Truth In Accounting: Don't Let It Die

Ronald M. Mano, (Email: rmano@weber.edu), Weber State University
David Durkee, (email: ddurkee@weber.edu), Weber State University
Matthew L. Mouritsen, (email: mmouritsen@weber.edu), Weber State University

Abstract

"Truth in Accounting," it seems to have a nice ring to it. "Managed Earnings," this does not sound so good to us. This paper is about what is happening in the Accounting world and what needs to be done and by whom. This document highlights current and past events, such as Enron, Continental Vending and others, that have neglected to perpetuate truth in accounting.

1. The Incentive to Write this Article

Recently, we read an article by Alfred M. King titled, "Applying New M&A Accounting Rules" which appeared in the November, 2001 issue of *Strategic Finance*. We are appalled at what Mr. King is suggesting and that a high quality journal such as *Strategic Finance* and a prestigious professional organization such as the Institute of Management Accountants would promote such an idea by publishing the article.

In the article, Mr. King provides ideas of how accountants can apply the rules of FAS 141 and 142 in such a manner that "impairment" losses are not charged against operating results. The entire article is devoted to how accountants can make the financial statements look better by manipulating how items are reported.

As we read the article, we wrote in the margin, "What happened to truth in accounting?" We have read far too many articles such as Mr. King's. Let us remind all accountants about former SEC chair, Arthur Levitt's, comments made in a speech delivered at New York University on September 28, 1998 where he condemned the accounting profession for what he called "managed earnings." We particularly recommend that Mr. King and the editor of *Strategic Finance* read that speech. It terrifies us, as a group of lowly accounting professors, to think that accountants are taking great pride that their ability with accounting is such that they are able to "manage earnings." It is doubly terrifying that respected journals such as *Strategic Finance* would publish articles not only promoting such accounting but giving details about how to do it.

We just heard that the FASB recently produced a video titled "Financially Correct." We ordered the video, have received it, and viewed it. It is moderated by Ben Stein and includes interviews with five highly respected professionals. Some brief quotes by those five individuals are presented in the FASB's *Status Report* of September 28, 2001. Here are some excerpts from their excerpts. Warren Buffet said, "We look at the numbers and try to evaluate the quality of the financial reporting." Abby Joseph Cohen said, "For investors to make good decisions...they need to know the truth." Jeffrey E. Garten said, "The integrity of the whole society is undermined if financial information is misrepresented..." Judy C. Lewent said, "Higher standards when properly implemented drive excellence." Finally, Floyd Norris said, "We are in a situation ...where the temptations to provide 'bad' financial reporting are probably greater than they used to be...the temptation to manage earnings...is probably greater than it used to be." Now we ask our readers, do the above comments seem to support "truth in accounting" or "managed earnings"? The answer is too obvious to even ask for an answer.

2. The Importance of the Accounting Profession

Accounting is a wonderful profession and vital to the financial well being of this great country. This profession has the potential to be the single most important entity contributing to the financial strength of our society or it has the potential to be absolutely worthless and not worthy of existence. If we have as our goal "truth in accounting" then we are

Readers with comments or questions are encouraged to contact the authors via email.
going to be the one and only hope for the financial survival of our economy. However, if our goal is to manipulate financial reporting as the King article suggests or to manage earnings as Arthur Levitt condemned, then this profession is completely worthless and professors such as us are simply involved in a massive fraud.

The auditors' report that must be included in all published financial reports of public companies states, "The financial statements fairly present...in accordance with generally accepted accounting principles..." We believe that this is and should be two statements rather than one. The financial statements should be both fairly presented and in accordance with GAAP and to the extent that GAAP does not fairly present, fairly presented should take precedence over GAAP.

3. Continental Vending

A case that occurred almost forty years ago and was settled in criminal court over thirty years ago is commonly called the Continental Vending case and officially called United States vs. Simon. In that case, two partners and a manager of Lybrand, Ross Bros. & Montgomery (now PricewaterhouseCoopers) were found guilty of criminal fraud. The Judge, in this case, held that the profession must be held to a higher standard than GAAP. The message was that auditors should evaluate the probable effect of disclosures on stockholders' investment decisions, and if disclosures are likely to affect such decisions, disclosure is appropriate, regardless of GAAP's requirements. In this case, the Judge specifically instructed the jury that they were to determine whether the financial statements were fairly presented and stated that following GAAP does not automatically lead to fairness (we do not footnote this case because this information is available in virtually any auditing textbook).

In these authors' opinions, this case is a critical one that should never be forgotten by the accounting profession. Clearly, simply "in accordance with GAAP" is not sufficient. However, that is exactly what the profession seems to have done. Later, in this paper, we will discuss the Con Agra and Enron cases. It is quite clear in those two cases that the accountants and auditors have forgotten the Continental Vending case.

4. SEC Promulgates the Obvious

On December 6, 1999, *The Wall Street Journal* contained an article titled, "SEC Lists Revenue-Booking Guideline, Says It Aims to Curb Dot-Com Abuses." It seems that the SEC had issued an official rule on the criteria that must exist before a company is allowed to book revenue.

That day, one of these authors (Mano) took the article to class and asked his undergraduate class here at Weber State University what they thought should exist before a company recognized revenue. They came up with the following list:

- An actual sale of goods or services
- A specified price
- The ability to collect

It turned out to be a pretty simple exercise because it took them about three minutes to come up with the list.

Two days later, he was the speaker at an Institute of Internal Auditors lunch meeting in Salt Lake City. Since the issue fit in well with his topic, he did the same exercise with that group of professionals. They came up with the same list in about the same amount of time. Next, he went to a faculty colleague and did the same exercise. In about the same amount of time, the colleague came up with the same list. He has conducted the exercise several additional times with other groups but always with the same result.

Here is the list of criteria that the SEC came up with as reported in the Wall Street Journal on December 6, 1999:

- An agreement to deliver products and services
- They have actually delivered the product or services

- They have fixed a price for the product or services
- They can collect the specified price

Now we ask readers of this article, "Why do we need a formal SEC rule to require what several different groups took about three minutes each to develop?" Could it be that there are some problems out there that relate to the recognition of revenue? It is regrettable when the SEC feels a need to promulgate, as a formal rule that which should be totally obvious to even marginally qualified accountants.

Exactly one month later (January 6, 2000), *The Wall Street Journal*, ran an article titled, "Auditors Miss a Fraud and SEC tries to put them out of Business." The article mentioned a particularly bold fraud where the company, Cal Micro, was, "booking bogus sales to fake companies for products that didn't exist." Now surely, Cal Micro's accountants did not need the SEC rule to tell them that "booking bogus sales to fake companies for products that didn't exist" is really not proper accounting.

5. Management Fraud-We Accountants Abhor It

We accountants talk of "Management Fraud". Sometimes we call it "Fraudulent Financial Statements." Arthur Leavitt, former Chairman of the SEC, talked about "Managed Earnings." Aren't all three about the same thing? Often, it seems that we accountants speak of this topic as if to excuse ourselves from any involvement in the issue. However, we ask this question, "Can fraudulent financial statements or whatever we choose to call this activity, ever occur without the participation of an accountant in some way?" We accountants need to look at ourselves and how we have participated in, or have been the architect of, management fraud. We do not criticize the SEC for promulgating the obvious. However, it is regrettable that we accountants have created or participated in the situation where the SEC feels compelled to promulgate the obvious.

Unfortunately, we who have been members of the accounting profession for some years have read or heard of numerous cases of fraudulent financial reporting, management fraud, managed earnings or whatever we choose to call it. We have heard of numerous lawsuits against accountants and many of those have been successful suits for the plaintiffs. We have even heard of accountants who have been sent to jail for participation in fraudulent reporting. None of this has shed a favorable light on what was, at least once, considered the most respected of all professions.

6. An Ancient Example From the Experiences of One of the Authors

When I (Mano) was in Lincoln, Nebraska, while working on my Ph.D. I obtained a copy of the annual report of Con Agra Corporation. Con Agra is an agribusiness corporation headquartered in Omaha, Nebraska. The company was audited by what was then Coopers & Lybrand (now PricewaterhouseCoopers) and their auditors' opinion was included in the annual report. It was a standard "unqualified" opinion that purported that the financial statements are fairly presented, in accordance with generally accepted accounting principles, thus implying full disclosure. As I read the annual report, I came across a footnote that I simply did not understand. The footnote related to taxes and I don't claim to be a tax expert but I do claim to have a pretty good basic understanding of taxes. After reading the footnote several times and being completely baffled, I went to visit a professor named Richard Johnson who is a CPA, an attorney, a truly brilliant person, and whom I consider to be a genuine tax expert.

Rick read the footnote over several times and confessed that he did not understand it. Finally, he admitted that he did not understand it but told me that he had an uncle who worked for Con Agra in the accounting function. Rick offered to call his uncle and ask him what the footnote meant. I asked Rick to do so. A few days later, I visited Rick in his office and asked him if he had called his uncle. Rick said that he had. I asked him what his uncle had said. Rick told me that his uncle had said, "It's none of your damn business!" To this day, I have no idea what that footnote meant. I must assume that Con Agra was somehow trying to disclose what they were required to disclose but for some reason did not want the general public, a non-tax accounting professor, a genuine tax expert, or even a relative to know what it really meant. Coopers & Lybrand had given the entire financial statements their stamp of approval even though they were probably fully aware that they were incomprehensible to anyone who would read them.

7. That Was Then (1978); This is Now

Recently, we read an article that appeared in the November 5, 2001 *Wall Street Journal* titled, "Andersen Faces Scrutiny on Clarity of Enron Disclosures." That article discusses how parts of the Enron annual report are "indecipherable." The article quotes Karen Denne, a spokesperson for Enron. In one part, she states that if anyone does not understand the financial statements all they need to do is ask. Judging from other statements made in the article which are attributed to Ms. Denne, we must assume that if we were to ask, her answer might be very similar to the response received from Rick Johnson's uncle in the Con Agra case. In another part of the article she tries to defend the quality of the financial statements by saying, "They comply with reporting requirements." Ms. Denne clearly does not seem to believe that "The financial statements fairly present...in accordance with generally accepted accounting principles..." are two statements. She then continues with this appalling statement, "...investors who didn't understand the transactions didn't have to buy Enron stock." Wow, what a way to justify a lack of full disclosure!!! In the same article, Douglas Carmichael, an accounting professor at Baruch College in New York, said of the disclosures, "The raw numbers may all be there. But any objective person would be hard pressed to understand the effects of these disclosures on the financial statements." Although Professor Carmichael's comment is aimed specifically at Enron, it could just as well be aimed at Con Agra (and perhaps many more companies) as well.

Exactly one week later, on November 12, 2001, there was another article on Enron titled, "Basic Principle of Accounting Tripped Enron." The article began by stating, "What could Arthur Andersen have done to protect the investing public from Enron? Brushing up on a basic accounting textbook might have helped…" The article states that portions of Enron's accounting practices amounted to violations of elementary accounting principles. The article then quotes former SEC Chief Accountant, Lynn Turner who asks, "How did both partners and the manager on this audit miss this simple Accounting 101 rule?" Since it was so simple, these authors can only assume that it was intentional rather than erroneous. We hope that the fact that Enron paid Andersen $25 million for the audit and $27 million for other services did not have an impact on Andersen auditors' judgment. Unfortunately, these authors' suspicious minds make us suspect that all of those dollars actually did have an impact.

Exactly one month after the first Enron article referenced above, another Enron article appeared in the December 5, 2001 *Wall Street Journal*. That article stated, "The Company (Enron) hired legions of lawyers and accountants to help it meet the letter of federal securities laws while trampling on the intent of those laws. It became adept at giving technically correct answers rather than simply honest ones." We accountants must resist any temptation to become involved in such fraudulent financial reporting. Fraudulent financial reporting is of no value in our society. We need to be the protectors of financial reporting integrity or this profession is of no value in our society.

8. Let Us Conclude With a Plea

Please journal editors. Please article writers. Please practicing accountants. Please auditors. Please accounting professors. Let's allow this profession to be the great profession that it can be by being involved and interested in nothing more or less than truth in accounting. Auditors, do not allow or participate in any form of fraudulent reporting. Let's not allow publication of articles that suggest and promote manipulation of financial reporting. Accounting Professors need to emphasize truthful reporting and never, never, never, suggest ways of manipulating or even smoothing income. We need to be the profession that provides the engine that drives this economy to new and greater heights. Only the truth can do that. Let's not ever be involved in managed earnings.