed accounting standards. Recently, the SEC has aggressively encroached on traditional accounting enforcement and self-regulatory schemes in slowing the growth of the multi-disciplinary practice (MDP) and significantly strengthening auditor independence rules. This flawed oversight of the financial reporting and regulatory model in the United States has helped usher in a period of *standards overload* and increased investor confusion over the comparability and credibility of financial statements while temporarily curbing the voracious appetites of the worlds largest multidisciplinary practices: the Big 5. This Comment will first address the implications and problems created by *standards overload,* which principally include a marked decline in financial statement comparability and transparency, and a brief review of the historical regulatory scheme and the interaction between the many disparate regulatory bodies. The Comment will then proceed to discuss the means through which earnings are manipulated and the SEC's role in curbing the problem. An alternative theory of earnings manipulation will be reviewed, as well as how the current regulatory structure has enabled companies to engage in creative accounting and earnings management. The Comment will then discuss the government's response to traditional self-regulation and the SEC's new independence rule. Finally, future developments and trends that would ensure financial reporting objectivity and comparability will be discussed and highlighted.

Blame for the many accounting failures has been widespread, shared in equal parts by incompetent or fraudulent management, coercive tendencies on auditors by management, inadequate standard setting by the regulatory bodies which promulgate these standards, poor enforcement of auditor behavior, and, ironically, strict compliance with inadequate standards (the so called *cookbook dilemma*). While fraud is often believed to be the single most prevalent factor in creating an environment of earnings management, it is the premise of this Comment that strict compliance with standards is just as likely to produce misleading financial statements, as they are to produce meaningful and transparent statements on which the public can place reliance. The Byzantine methods through which earnings can be manipulated must first be understood through the prism of the regulatory mechanism. It is to this mechanism to which we now turn.

II. CREATION OF ACCOUNTING STANDARDS & REGULATIONS AND REGULATORY INTERACTION

Before discussing the implications and consequences of *standards overload*, it is important to understand the backdrop against which these standards are created. The SEC, established in 1934 by congressional legislation, is an independent federal regulatory agency which possesses the "authority to prescribe the form and content of financial statements contained in registration statements accompanying an offer to sell securities to the public and in subsequent periodic reports filed with the commission."[1] Those companies listed on national securities exchanges, or traded in the over-the-counter market, or have issued securities in interstate markets, may be subject to the jurisdiction of the SEC.[2] In their zeal to attract corporations to become domiciled in their states, state governments often prescribed and enacted legislation incompatible with the requirements of adequate and reliable public disclosure of information.[3] The federal response to these inconsistencies and inadequacies in state laws led to their harmonization through the establishment of the SEC.[4] "The SEC also exercises supervisory authority over auditing standards and procedures, including the standards of auditor independence."[5] In addition to its regulatory authority over the flow of information published by the registrant's, and its supervisory authority over auditing standards and procedures, the SEC administers a series of acts only peripherally related to these core duties.[6] "The SEC is composed of five full-time members, known as commissioners, who are appointed by the president and confirmed by the Senate."[7] A series of regulations proscribe and limit political affiliations and ties among the commissioners.[8] The current and outgoing chairman is Arthur Levitt Jr.[9] The SEC's staff is composed of close to 3000 employees, from which the chief accountant is the principal adviser to the commissioners on accounting related matters.[10]

The SEC has traditionally delegated its authority as the standard setter and its authority over auditing standards and procedures to an alphabet soup of private regulatory bodies that have evolved over time. The Financial Accounting Standards Board (FASB), comprised in 1973 as the result of previous failed standard setting attempts, is the primary private standard setter, and is composed of seven full-time members and overseen and funded by the trustees of the independent Financial Accounting Foundation (FAF).[11]

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1 Stephen A. Zeff, *A Perspective on the U.S. Public/Private-Sector Approach to the Regulation of Financial Reporting*, ACCT. HORIZONS, Mar. 1995, at 52.

2 *Id.* at 53.

3 *Id.*

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.* at 54.

9 *Id.*

10 *Id.*

11 *Id.* at 56.

The SEC has generally acquiesced to the rules and standards adopted by the FASB, otherwise known as (GAAP). The FAF's Board of Trustees is comprised of sixteen members, who represent various private and public interests.[12] The FASB's principal pronouncement is known as a Statement of Financial Accounting Standards, which is enacted only after extensive deliberation and regard for due process.[13] Delegation of the SEC's supervisory authority over auditing standards and procedures has been primarily directed towards the American Institute of Certified Public Accountants (AICPA), the national professional organization of certified public accountants.[14]

Interaction between these three regulatory bodies has historically been tempestuous and strained.[15] Publicly though, the SEC and the FASB remain in almost daily contact and continue to emphasize the deliberative roles each has on the other.[16] Additionally, significant movement of personnel between both bodies has occurred, further enhancing the public image of complementary, rather then adversarial or conflictive, roles.[17] This public image belies significant tension between the SEC and the FASB. Both bodies engaged each other as early as the 1940s and 1950s in a series of fundamental debates that would shape and help define the nature of financial reporting.[18] These issues included inter-period tax allocation, income statement inclusion concepts, stock options, and upward asset revaluations.[19] Throughout the mid to late '60s, the executive branch actively intervened in blocking or deferring the FASB's predecessor, the Accounting Principles Board, from implementing its accounting for the investment credit, which was intended to provide businesses with a tax credit equal to a percentage of the cost of newly purchased equipment and machinery.[20] The APB supported a deferred approach through which the credit would be realized incrementally in annual installments.[21] Successive administrations supported, on policy reasons, the immediate realization of the tax credit against current income.[22] The tension over the investment tax credit lasted for over eight years, and purportedly ended when the SEC announced that

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12 Glenn Cheney, *FASB Face-Off Ends With SEC Victory*, ACCT. TODAY, July 29, 1996, at 1.

13 Zeff, *supra* note 1, at 56.

14 *Id.* at 56.

15 *Id.* at 57.

16 *Id.* at 56.

17 *Id.*

18 *Id.* at 57.

19 *Id.*

20 *Id.* at 58.

21 *Id.*

22 *Id.*

it would abide by the APB's recommendation.[23] The Treasury Department, though, obtained direct congressional approval for disallowance of the APB position.[24] This was the first instance in which a government department, aided by Congress, would intervene in such direct and unrestrained fashion in the private standard setting process.[25]

The threat of direct SEC intervention grew over time and was precipitated by pressures applied by disparate constituencies and their lobbies in attempts to coerce and manipulate the financial reporting model and the standard setters.[26] Tensions between the SEC and the private standard-setters were reflected not only in the standard setting arena, but also in the composition of the standard setting bodies themselves. In 1996, the FAF, under extreme pressure from the SEC, restructured the ranks of its Board of Trustees.[27] Since its inception, the FAF Board had consisted of sixteen accounting and financial professionals, of whom three were from the governmental accounting sector, ten were from the corporate sector, and three were purportedly independent.[28] As the FAF appoints the seven members of the FASB and its ancillary Board, the five members of the Governmental Accounting Standards Board (GASB), its structure and composition are viewed and perceived as significant in the standard setting process.[29] The SEC, fearing significant and far reaching recommendations by the FAF for structural changes to the FASB, viewed the proposed changes "as a ploy to instill greater corporate control over the FASB process."[30] In a battle of epic proportions and open hostility, the chairperson of the SEC, Arthur Levitt, and the chairperson of the FAF, Michael Cook, engaged in heated and intense negotiations over these changes.[31] In the end, the SEC prevailed, and managed to restructure the Board of the FAF with eight corporate seats and eight non-corporate or disinterested seats; balance had been achieved.[32] One observer was quoted as saying, "I think this move is very constructive, it avoids that situation of having inmates in charge of the institution."[33] The same observer noted that an FAF dominated by corporate and public accountants worked well until the age of increased competition

23 *Id.*
24 *Id.*
25 *Id.*
26 *Id.* at 59.
27 Cheney, *supra* note 12, at 1.
28 *Id.*
29 *Id.* at 1.
30 *Id.* at 41.
31 *Id.*
32 *Id.*
33 *Id.*

decreased auditors' independence, a fact he believes renders auditors more susceptible to the desires of corporate clients.[34] A more serious compromise of accounting standards occurred several years before this face-off, when the FASB was working on a new standard for stock based compensation.[35] A proposed draft of the statement was anathema to major corporations, which would have required them to report stock option compensation as expenses.[36] The corporations and the major accounting firms intensely lobbied Congress to pass a resolution against the FASB's proposals, in an effort to scuttle them.[37] The U.S. Senate acquiesced, and the resulting standard was significantly modified from the original draft, which required only disclosure of the effects of the stock option compensation rather than their recordation.[38] Many viewed the compromise as a significant fault line and breach of the integrity of the FASB.[39]

While indirect congressional and executive oversight had been achieved through the efforts of SEC intervention and Senate resolutions, direct congressional oversight of the regulatory scheme was largely absent until Representative John Dingell (D-MI), Chairman of the Committee on Commerce of the U.S. House of Representatives, requested a comprehensive review of the status of the accounting profession in 1996 by the General Accounting Office (GAO).[40] This review entailed the most comprehensive assessment of the financial reporting system and self-regulatory model to date, and served to identify and highlight significant weaknesses in these systems. The report would eventually be used as a springboard to further enhance the SEC's direct regulation of the standard setting and self-regulatory processes. The GAO identified five major issues: 1) Auditor independence (independence in fact and in appearance from the audit client); 2) Auditor's responsibilities for fraud and internal controls; 3) Audit quality; 4) The accounting and auditing standard setting processes and the effectiveness of financial reporting, and 5) The role of the auditor in the further enhancement of financial reporting.[41] The GAO report noted that despite corrective actions initiated by the accounting profession in an effort to strengthen auditor independence, significant concerns remained, and would become exacerbated as the profession moved to provide new services

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34 *Id.*

35 *Id.*

36 *Id.*

37 *Id.*

38 *Id.*

39 *Id.*

40 United States Gen. Acct. Office, *The Accounting Profession, Major Issues: Progress and Concerns*, (Sept. 1996), *available at* http://www.access.gpo.gov/su_docs/aces/aces160.shtml.

41 *Id.* at 4.

outside of the traditional and core niches.[42] More significantly however, the GAO report noted that user participation in the standard setting processes and the pressures brought to bear on the FASB by the many constituent lobbies which seek to influence accounting standards remain areas of heightened concern.[43] It further noted:

> [U]ser representation and participation remains lower than other groups, making it difficult to produce standards that have a bounce perspective in meeting users needs. In practice, audit standard setting has been primarily the domain of the accounting profession. Auditing standards have been influenced by auditors' liability concerns and perceptions of a lack of cost benefit that have constrained the scope of audit. The SEC, which has ultimate authority for standard setting and responsibility for protecting the public interest, has not always strongly asserted that role in its relationship with the standard setters. Recently, the SEC expressed strong views that the majority of the FAF trustees should be public representatives as a means to strengthen both the substance and perceptions of FASB's independence, and reached agreement with FAF that trustee membership will be bounced between constituent and public members. GAO believes the SEC's recent attention to strengthening standard setting is a step in the right direction.[44]

Regarding the SEC's vigilance and oversight of the private standard setting process, the GAO stated:

> [I]t is important that the SEC continue to monitor the operation of the standard setting process to insure FASB's ability to objectively set standards. . . . It is essential that any changes made to improve the efficiency of FASB's operations do not adversely affect its independence as the standard setters since independence is critical to achieving acceptance of the standard setting process. . . . GAO believes that the SEC has not always strongly asserted leadership in its relationship with the standard setters and that more progress could be achieved in resolving major issues facing the standard setters if that were to occur. The SEC's recent action resulting in

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42 *Id.* at 8.

43 *Id.* at 13.

44 *Id.* at 14.

restructuring FAF is a prime example of progress achieved through SEC leadership.[45]

It is clear that the GAO report, while issued in 1996, strongly foreshadowed the impending debates regarding auditor independence, the multidisciplinary practice of accounting, and the SEC's increased role over the standard setting and self-regulation processes.

III. EXAMPLES OF EARNINGS MANAGEMENT AND CREATIVE ACCOUNTING

The GAO report clearly detailed perceived weaknesses in the standard setting and self-regulatory processes, yet failed to clearly define a little recognized plague creeping through financial America: the threat of creative accounting and earnings management. Creative accounting and earnings management occurs when organizations are tempted to manipulate earnings through the creative application of accounting principles, or through flagrant abuse in the application of those principles. Earnings management is a by-product of the perceived need to inflate earnings to meet or exceed Wall Street expectations.[46] These expectations are created as a result of consensus opinions generated by the hundreds of analysts on Wall Street.[47] Failure to achieve or reach these expectations can create powerful downward pulls on company stock valuations and affect both shareholder value and employee compensation through the devaluation or worthlessness of stock option incentives. Powerful incentives to reach elusive earnings expectations can create serious conflicts of interest among corporate executives eager to meet these expectations. Several academic theories have developed to both explain and regulate creative accounting and earnings management. SEC Chairman Arthur Levitt Jr. championed the most pervasive and widely accepted of these theories in 1998 in his speech to the New York State Society of Certified Public Accountants.[48] In essence, this speech served as the bellwether for the SEC's efforts to enforce and prosecute those individuals and organizations it felt were engaging in widespread and pervasive earnings management. In it, Mr. Levitt characterized the process of earnings management as a game among market participants and one that would have serious repercussions

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45 *Id.* at 15.

46 Lois Herzeca, *Financial Reporting Becomes SEC Target; Aggressive Action Plan Under Way*, NEW YORK LAW JOURNAL, Feb. 1999, at 9, *available at* LEXIS-NEXIS, News Group File.

47 *Id.*

48 Arthur Levitt, *The Numbers Game; Manipulation of Earnings in Financial Reports*, THE CPA JOURNAL, Dec., 1998, at 14, *available at* LEXIS-NEXIS, News Group File.

and adverse consequences for America's financial reporting system.[49] He implied nothing short of subtle collusion between corporate managers, auditors, and analysts and acknowledged a perversion of corporate accounting was occurring on a massive scale, which undermined the integrity of the financial reporting system.[50] Mr. Levitt's outline of the game was striking in its simplicity:

> Companies try to meet or beat Wall Street earnings projections in order to grow market capitalization an increase the value of stock options. Their ability to do this depends on achieving the earnings expectations of analysts. And analysts seek constant guidance from companies to frame those expectations. Auditors, who want to retain their clients, are under pressure not to stand in the way.[51]

The method of achieving earnings management primarily involves the use of accounting techniques created primarily to allow and encourage companies to be flexible in the recording of their transactions in order to facilitate the primary goal of generally accepted accounting principles, that of ensuring substance over form in the recognition of an accounting transaction whenever possible. This flexibility is also encouraged because the standard setters are wise enough to realize that every new or unique business arrangement or transaction cannot be anticipated or somehow bullied into conforming to existing accounting rules and regulations.[52] Earnings management occurs when this flexibility is exploited in an effort to conceal financial volatility.[53] Mr. Levitt then provided significant illustrations of the methods by which earnings can be successfully managed and shaped to accomplish the desired result.

Levitt called the first of these methods "big bath restructuring charges," where "a company overstates its restructuring charges to clean up its balance sheet, takes a large one time earnings hit, and then later reverses some of those charges and adds them back into income in a period in which earnings would otherwise fall short.[54] This method of enhancing future earnings is surprisingly simple and even encouraged by Wall Street analysts. Under generally accepted accounting principles, when a company commits itself to exit a business or close a factory in the near future, it must estimate and

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49 *Id.*

50 *Id.*

51 *Id.*

52 *Id.*

53 *Id.*

54 Herzeca, *supra* note 46.

record the total costs that it may eventually incur in the year in which the decision was made, although most of the costs associated with the restructuring will occur in the future.[55] These charges include items such as severance costs and costs to facilitate plant closings, and significantly dampen the initial years earnings and profits, although the costs may not be paid for many years to come.[56] These costs are accumulated in liability accounts called reserves, which may be adjusted up or down depending on actual costs incurred in the restructuring. Manipulation occurs because companies purposely overestimate the restructuring charges in an effort to cleanse the balance sheet in the current year and absorb the negative earnings related to the restructuring, yet reverse the charges in future years, creating *false* income from the reversal of the reserves.[57] Analysts overlook the initial years' overstatement (big bath) as bitter medicine, and look only to the operating results for their analysis of future earnings growth.[58] Companies may also improperly channel impermissible costs through the restructuring charge byline, charging earnings in the current year that are properly chargeable to succeeding years.[59] Intentional inflation of future earnings and deflation of current earnings is only one-way in which charges can be successfully used to manipulate shareholder confidence.

Cookie jar reserves are charges that are used to lower and smooth current year income in periods of earnings volatility by creating unrealistic estimates of liabilities for such items as sales returns, loan losses, or warranty costs.[60] Wall Street disapproves of earnings volatility in general, and frequently seeks incremental earnings growth rather than unexpected changes. Companies that have outperformed analysts' growth expectations in the current year, will frequently fear successive years' growth expectations, and will seek to modify those expectations by lowering current year earnings through these charges.[61] These accruals are then reversed when financial fortunes have dipped.[62] This variant of the big bath charge is easily concealed from even astute investors or outside directors, which makes accurate company valuation very difficult if not impossible.[63]

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55 Carol Loomis, *Lies, Damned Lies, and Managed Earnings*, FORTUNE, Aug. 2, 1999, at 74, *available at* LEXIS-NEXIS, News Group File.

56 *Id.*

57 *Id.*

58 *Id.*

59 *Id.*

60 Levitt, *supra* note 48.

61 Sandra Rubin, *Market Pushes Many Firms to Paper Over the Cracks*, THE NATIONAL POST, Mar. 17, 2000, at C9, *available at* LEXIS-NEXIS, News Group File.

62 Levitt, *supra* note 48.

63 Loomis, *supra* note 55.

Levitt next assailed improper revenue recognition, whereby companies manipulate earnings through improper revenue recognition techniques.[64] Improper revenue recognition occurs when sales are recorded before they are truly earned.[65] Of the many areas discussed by Levitt, the wrongful booking of sales appears as the most closely related to outright fraud.[66] Generally, accepted accounting principles are very conservative and straightforward in their approach to revenue recognition.[67] Many of the most egregious accounting scandals have occurred because of improper and fraudulent revenue recognition, and appeared at high-profile corporations such as Sensormatic and Sunbeam.[68] Sensormatic invoked the wrath of the SEC by simply keeping their books open at the end of quarters to meet their earnings projections.[69] Sunbeam recorded as sales goods still residing in its warehouses.[70] These blatant and flagrant examples of earnings management probably required subtle collusion between company management, senior accounting executives, and their auditors, as these abuses are easy to detect and prevent. A partner at a Big Six accounting firm stresses that manipulation of revenue usually starts as a modest attempt to lift sales in a particular quarter, but then escalates into ever more creative schemes, such as the bill and hold relationship, where customers are invoiced for products not yet delivered, or creative consignment schemes that allow companies to return unsold goods.[71]

Levitt next addressed a topic about which the corporate, audit, and academic communities have debated endlessly over a period of decades, the concept and abuse of materiality. This elusive concept has been defined and re-defined countless times among academicians, auditors and the courts. It is this uncertainty that has permitted unscrupulous CFO's to manage earnings by promoting the concept of immateriality when transactions are being examined and questioned by their auditors or the SEC. Individual misstatements in the general ledger may often seem immaterial and inconsequential in nature, but the aggregate, absolute effect of these misstatements may in fact be quite material and substantial to those statements. Levitt warned that "in markets where missing an earnings projection by a penny can result in a loss of millions of dollars in market

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64 Levitt, *supra* note 48.

65 *Id.*

66 Loomis, *supra* note 55.

67 *Id.*

68 *Id.*

69 *Id.*

70 *Id.*

71 Lawrence Quinn, *Accounting Sleuths, Investigating Accounting Irregularities*, STRATEGIC FIN., Oct. 2000, *available at* LEXIS-NEXIS, News Group File.

capitalization, I have a hard time accepting that some of these so-called non events simply don't matter, or are immaterial."[72] Materiality has traditionally been defined in both quantitative and qualitative terms.[73] Auditors and accountants have traditionally defined quantitative materiality by numerical benchmarks and standards that purport to strictly define a threshold below which any given transaction is deemed immaterial. Qualitative materiality considers the impact of an omission independent of the company's numerical data.[74] These amorphous definitions have given rise to a wide variety of techniques among the Big 5 accounting firms and the hundreds of mid-level firms that have individually attempted to develop specific and precise methodologies for measuring materiality within the scope of an audit. Their techniques have been as widely divergent as the firm cultures themselves, and have left many experienced auditors confused and uncertain when "passing" on potential audit adjustments of less than a quarter million dollars because the materiality threshold for that particular audit was a quarter million dollars. Less than a year after Levitt's speech in New York, the SEC published Staff Accounting Bulletin No. 99 ("SAB No. 99), which aimed to "provide guidance to auditors and corporate officers in applying materiality standards to the preparation of financial statements filed with the Commission."[75] SAB No. 99 "demands that auditors use qualitative elements to illuminate and expand the traditional quantitative materiality analysis, not undertake a qualitative analysis completely divorced from the quantitative analysis."[76] This new standard has been roundly criticized, and one comment notes:

> The practical problems of applying SAB No. 99 added to its philosophical shortcomings. Even if one were to agree that qualitative factors should be incorporated into the materiality calculus, a strong case can be made that SAB No. 99 fails to offer a workable framework with which to incorporate such considerations. Many attorneys have noted their clients' opinions that SAB No. 99 is too ambiguous in that the staff fails to articulate a precise, intelligible definition of qualitative materiality. The SEC should not

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72 Levitt, *supra* note 48.

73 Glenn Miller, *Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into The Murky World of Qualitative Materiality*, 95 NW. U. L. REV. 361, 361-390 (2000).

74 *Id.* at 363.

75 *Id.* at 383.

76 *Id.*

be surprised that the financial community has chided it for releasing an ambiguous bulletin.[77]

Levitt's final and primary assault on the techniques and methodologies of earnings management occurred in the highly technical field of acquisition accounting. Creative acquisition accounting involves the judgmental allocation of values to purchased assets. Traditional merger accounting requires a purchaser to assign values to purchased assets, capitalize them, and right- off these assets in future years.[78] Many high-technology companies though, have sought to assign purchased value to in-process research and development ("IPR&D"), which must be written off in the current year, and therefore, do not drag down future earnings.[79] The assignment of maximum amounts of the purchase price to IPR&D involves much creative judgment and aggressive valuation techniques.[80]

IV. THE SEC'S RESPONSE TO EARNINGS MANIPULATION

The SEC's response to the methods of manipulating earnings has been to encourage stricter compliance with existing accounting rules, greater enforcement, and policing efforts by the SEC, and widespread cultural change of the corporate ethos, which encourages such behavior.[81] Chairman Levitt outlined a nine-point proposal whose common theme was hyper-technical reliance and adherence to the established standards and a call for greater specificity within those standards. Indeed, five of Levitt's proposals addressed the inadequate technical nature of our current standards in resolving the serious issues outlined above.[82] These proposals were primarily aimed at requiring the SEC, the AICPA, and the FASB to establish standards that would clarify and provide guidance on those topics outlined by Levitt as serious breaches of governance.[83] The sixth proposal would require the SEC to aggressively target companies that were engaging in those practices and enhance SEC regulatory oversight of these companies.[84] The seventh proposal targets the accounting and auditing industries, requires auditors to improve the quality of their audits through enhanced supervision, training

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77 *Id.* at 390.

78 Loomis, *supra* note 55.

79 *Id.*

80 *Id.*

81 Levitt, *supra* note 48.

82 *Id.*

83 *Id.*

84 *Id.*

and focus of the auditors, and establishes further review of audit methodologies by the private standard setting bodies.[85]

The eighth proposal outlined by Levitt would empower audit committees with greater authority to independently represent the interests of shareholders, render impartial judgments, and not remain beholden to corporate management.[86] Finally, Chairman Levitt challenged corporate management and Wall Street to re-examine our current environment:

> I believe we need to embrace nothing less than cultural change. For corporate managers, remember, the integrity of the numbers in the financial reporting system is directly related to the long-term interests of the Corporation. While the temptations are great, and the pressures strong, illusions in numbers are only that - ephemeral, and ultimately self-destructive. To Wall Street, I say look beyond the latest quarter. Punish those who rely on deception rather than the practice of openness and transparency.[87]

Levitt's clarion call for a change in corporate culture, although both far-reaching and sincere, remains little more than an amorphous and hopelessly optimistic *wish list*, rather than a recognition of the powerful countervailing forces constantly poised to undermine the credibility and transparency of the financial reporting model. Corporate, shareholder, and auditor self-interests remain conflicted with the ideals of financial credibility and integrity. The unceasing demands of Wall Street ultimately dictate the financial reporting climate adopted by the subject companies. These demands speak of only one ideal: that of increasing shareholder value through incremental earnings growth and realization of analyst projections. This vortex of realization and incremental earnings growth is readily attainable in high growth economic climates, but can remain illusory in periods of moderate economic growth or in stable, well-defined industries. The pressure to accommodate, though, is relentless, and causes the subtle yet perverse degradation of accounting standards that ultimately leads to outright fraud.[88] Levitt himself understood this process, when he remarked that "Wall Street itself is an obstacle: it wants consistent earnings, however attained."[89] One stock analyst boldly urged that

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85 *Id.*

86 *Id.*

87 *Id.*

88 Loomis, *supra* note 55.

89 *Id.*

companies consider hiding earnings for future use and was quoted as saying, "If you don't play the game, you're going to get hurt."[90]

Levitt's review and analysis of the methods of managing earnings and his detailed nine point plan to combat creative accounting is compliance based in its approach, and speaks of addressing the problems through more vigilant enforcement, more good judgment by corporate accounting and auditing staff, and mounds of new regulations loaded with enough specificity to circumvent the questionable use of that judgment. Levitt posits that the problem is one of non-compliance with accounting standards by rogue entities and treasonous auditors. An alternative theory of corporate governance holds that Levitt's proposed solutions would simply compound the problem, rather than assist in correcting them. These theorists argue that increasing compliance with the growing volume of rules and statutes has rendered financial statements unserviceable to the very consumers they purport to protect - the investing public.[91]

V. AN ALTERNATIVE VIEW OF EARNINGS MANIPULATION

An exhaustive study of corporate failures in Australia by F.L. Clarke, G.W. Dean and K.G. Oliver, explored the notion that greater compliance with proscribed standards and zealous enforcement of those standards would achieve serviceable financial standards that were informative and models of comparability, the SEC's over-arching concern for many decades.[92] Indeed, in 1972, SEC Chairman William J. Casey stated that "the desirability of making earnings statements as comparable and as uniform as possible should gain priority over the frequently conflicting objective of affording management choice and flexibility in the way it keeps score."[93] The Australian analysis concludes that even meticulous compliance with approved accounting standards and strict enforcement by the regulatory bodies may not produce serviceable financial statements.[94] The authors stress that "compliance with standards then in vogue was as likely to have contributed to creative accounting as deviation from them. Perversely, corporate regulators and the accounting profession are calling for even more accounting and auditing standards."[95] The accounting profession's desire for

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90 *Id.*

91 F.L. CLARKE ET AL., CORPORATE COLLAPSE, REGULATORY, ACCOUNTING, AND ETHICAL FAILURE 12 (Cambridge University Press 1997).

92 Zeff, *supra* note 1, at 58.

93 *Id.*

94 F.L. Clarke et al., *supra* note 91, at 12.

95 *Id.* at 14

more numerous and explicit financial statements stems in part from the litigious nature of American society and the consuming battle for clients who *opinion shop* before selecting their auditors.[96] By explicitly imposing detailed standards on the financial statements, auditors could essentially shield themselves from liability by citing express provisions from GAAP in defense of the accounting positions taken, and thereby avoid being held directly responsible for making those judgments.[97] Auditors would also reduce the tendency to opinion shop by stressing the unyielding nature and detail of the standards in defense of the positions taken. The Australian study instead focuses on the product of the accounting process, the financial statements, and their ability to convey data accurately, without misrepresentation and lack of comparability, as opposed to singularly focusing on the process of accounting and its methodology.[98] Topically, understanding the plethora of new accounting standards may become unmanageable and burdensome, according to Goldman Sachs' Gabrielle Napolitano, managing director.[99] She states, "keeping abreast of changing accounting regulations is not easy. Investors, analysts, creditors, and corporate executives may find themselves hard pressed to maintain a comprehensive understanding of the major proposals introduced."[100] More fundamentally, the new SEC initiatives of demanding stricter compliance with existing standards have had the unintended effect of producing conflicts with banking industry regulators. This result was accomplished because of the SEC's continued investigation of the banking industries loan loss reserves practices.[101] Traditionally, banking regulators have permitted and even encouraged banks to record loan loss reserves in the banks' loan portfolios when disturbed economic circumstances in the geographic areas serviced by those banks indicate increased volatility and financial instability.[102] The SEC ultimately scrutinized this conservative approach in its effort to clamp down on the unscrupulous use of reserves in manipulating earnings. The SEC's scrutiny led to an unusual joint statement issued by the SEC, the Federal Deposit Insurance Corporation, the Federal Reserve Bank, the Office of the Comptroller of the Currency and the Office of Thrift Supervision, in which they pledged to work together to develop further guidance, and that "although management's process for determining allowance adequacy is

96 Zeff, *supra* note 1, at 65.

97 *Id.* at 65.

98 F.L. Clarke et al., *supra* note 91, at 17.

99 Quinn, *supra* note 71.

100 *Id.*

101 Herzeca, *supra* note 46.

102 *Id.*

judgmental and results in a range of estimated losses, it must not be used to manipulate earnings or mislead investors, fund providers, regulators or other affected parties."[103] This incident and the vague and amorphous statement produced by the regulatory agencies is an unusual instance of confusion and disagreement between the regulators, yet clearly demonstrates the ambiguity inherent in the current financial reporting model and the uncertainty facing even informed investors and readers of these documents, who require a high level of precision and comparability before making important financial decisions. Absolute reliance on financial statements that purport to faithfully represent an organization's financial condition, given this cloud of uncertainty, can have disastrous effects.

The Australian study concludes that "accounting standards have failed to match the admirable claims of the leaders of the profession - namely, that compliance with them would reduce the diversity of accounting practices and thereby provide data relevant to the making of informed financial assessments."[104] The authors add, "Defying financial common sense, complying with certain practices endorsed by the accounting profession itself, producing the standard nonsensical, fictional financial outcomes, are not regarded by either the regulators or (so it seems) the accounting profession to be a willful indulgence in creative accounting."[105] This argument posits that the standard setters' attempts to excise professional judgment from the financial statements ultimately leads to useful data, a position strikingly similar to that proposed by the SEC, whose attempts to impose greater controls over the exercise of that judgment were notably outlined by Chairman Levitt. Control of the process by which standards are developed and applied and zealous enforcement of those standards through strenuous regulatory activity over behavior deemed non-compliant appears to be the principal mechanism to ensure the stability of the financial reporting model worldwide. This attempt to excise and regulate judgment from financial reporting ultimately obviates the need for serious discussion regarding the quality of the output, rather than the behavior of the input. The required output is best described as accurate, representative and comparable financial reporting, from which investors, analysts, creditors, and the public can fairly assess the financial dynamics of an organization.

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[103] Herzeca, *supra* note 46.

[104] F.L. Clarke et al., *supra* note 91, at 17.

[105] *Id.* at 18.

VI. FICTIONAL REPORTING AND ITS CONSEQUENCES

The authors of the study, similar to Levitt's attacks on certain rogue accounting practices, described financial reporting practices that produced fictional and sometimes aberrant statements that were misleading if not outright fraudulent. These areas include tax effect accounting, which are methods:

> Mandated by the profession to report the financial effects due to timing or permanent differences between actual taxation payable and tax payable based on professional accounting treatments of transactions. Resulting deferred tax standards and credits do not have any real world referent. They are fictions - fictions that are legitimately the product of applying the standard.[106]

The authors then follow by stating, "Fictions arise, too, through the artifacts of consolidated financial statements - goodwill and capital reserves emerging entirely from the mechanics of consolidation, the elimination of the effects of transactions between related companies without regard for the actual financial outcomes and the exacerbated consolidated impact of injecting tax effect accounting."[107] Consolidated financial statements are traps for the unwary, hiding and masking transactions through Byzantine group structures and idiosyncratic consolidating techniques.[108] The study suggests that:

> Even with modern-day computer power, it is virtually an impossibility to track through those types of corporate mazes, let alone determine unambiguously the financial implications of transactions within them. An essential feature of *groupthink* is that only the parties to the transaction really now, and believe only they need to now, the intricacies. Consolidation accounting, in many ways, helps to secure them to outsiders and, we suggest, perhaps to most of the insiders too.[109]

Consolidation procedures require that inter-group transactions be eliminated when the financial statements of the group are consolidated, on the theory

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106 *Id.* at 18.

107 *Id.*

108 *Id.* at 209.

109 *Id.* at 211 (emphasis added).

that this procedure eliminates transactions between the group that are not at arms length and which may in fact be shams. But consolidation accounting has another, less obvious yet insidious result, it purposely conceals and buries subsidiary information within the group's consolidation, hiding both the enlightening and damaging aspects of subsidiary performance within the whole.[110] Furthermore, consolidation accounting purports to represent the economic activity of a group of legally separate and unique entities under the fictional mantra of the group.[111] The Australian study believes that "groups are being presented as commercial reality. Yet virtually every aspect of the financial, social and legal setting in which groups operate clearly indicates they are not."[112] Consolidation techniques are the product of relying on economic form over legal form and financial substance.[113] They obfuscate, confuse, and conceal data that might normally be available to users of financial statements, and may serve to hide data from shareholders and creditors that is damaging or otherwise disparaging. Data not found in unconsolidated financial reports mysteriously appear in consolidated statements under the guise of economic substance, yet bear little relation to real world substance and the individual, disaggregated accounts of the subsidiary.[114] This theory of aggregation is contrary to the norms found in GAAP, that of full disclosure and careful consideration of an entities' viability as a going concern. Meaningful interpretation of operating results, company, product line, and entity viability are made more difficult.[115] Consolidation accounting purports to represent a fictitious legal structure which by its very nature "lacks legal capacity generally to exercise property rights, sue or be sued, incur physical or financial damage or impose it upon others; the statements contradict the legal, social and financial essence which their constituent corporations enjoy."[116] Countervailing (and popular) arguments steadfastly hold that the substance over form mantra, very popular since the 1920's, provides shelter and meaning for these consolidation techniques, yet reason and logic dictates otherwise.[117] Prevailing consolidation techniques ignore the legal and financial implications that the aggregated assets and liabilities are neither owned nor made available to the group.[118] This group mentality encourages users and readers of financial statements to view the

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110 *Id.* at 217.

111 *Id.* at 213.

112 *Id.* at 214.

113 *Id.* at 219.

114 *Id.* at 221.

115 *Id.*

116 *Id.* at 222.

117 *Id.*

118 *Id.*

entities of the consolidated group as virtual branches of the parent, again creating a dangerous fiction rendering the financial statements less meaningful and serviceable.[119] The grandest of these fictions, though, is the assumption engendered by consolidation accounting that profits and losses of the subsidiary entities will pass through to the parent entity through dividend payments.[120] Consolidated income or loss will rarely be even similar to the sum of the disaggregated amounts, the usual result of applying amortization techniques to the assets of the subsidiary.[121] Applying tax effect accounting throughout the consolidation process, whose group tax implications will likely never come to fruition, further exacerbates the anomalies of the consolidation process.[122] The authors of the study conclude their analysis of consolidation accounting by stating:

> Data so contrived, so removed from real-world referents are unlikely to inform anybody of the wealth and progress of the constituent companies, either individually or collectively. Despite the financial obfuscation they facilitate, their counterfactual footings and the resulting artifacts, surprisingly consolidated financial statements are perceived by legislative draftsmen, many legal practitioners, the courts, and many accountants to be a means for lifting the corporate veil. To the contrary, they appear to achieve precisely the opposite.[123]

The concept of creative accounting can itself spur disagreement over its intended meaning.[124] The prevailing definition describes creative accounting as a series of acts of intentional misstatements performed for the purpose of deception, which deviate significantly from the prevailing accounting standard.[125] This definition perhaps most closely approximates that of Chairman Levitt's in its breadth and scope. Other proponents have argued that creative accounting techniques indeed serve a useful purpose - that of presenting financial statements as models of the substance of their transactions, rather than their purely compliant forms.[126] While intellectually appealing and having some merit, this proposition has often been raised in

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119 *Id.* at 223.

120 *Id.*

121 *Id.* at 224.

122 *Id.*

123 *Id.* at 225.

124 *Id.* at 21.

125 *Id.*

126 *Id.*

defense of many of the practices against which Levitt outlined as intolerable. This argument presupposes that any benchmark or standard could be applied against which to measure what constitutes the substance of any given transaction. The substance of a transaction is indeed a variable and fluid measurement, one that is open to great variability in judgment and one that becomes increasingly difficult to measure as the nature and complexity of a transaction increases. Chairman Levitt's nine point initiative simply presupposes that better judgment, more education, higher ethics, and more professional training will somehow convey the essence of that substance and establish the definitive benchmark that will enable a complete class of financial statements within a given industry to remain completely comparable and transparent. This shortsighted approach is indeed indicative of the continuing focus on the inputs, or processes of those financial statements rather than their outputs: serviceability to consumers, shareholders, creditors, and the public. One Australian accounting review committee noted in the 1960's, "there are still more than a million possible reported sets of accounting data for one company in any one period."[127] The Australian study reached some startling conclusions regarding those inputs, including:

> [O]ur view is that, perversely conventional accounting practices frequently frustrate those attempts to tell the financial truth. Contrary to the popular view, is our proposition that compliance with the so-called spirit of many conventional practices and endorsed standards produces grossly misleading data, without necessarily any intention to deceive on anybody's part.[128]

The authors further assert that "much of the rhetoric about creative accounting has been misplaced. Departure from the standards is, as often as not, the only way to produce data likely to accord with the financial facts."[129] The study concludes its assessment of creative accounting by stating that "instead of producing a perceived improvement in the quality of accounting data, the increase in the number of standards is correlated positively with increased complaint, criticism, bewilderment, frustration, disbelief and, ultimately, increased litigation."[130] Another report concluded, "Financial reports move markets. International capital flows will be rational only if accounting procedures generate reliable information that permits investors

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127 *Id.* at 19.

128 *Id.* at 23.

129 *Id.* at 29.

130 *Id.* at 30.

to compare income statements and balance sheets from different commercial cultures."[131]

VII. THE SEC'S FLAWED RESPONSE AND REGULATORY ENFORCEMENT

Beyond the SEC's growing intolerance of the abuse of standards, which nonetheless encourage creative accounting and earnings manipulation, lies the enforcement of those standards, and the future evolution of the accounting and legal professions. The SEC has concluded that its rigorous oversight of the profession's self-enforcement regime is the primary means of ensuring full compliance with those standards.[132] Indeed, many feel that "an unhappy consequence of the SEC's rigorous enforcement system has been to inhibit desirable innovations in financial reporting."[133] Furthermore, they add that the "SEC has engendered a climate of conformity, which has been hostile to experimentation with nonstandard approaches to measuring and reporting accounting information in the audited financial statements."[134] The report concludes that the SEC has been primarily concerned with "the potential of financial information to mislead than to inform."[135] The SEC has shifted this focus somewhat to include discussion of "soft" topics in the Management Discussion & Analysis section that accompanies the core financial statements, although their emphasis on misleading information predominates most SEC disclosure requirements.[136] This emphasis has precluded attention to the development of serviceable financial statements.

The SEC's primary thrust in its oversight of the self-regulatory mechanism has been the development of the audit independence rules, which attempt to ensure that auditors remain independent of their clients in both appearance and fact. Auditors bridge the "information and credibility gaps which exist between top corporate management and those who are financially interested in the wealth controlled by such management."[137] Audits inspire investor confidence by providing credibility to the management prepared financial statements, and thus secure a central role in

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131 Martin Mayer, *FASB on Trial*, INSTITUTIONAL INVESTOR, Nov. 1997, IBISWeb, Business Source Elite.

132 Zeff, *supra* note 1, at 61.

133 *Id.* at 63.

134 *Id.*

135 *Id.* at 64.

136 *Id.*

137 Lorie Soares, *The Big Eight, Management Consulting and Independence: Myth or Reality?*, 61 S. CAL. L. REV. 1511, 1511-26 (1988).

the operation of the capital markets.[138] Over time, independence issues have become the cornerstone of Levitt's assault on the self-regulatory regime that has existed for decades, principally due to the rise in revenues from consulting services among the Big 5 accounting firms. Consulting revenue now contributes approximately 51% of their revenue, and continues to grow three times as fast as the audit component.[139] Consulting services offered by the Big 5 include: general management, financial management, operations management, marketing, systems management, public utility services, and human resources management.[140] This list is certainly not all-inclusive, and omits many niche practice specialties such as real estate consulting, which was developed at Ernst & Young through their acquisition of Kenneth Leventhal & Company. While many of the firms have recently shed their consulting practices in an effort to command high value while demand for these services remains high, the Big 5 fear that Levitt's assault will undermine their efforts to rebuild or reorganize their practices in the future.[141] The primary thrust of Levitt's concerns is the inherent conflicts of interest that may be generated when one firm is engaged to offer multiple levels of service to a large corporation, while continuing to audit that entity. Levitt has alleged a fundamental undermining of the audit regime in the Big 5s' efforts to aggressively grow their practices.[142] He bases his arguments not on conclusive evidence of a direct relationship between audit failure and consulting growth, but in a continuing pattern of audit and accounting failures and on alarming trends in financial reporting restatements.[143] Levitt is firmly convinced that auditors are relaxing their vigilance and growing closer to management in an effort to garner more non-accounting revenue.[144] The reason for this trend is simple: audit and tax growth has remained stagnant as a percentage of revenues. The number of public companies requiring audits grew by only 1% from 1993-1999.[145] As the information age ushers in a plethora of global communications growth and information processing needs, the Big 5, with their enormous pool of intellectual capital and their intimate knowledge of the integrative nature of an entities resources, stand poised to offer these services in a comprehensive one-stop shop environment. Levitt believes these services can pose serious conflicts

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138 *Id.* at 1516.

139 Mike McNamee et al., *Accounting Wars*, BUSINESSWEEK, Sept. 25, 2000, *available at* http://www.Businessweek.com.

140 Soares, *supra* note 137, at 1514.

141 McNamee et al., *supra* note 139.

142 *Id.*

143 *Id.*

144 *Id.*

145 *Id.*

on auditor independence and judgment, as implementation of these services would force Big 5 firms to essentially assume the role of management. They would then be forced into the untenable position of auditing their own work, a prospect that unnerves even many certified public accountants.[146] Even if complete objectivity could be retained, the appearance of a conflict is inevitable, as audit firms devote greater resources to their audit clients in nontraditional practice areas, especially if those areas are of an operational nature.[147]

In response to these warnings and motivation from a sharply worded GAO report issued in 1996, the accounting profession and the SEC agreed in 1997 to establish the private Independence Standards Board.[148] The ISB's mission was to develop a conceptual framework through which future regulations could be filtered, identification of emerging independence issues, and providing practitioner guidance in this field.[149] However, trouble for the ISB quickly ensued as Levitt challenged the initial composition of the Board's membership, complaining that accountants or their allies held most of the positions on the Board.[150] Furthermore, a 1998 probe of PricewaterhouseCoopers found that a great number of employees were purchasing stock in the companies which the firm audited, which is strictly prohibited under past and current independence rules and is one of the primary underpinnings of the independence rules.[151] Approximately half of the firms' partners had violated the rules, and nearly 8,000 violations were discovered.[152] Several high profile cases before the SEC also cast a pall over the professions deemed independence. In one of those cases, MicroStrategy Inc.'s restatement of three years of financial reports cost shareholders $10.4 billion in one week.[153] It was subsequently discovered that numerous financial ties existed between the software company and its auditor, PricewaterhouseCoopers, which was also a reseller of its software.[154] Additionally, the SEC alleges that the two companies attempted to hide their financial ties by using a third party as an intermediary.[155] Another high profile case involves Waste Management and Arthur Andersen, its auditor of over thirty years, in which the SEC alleged a *revolving door* policy existed between the

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146 *Id.*

147 Soares, *supra* note 137, at 1526.

148 Gregory Jenkins, *A Declaration of Independence*, JOURNAL OF ACCOUNTANCY, May 1999, at 31.

149 *Id.*

150 *Id.*

151 *Id.*

152 *Id.*

153 *Id.*

154 *Id.*

155 *Id.*

company and its auditor, extensive cross selling of consulting services by its auditors which included the payment of bonuses to members of the audit team, and excessively high consulting fees.[156] The SEC alleges that these financial jackpots created powerful incentives in forcing Arthur Andersen to accept Waste Management's earnings manipulation and creative accounting practices, which resulted in an $859 million loss in market capitalization and a restatement of income, and included a $3.5 million charge against earnings as far back as 1992.[157] While these cases do not represent proof positive of a direct correlation between consulting services and impairment of auditing services, the tone and tenor of the SEC's remarks indicate that it believes such a relationship exists.

Levitt proceeded on his crusade to vigorously enforce the independence rules, which he believed were crippling the integrity of the financial reporting model, from which investor confidence ultimately derived, and in June of 2000 proposed the most sweeping independence rules in decades. The proposed rules would have banned ten categories of non-audit services, which included: bookkeeping services, financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing, assumption of decision-making or supervisory functions, human resources, broker dealer or investment adviser status, legal services, experts services, and a catch-all provision designed to prohibit appearance based conflicts.[158] These rules, if implemented, would have required massive restructuring of the accounting and auditing profession. Although the proposals were substantial and far reaching, opposition to their implementation was equally vociferous. Although the final regulations, set forth in December 2000, enacted most of the same prohibitions enumerated in their June proposal, the SEC succumbed to relentless political pressure and significantly diluted the outright ban on information technology services, which was the most significant of the ten categories initially proposed.[159] Additionally, the outright ban on the internal audit outsourcing was significantly diluted.[160] In many respects, the new regulations simply codify existing regulations, and were viewed as a victory for the accounting profession.[161] Significantly, though, the ban includes a prohibition on the rendering of legal services, which could seriously hamper the efforts by many

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156 *Id.*

157 *Id.*

158 Richard Miller, *SEC's Final Rule on Auditor Independence Generally Reflects Negotiated Compromise*, THE CPA LETTER, Jan. 2001, at 1.

159 *Id.*

160 *Id.*

161 *Id.*

of the Big 5 to develop successful law practices in North America as they have done in Europe. This ban, coupled with current ABA prohibitions on multidisciplinary practices, could successfully block efforts to develop completely integrated accounting and legal practices. As the regulations were just announced in December of 2000, it is still too early to determine their actual significance in this area. Judicial or legislative fiat, for many years the bulwark of the accounting lobby, could successfully erode this prohibition.

VIII. THE FAILURE OF CURRENT WISDOM

The SEC has recently demonstrated a willingness to dramatically increase its authorized oversight of the accounting profession and correspondingly decrease the professions self-regulatory nature. Its willingness to pre-empt the Independence Standards Board, a Board it willingly approved and helped fashion, should sound a cautionary note throughout the profession. Chairperson Levitt's re-distribution of the FAF Board and his desire to dramatically increase enforcement efforts at the SEC demonstrate increased willingness to expand its direct regulatory powers. However diluted, his successful efforts to implement and codify new independence standards could spell a death knell for the complete integration of the accounting and legal professions. At a minimum, these efforts could lead to protracted battles at the federal and state level, as individual states, which act as regulatory gatekeepers, attempt to harmonize their rules with the federal mandates. Intense lobbying of the legislative and executive branches by those hoping to develop true MDP's, could lead to epic struggles that could ultimately shape the nature of the profession's regulatory design. Indeed, many continue to question the wisdom of allowing the standard setting and enforcement mechanisms of the profession to be guided by the premise of self-regulation, noting that investor confidence in the largest capital markets in the world largely depend upon their decisions and judgments. Levitt has echoed these sentiments from his bully pulpit, demanding greater transparency and comparability from the financial reporting system. In a far-reaching interview, Levitt publicly condemned the accounting profession, and stated, "The accounting profession, and particularly the AICPA, have been almost oblivious to the words public interest. Independence, full disclosure, and public perceptions - which the accounting industry dismisses as a relevant - or the cornerstones that have made our markets the best in the world."[162] He concluded by saying:

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[162] McNamee et al., *supra* note 139.

> Our markets are based on perceptions. That's what fuels public confidence, that's what moves the markets. The number of accounting misdeeds and the high profile failures and the managed-earnings cases are what have eroded public confidence. It's the commission's job to provide for full disclosure and reporting that is as accurate as possible. And with self-regulation, perception is doubly important.[163]

Levitt's goals and intentions are accurate in their service of the investing public, but the substance of his criticisms and his proposed changes do little to mitigate the dangers of earnings management. They instead focus on individual misdeeds and the need for greater regulatory efforts, rather than on the serviceability of the financial reporting model as presently structured. This "cult of personality" has in fact diverted attention away from fundamental restructuring towards individual scapegoats and single instances of ethics failures, bad management, and inadequate educational resources.[164] While many of these individual failures warrant serious attention and enforcement, the zealous blame heaped upon them obscures accountings failings as a reporting mechanism through which the consumer may feel justified in placing full and unquestioned reliance. Indeed, "professional accountancy bodies suggest that the remedy is more education - educate the public on the limited utility of traditional accounting information. This approach is a curious example of caveat emptor."[165] In their most blistering criticism of the study, the Australian authors focused directly on the regulatory maze in the United States, which parallels in many respects that found in Australia, and concluded that:

> Regulation through threat of sanction for noncompliance with the prescribed rules appears to have been spawned by the push for a formula approach to financial disclosure - the cookbook approach. Central to that theme has been the philosophy that the greater the number of rules, the more predictable the regulators' behavior, the less accountants exercise professional judgment - the more effective the regulation. Perversely, the greater the regulation less reliable accounting has become, and a fatal attrition of accountants'

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163 *Id.*

164 F.L. Clarke et al., *supra* note 91, at 9.

165 *Id.* at 10.

professional judgment has become more of a reality than a mere possibility.[166]

The contrast between assurances given to consumers of ordinary goods and services and that given to users of financial statements has never been more revealing, in that both groups of users have nearly identical expectations of the end products, the presumptions of serviceability.[167] Even the time honored warranty of fitness for a particular purpose notable in the consumer goods arena may reasonably apply, if only through common sense, in that it is reasonable to assume that accounting data "are fit to be used to calculate a variety of financial ratios whose products will be indicative of the Company's financial characteristics -- solvency, liquidity" and other crucial performance measures through which a realistic portrait of an organizations viability and financial health and strength will emerge.[168]

IX. THE REFORMATION

Chairman Levitt recently announced his retirement, and the incoming administration has yet to appoint his successor. The incoming chairperson will play a pivotal role in shaping the accounting profession. This change notwithstanding, while the trend towards increased vigilance of earnings management and zealous enforcement may sometimes deter the brazen and unscrupulous, it will not, however, deter honest accountants from applying prescriptive standards to financial data, often leading to bizarre and unintended results. Accounting failures are many times the results of poorly constructed standards that have no legal or economic basis. The mantra of substance over form so dearly cherished by those in the accounting community fails to reveal and clarify the arcane ambiguities of consolidation accounting and historical, cost based financial reporting. Levitt's goals are sweeping and substantive, yet his methods cosmetic and superficial. The real issues have yet to be addressed by any private or governmental regulatory agency. The status quo has pervaded the national conscious for decades, and has entrenched itself in a generation of accountants bred through Big 5 indoctrination and gospel. The captains of industry, board members of the regulatory agencies, and members of the national accounting firms share common ground in seeking to avoid disruptive change. The accounting industry seeks, most importantly, to avoid liability, and the cookbook

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166 *Id.* at 238.

167 *Id.* at 242.

168 *Id.* at 243.

standards pervasive today well accomplish that goal. Captains of industry seek to manipulate accounting data to create financial reports that view their organization most favorably. Regulatory agency members are often products of private industry, as many are tapped directly from the boardrooms of corporate America and the accounting industry, hence, they too have no incentive to seek substantive reform of our financial reporting system.

Substantial modification of the financial reporting model would involve reform of financial consolidation principles, to reflect the legal and economic reality of the corporate structure. A shift to fair value accounting (assets and liabilities valued at their *real world* referents) would prevent the gross miscalculations of value that continue to plague analysis of corporate stability and liquidity. Valuation analysis would be greatly simplified and unshackled of the costs of engaging in costly valuation analysis in determining current asset value. Indeed, fixed asset depreciation models and real property accounting are little more than cookbook applications having little economic substance. In light of these inadequacies, it is not surprising that expert investment analysts are unable to fairly evaluate company performance and future potential, as financial ratios based on inaccurate financial statements are useless at best and deceptive or fraudulent at worst.

Unlike the British Commonwealth, the Unites States does not recognize the subjective override of the *true and fair value* standard, which demands representational faithfulness of the financial statements, irrespective of the raw financial reporting, but instead mandates conformity with GAAP as the prevailing standard.[169] The literal meaning of *conformity* implies strict compliance and non-deviance. This standard has failed the test of representational faithfulness. Furthermore:

> What is inexplicable is the promotion of the idea that the way to repair the damaged image of accounting and auditing is to have consumers understand that accounting data are not serviceable, that published financial statements are limited in their function - do not disclose the wealth and progress of companies; and that whereas they are to be declared true and fair, they are no such thing. That is, to explain that there is not so much an expectation gap as what amounts to a performance gap . . . From the published financial statements it remains impossible to assess the wealth and progress of a company, virtually impossible to calculate reliable indicators of solvency, rate of return, asset backing, gearing and the like. Published financial statements contained data which are mere artifacts of the processing

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[169] Zeff, *supra* note 1, at 65.

> rules imposed upon accountants through the compulsory imposition of accounting standards, some of which lead to data being pure fiction. The latter are not merely unrepresentative of what they describe; they have nothing to describe, no referent in the real world.[170]

This scathing analysis of the present state of the accounting profession represents a clarion call to our economic leaders to demand structural changes in the way financial data are prepared and packaged. Otherwise, the accounting profession itself may be in jeopardy of losing claim to that very term. A technician can easily replace a professional's judgment, if the only required expertise is that of engaging a complex set of rules and procedures.[171] Levitt has the right idea, but the wrong method.

X. EPILOGUE: ENRON

The fall of the house of Enron, the huge energy-trading conglomerate, in late 2001, has thrust the often arcane and academic accounting community into the public spotlight, a position it neither seeks nor relishes. This paper was completed almost eight months before Enron's debacle, yet little academic research or guidance existed to foretell the likelihood of such a catastrophe. Indeed, other than the often-excited utterances of former SEC chair Arthur Levitt, it was difficult to find sympathy for even minor changes or revisions to existing paradigms and structures. Substantial lobbying efforts by the accounting community often guaranteed the failure of even a modicum of reform. The failure of the Enron Corporation, though, profoundly changed this focus and elevated Levitt to near mythical stature in the financial community. Enron's failures have barely begun to be understood, and it's tangled web of hundreds or thousands of partnerships, off-balance sheet financing mechanisms, and complicated hedge's may require years of analysis and thousands of hours of resources to untangle. Enron's failure was so complete, its efforts to obfuscate so thorough and pervasive, that the financial community, and indeed the entire country, is in the throes of perhaps the grandest collusive fraud perpetrated in the nations history.

Enron's collapse clearly demonstrates the grossly inadequate nature of public debate and understanding of financial statement inadequacy. This, at a time when earnings manipulation is easily achieved by creative accountants

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170 F.L. Clarke et al., *supra* note 91, at 256-57.

171 *Id.* at 259.

adhering to the letter but not the spirit of the financial accounting rules. Strict adherence to these rules by auditors has resulted in less transparency and greatly diminished levels of auditor judgment. As auditor judgment is replaced by standards that encourage a formulaic *cookbook* approach, it is easy for the auditor to absolve himself of the need to review the financial statements for transparency and disclosure, and instead point to the GAAP and GAAS statutes as safe harbors. It may be ghastly to think that the Enron auditors complied with the letter of these standards (and the law) yet succeeded in creating the most tangled set of financial statements ever assembled. The failure lies largely in the principles themselves and the lack of professional accountability amongst auditors. Auditor judgment has been replaced by this formulaic adherence to the standards. Additionally, the conflict of interest created by performing consulting engagements, which typically generate many times the audit revenue, and that of opining on the fairness of the same company's financial reporting mechanism, is obvious. Audit firms that also serve as internal auditors for these companies may also be compromised in their ability to be fair and objective. Finally, self-regulation has been a failure, as industry guidelines and regulation methods have been ineffectual in curbing these excesses.

The profound changes required may rally the accounting community to bitterly resist these changes at the Congressional level, the Executive branch (the SEC), and within the industry itself. Arthur Levitt fought a continual battle to reform some of the problems, yet was defeated on almost every important initiative. Harvey Pitt, the current SEC chairperson, is a former defender and lawyer of the Big 5, and may succumb to pressure to maintain the status quo.[172] Enron may ultimately be regarded as a lone criminal misadventure, and a cosmetic regulatory scheme will replace the recently resigned Public Oversight Board.[173] Given the current administration's zealous de-regulatory advocacy, significant changes in both the structure of accounting self-regulation and the rule making process may be difficult and seem unlikely. Cosmetic changes will likely be instituted, as imminent Congressional elections may motivate minimalist reform. The average person will be none the wiser, believing that those responsible have been brought to justice, yet earnings manipulation will continue apace. The few who understand the depth of the problem will simply continue to watch the largest con game ever devised, hoping that their investments do not fall prey to these scams.

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172 David Leonhardt, *How Will Washington Read the Signs?*, N.Y. TIMES, Feb. 10, 2002.

173 *Id.*