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Lynn E. Turner

INTRODUCTION

History is a fascinating subject. It provides us with perspectives on the past, often with the accuracy and clarity of 20/20 hindsight. At the same time, history serves as a teacher of lessons to be learned and, by doing so, provides us a glimpse into the future. Oftentimes, the lessons of the past have provided a roadmap to what lurks ahead should similar roads be traveled. And should the lessons of the past be ignored and mistakes be repeated, then history serves as the judge and jury.

The history of the accounting profession is no different. It often mirrors the history of the capital markets in that, during good times, the accounting profession often enjoys a fine reputation. But when the markets fizzle and scandals *appear*, the upstanding reputations of accountants *disappear* overnight.

The U.S. capital markets have been through several disruptive time periods since their beginnings in the 1790s. No less than six times have the markets lost the confidence of investors and suffered significant declines in value.[1] During good times, investors place their bets on investments in new technologies as hopes for rising stock prices become the norm. For example, in the period leading up to the 1929 market crash, *The New York Times* spoke of recently developed technological marvels including the discovery of radio and growth in manufacturing of automobiles and airplanes. The values of assets were constantly being "fair valued" higher and higher. Such occurrences tend to create an insatiable demand for stocks, driving prices ever higher. Few investors want to be left out of the ever-rising market as fortunes are made. Ultimately, for both investor and auditor, economic reality sets in. And once again, the lesson is learned that markets built on a foundation of false numbers don't create wealth; they merely transfer it. By the time the lesson is learned, mistakes of the past have often been repeated and millions, billions, or these days, trillions, in value are lost.

Often the mistakes of years past could have been avoided by greater transparency, independence and avoidance of inherent conflicts, and better oversight and governance. Yet efforts to instill these principles in the capital markets have been fought vehemently by those who stand to profit from a lack of their enforcement. For example, after the 1972/1973 bear market, efforts were made to create greater independence among auditors, to

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[1] See Gordon (1999) for a history of the U.S. capital markets.

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create stronger audit committees, and to create an independent regulator for the accounting profession. Congress did pass the Foreign Corrupt Practices Act (FCPA, U.S. Congress 1977), mandating companies have adequate internal controls to ensure the accuracy of their books and records and financial reporting. Members of Congress also introduced and debated legislation that, to a large degree, mirrored much of the Sarbanes-Oxley Act of 2002 (SOX, U.S. House of Representatives 2002).[2] However, the legislation failed to move forward as accounting firms lobbied vigorously and gave their assurance that they could remain independent and do a better job of auditing.

Names from years gone by—such as McKesson-Robbins, Penn Central, Equity Funding, and ZZZZ Best—are just as well known as the scandals of more recent years—including Enron, WorldCom, Adelphia, Parmalat, and Tyco. These scandals have many characteristics in common, including lax accounting and auditing standards, cozy relationships with management, and less-than-rigorous oversight that played in contributing to the problems the accounting profession and capital markets encountered. In the ensuing search for someone to blame, auditors and accountants were, and are, often branded with a big red "A" on their chests.

A common thread that serves to tie these scandals together is a lack of transparency in financial reporting, resulting in numbers being reported to investors that do not reflect economic reality, coupled with lax homework on the part of investors. In good economic times, this common thread begets a "suspended disbelief" among investors, as if they were watching a movie unfold. And when it is coupled with a long-enough sustained upturn in the markets, it serves to cause market participants and regulators to believe in their own invincibility, just like a 16-year-old who has been given the keys to a new car. In both cases, too often a bad wreck is the outcome.

Accordingly, today we have an opportune moment to reconsider some of the recent events that affected financial reporting and transparency in the capital markets. In turn, these events provide us with some lessons to be learned from, or as may be the case, repeated when we choose to ignore the past. And of course, history will be our judge.

In the following sections, I first provide my views of the events that have shaped our profession in recent years. I conclude by discussing several areas where I believe we still need reform. I hope that this article will provide accounting students and educators with a basis for spirited classroom discussions of the past, present, and future of our profession. Ultimately, it is my hope that the next generation of accounting professional will do a better job of learning from history and remembering their obligations to the investing public—those who provide much of the financial capital to run our economy.

IN THE BEGINNING ...

Our journey into the history of the recent scandals begins in September 1998 at New York University. By that time, cases such as Cendant, W. R. Grace, Waste Management, and Sunbeam had already imploded. Evidence from these cases was beginning to reach the staff of the Securities and Exchange Commission (SEC) and what they saw was alarming. Manipulative financial reporting by companies using such techniques as "big bath" charges, recognizing revenue before its time, and playing games with "materiality" was becoming a way of "playing the game." Financial reporting standards governing mergers, complex

[2] See H.R. 13175, Public Accountancy Regulatory Act. 95th Congress, 2nd session, June 16, 1978. This bill was introduced to establish a National Organization of Securities and Exchange Commission Accountancy that would register and review the work of U.S. and international auditing firms. It also required that audit committee members be independent and responsible for hiring and firing the auditors.

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financial instruments, stock options, and debts hidden from balance sheets and investors failed to reflect economic reality.[3] Auditors were giving "clean opinions" on numbers that would eventually fail the test of common sense and reasonableness. At the same time, auditors were pressing the SEC for the authority to provide a wider scope of services to the companies they audited. In some cases audit committees seemed to exist only on paper. And the last thing Chief Financial Officers (CFOs) wanted to learn about at conferences was accounting.

This situation set the stage for "The Numbers Game," a speech then SEC Chairman Arthur Levitt, Jr. gave that September at New York University (Levitt 1998). Many leaders of business and finance had been invited and were in the audience that night. Chief Executive Officers (CEOs) from companies in the Business Roundtable, an organization of some 200 of the nation's largest businesses, were present. There were also leaders of the accounting profession, including the CEOs of the major accounting firms, as well as accounting and auditing standards setters. This was a speech on a topic that was beginning to get people's attention.

That night, Chairman Levitt certainly succeeded in drawing attention to his concerns. He described how a culture of gamesmanship had taken hold in the financial community. He called on those within that community to change that culture; he emphasized that transparent financial reporting was the lifeblood of the capital markets and was necessary if investors were to make informed decisions on how to allocate their capital. He set forth a nine-point plan for addressing the troubling trends that he had seen as SEC Chairman. The plan included additional guidance from the SEC, its staff, and the FASB to rein in abusive accounting practices, the establishment of a committee to consider the effectiveness of audits, and an effort by the stock exchanges to strengthen and improve audit committees.[4]

Levitt closed his remarks by challenging the business community:

> I believe we need to embrace nothing less than a 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 a corporation. While the temptations are great, and the pressures strong, illusions in numbers are only that—ephemeral, and ultimately self-destructive. (Levitt 1998)

Some members of the financial community such as Bill Steere (CEO at Pfizer), John Biggs (Chairman of TIAA-CREF), and Ed Jenkins (Chairman of the Financial Accounting Standards Board [FASB]) quickly became engaged in assisting Chairman Levitt and the SEC with the Levitt Plan. However, as we know all too well today, others ignored Levitt's warnings, instead caving to temptation and ultimately heading down that path to self-destruction.

MANAGING THE EARNINGS WHEN MANAGING THE BUSINESS DOESN'T WORK

In his speech, Levitt used a term that was getting more and more attention in the media, "earnings management." As used by the SEC staff, it meant accounting designed or structured to get a desired result that differed from the underlying economics of a transaction.

[3] See Condon (1998). The author lists many of the common abuses of accounting being used at that time by companies such as GM, Boeing, and Fine Host, all of which would suffer financial scandals.

[4] As a precursor to corporate governance issues that would later emerge, Levitt was critical in remarks—not included in the prepared text—of a particular audit committee that seemed to lack the requisite financial expertise to carry out its duties. It was the audit committee for Walt Disney Company.

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In essence, executives would manage the numbers when management of the business was not getting the desired results.

The SEC staff saw numerous examples of earnings management as the market heated up in the latter half of the 1990s. In cases such as Cendant, companies set up large liability accounts as "reserves" on their balance sheet, with a corresponding large expense in the income statement often labeled as a "nonrecurring and non-cash charge." Companies such as Tyco that were making acquisitions would set up such reserves as part of the acquisition accounting, a practice referred to as "spring loading." Unfortunately, both sell and buy side analysts bought into the stories that management would spin, saying that these charges should be ignored. For some analysts, keeping the management of a company that might provide a large investment banking fee happy became a normal part of doing business. In fact, analysts often drove the prices of the stocks of companies taking such huge charges higher.

The standard that accountants followed for the establishment of these reserves was a simple one, with plenty of judgment permitted by its basic principle. It required that when it became probable or likely that a loss or cost had been incurred, a company should report that loss. But losses could not be anticipated and were to be disclosed only, and not recorded if they were not yet likely. However, companies began anticipating and recording the costs of plant layoffs and other events that would not occur for years, thereby reporting "big baths" that analysts ignored, while improving future earnings by recording future costs in the current period.

The use of "big bath" accounting had started to increase in the 1980s as American businesses began to restructure their operations and reduce costs to become more competitive with companies in Japan and other countries. Then around 1993, its use grew significantly. In one egregious case, Xerox reported a large charge even though, according to a press account, the company was unsure of what they would include in it. That certainly was a precursor of things to come.[5]

In 1994, the SEC chief accountant urged the FASB and one of its task forces, the Emerging Issues Task Force (EITF), to change the accounting standards to prevent this and other abuses.[6] However, the EITF, populated with several representatives from business, and auditors who were reluctant to oppose business representatives on this group, essentially blessed the status quo. Not surprisingly, one of the companies that lobbied its accounting firm representative on the EITF was U.S. West, a telecommunications company that became

[5] The Form 10-K, available at: http://www.sec.gov/Archives/edgar/data/108772/0000108772-95-000005.txt, states: "In 1993, the Company recorded special charges which aggregated $1,373 million ... The Company anticipated, as a result of this restructuring program, to reduce its worldwide Document Processing work force by more than 10,000 employees by early 1996." Three years later in the 1996 Form 10-K, over $170 million of the restructuring liability remained.

[6] See Schuetze (1994). Mr. Schuetze noted that in January 1994, after studying the issue in 1993, the SEC staff had asked the EITF to address accounting for restructurings. In his remarks, the Chief Accountant was critical of the EITF deliberations on the issue in 1994, challenging whether such costs were a liability that should be recorded, and questioning their verifiability and the resulting noncomparability in financial statements.

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headline material after a merger with the much smaller Qwest. Of equal interest is the fact that prior to 2004, the EITF had *no* members from the investor community.[7]

This was not the first time the EITF would fail investors. In the 1980s, companies began to "structure" and "engineer" transactions to get around accounting rules. Such "engineering" became possible because the Federal Trade Commission outlawed rules the accounting profession had established preventing a company from shopping among auditors until it found one that would provide the answer the company was looking for.

By the mid-1980s, Wall Street had become quite accomplished at finding new ways to circumvent the FASB standards—even before the ink was dry. One such effort resulted in the creation of "special purpose entities" (SPEs). These entities were structured to give the company setting up the SPE the vast majority of the economic benefits from the assets it owned, such as real estate or receivables, that it received from the sponsor. Yet accounting firms began to provide written opinions to Wall Street that blessed sponsoring companies that were hiding assets and liabilities off balance sheets, away from the view of investors. This was justified through the establishment of nominal stockholders who received an interest in the SPE that was more akin to a debt or preferred interest. Yet by contract, the SPE sponsor really controlled the entity.

Between 1987 and 1989, the SEC staff began to challenge SPEs, arguing they should be consolidated along with their assets and liabilities on the sponsors' balance sheets.[8] In deference to the private sector, the SEC referred the matter to the EITF in 1990. And once again, the EITF failed investors when it reached a conclusion that if there was a nominal investor who put in some minimal amount of equity, then the sponsor could avoid consolidating the SPE and keep its assets, liabilities, and losses off the sponsor's financial statements. For investors, this meant "out of sight and out of mind." Unfortunately, despite the SEC staff's guidance to the contrary, the major accounting firms told Wall Street they would accept such accounting shenanigans provided just 3 percent of the SPE's capital representing 100 percent of its equity came from investors other than the sponsor. This was the 3 percent number that later proved to be a major contributor to the lack of transparency at Enron.

Another earnings management technique that started showing up in the mid-1990s was the creative interpretation and manipulation of "material." By 1996–97, the SEC staff were noting in speeches that companies were leaving significant numbers of adjustments unrecorded on what was commonly referred to as the "score sheet" or list of passed adjustments.[9] In addition, amounts that had been accumulating over time and had grown material were also being deemed immaterial. The argument espoused, by companies including Waste

[7] In a letter dated October 22, 1992 to Shaun O'Malley, the President of the Financial Accounting Foundation, then SEC Chairman Richard Breeden wrote regarding two seats at the FASB that needed to be filled beginning July 1, 1993. Chairman Breeden wrote: "Because of their backgrounds, preparers and auditors generally are not the most knowledgeable source for identifying the most useful and relevant information for the purpose of making investment and credit decisions, which is the fundamental purpose for financial statements and reports. Today, the users of financial information—the people for whom the financial information primarily is gathered and presented—appear to be left out of the process. The appointment of two new Board members is an excellent opportunity for the Board to regain touch with the intended, ultimate beneficiaries of its work."

[8] EITF Topic D-14 discussed by the Task Force beginning in February 1989 notes the "SEC staff is becoming increasingly concerned about certain ... transactions involving special-purpose entities (SPEs)."

[9] The Auditing Standards Board Highlights, from its December 15–16, 1998 meeting, states: "David Landsittel, Chair, Big Five Audit Materiality Task Force (task force), presented a letter addressed to Lynn Turner from Robert H. Herz, task force member, with attachments that describe the task force's recommendations to address practice issues relating to audit materiality. The task force was convened in March 1998 to examine concerns expressed by the SEC staff at the annual SEC Conference sponsored by the AICPA in December 1997 and to formulate responses addressing the issues" (ASB 1998).

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Management and W. R. Grace, was that while in aggregate the accumulated errors might be material, they were not material in any particular quarter. The SEC staff had previously banned such arguments, stating "if the cumulative effect is material to current operations or to the trends of the reported results of operations, then the individual income statements of the earlier years should be retroactively adjusted."[10] However, CFOs, controllers, and auditors were simply ignoring this guidance.

The issue of materiality came to a head in the summer of 1998 when a fast food retailer announced a large impairment charge for kitchen equipment the company was replacing throughout its stores. The company management and board had been discussing for some time the need to replace the equipment, but had never adjusted the depreciable lives of the assets downward. Instead, the company avoided larger depreciation charges while using the equipment and took a "big bath" write-off for the remaining undepreciated costs including, literally, the kitchen sink. When the SEC staff challenged the company on its accounting, the response was the adjustment was only 4.9 percent of net income and the company considered 5 percent to be its materiality threshold. The auditors quickly weighed in that, though they had informed management that the accounting was improper, they did not require the client to book the adjustment. In this case booking the adjustment would have meant the company missed its projected numbers for the quarter. The reality was the company was playing "the numbers game" and the supposedly independent auditors were playing the game as well. This case, combined with the manipulation of materiality found in the Waste Management and W. R. Grace enforcement cases, resulted in Levitt's recommendation that the SEC staff issue new guidance on how materiality should be evaluated.[11]

The SEC staff also met with the Chairman of the FASB in 1998 to discuss materiality. The FASB Chairman brought up the issue of companies intentionally ignoring FASB guidance under the guise of materiality. As companies would enter into a new type of transaction, they would misapply generally accepted accounting principles (GAAP), arguing the impact on the financial statements was immaterial. Then when the impact became material, they would argue it was industry practice and therefore acceptable, even if contrary to GAAP. The concerns of the FASB Chairman and abuses such as the one described about

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[10] SAB Topic 5(F) was originally issued as SAB No. 32 and codified as Topic 5(F) in SAB No. 40, which was a codification of SAB Nos. 1–38. SAB No. 40 was issued January 31, 1981.

[11] See SEC AAER 1140 in the "Matter of W. R. Grace and Co.," June 30, 1999, which states in part: "Furthermore, in addition to the quantitative impact, another factor affecting materiality is that it was former Grace and NMC senior management that was manipulating the income of the Health Care Group and/or Grace. In this instance, the misstatements and omissions, especially when considered in light of the fact that the manipulation involved former Grace and NMC senior management, had a direct bearing on the Health Care Group's and Grace's profitability trends, and were therefore material."

See also AAER 1405, in the "Matter of Arthur Andersen," June 19, 2001, which states: "In any event, assessments of materiality should never be purely mechanical. Quantifying, in percentage terms, the magnitude of a misstatement, regardless of size, is only the beginning of an analysis of materiality. It cannot appropriately be used as a substitute for a full analysis of all relevant, qualitative considerations, particularly where, as here, Waste Management had been assessed as a 'high risk client' and there were numerous red flags and other indicia of irregularities in the Company's financial statements. Instead of ascribing sufficient weight to the other issues that were not listed as PAJEs and requiring additional audit procedures to determine whether there were additional misstatements in the account balances and classes of transactions that were audited, Andersen applied the 'roll-forward' analysis to only those misstatements for which the engagement team listed PAJEs."

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the fast food retailer, ultimately led the SEC staff to issue Staff Accounting Bulletin (SAB) No. 99 (SEC 1999a).[12]

"It's industry practice" was the argument made by many technology companies that had taken huge immediate write-offs of in-process research and development (IPR&D) costs acquired from other companies. WorldCom and AOL both attempted to take such charges in the summer of 1998. In the case of AOL, the company provided the SEC staff with a copy of a briefing the target company had provided to the AOL board. In those materials was a page that set forth several awards the technology and software had received as a new product. The irony was the software was not in development, but rather was being sold as a commercial product and did not even qualify as IPR&D under GAAP.

During 1998 and 1999, more than 50 companies had to correct their accounting for IPR&D.[13] As the controller of one well-known Silicon Valley company noted, it was questionable as to whether any company had accounted for its IPR&D properly.[14] But nonetheless, the restatements caused an uproar in the "Valley"—enough so that a large group of technology company CFOs and controllers met with the SEC staff in Washington to discuss the issue. One important point these finance chiefs made to the SEC staff was that if the SEC were to take action for erroneous accounting on this issue, then the SEC should act against the auditors. Many corporate representatives stated that they relied entirely on the numbers the auditors had provided them; if those numbers were wrong, then it was the auditor's fault. This management response raised serious questions with respect to the management representation letters these executives were issuing to the auditors. So much for the notion that the financial statements are the responsibility of management, and it is the role of the auditor to give an independent opinion as to the fairness of the claims therein. More unfortunate was that this same viewpoint would be heard again by Congress and the courts as executives of companies such as Enron testified before them.

Another troublesome financial reporting practice that grew during the 1980s and 1990s was the practice some companies began of providing "earnings guidance" along with "pro forma" numbers. The latter involved reporting earnings without all the "bad stuff" such as losses and expenses such as for restructuring charges, declines in values of assets, acquisition costs or whatever else seemed to be depressing earnings for a quarter. In one such instance, a company even began to exclude part of its payroll costs in presenting its pro forma earnings. By providing these pro forma earnings, companies could make themselves look as though they were actually doing better than they were economically. And of course, analysts were only too happy to facilitate such spin; by doing so, they could make a case for higher public offering prices, and ultimately larger investment banking fees.

But earnings guidance, while often blamed on Wall Street, came directly from management. While management would (and still does) harp on the short-term mentality of

[12] The legitimacy of the SAB would be quickly challenged in a court case, *Ganino v. Citizens*, in the U.S. Second Circuit Court of Appeals. However, in its decision of September 6, 2000, the Court stated: "Nonetheless, because SEC staff accounting bulletins 'constitute a body of experience and informed knowledge' ... and SAB No. 99 is thoroughly reasoned and consistent with existing law ... we find it persuasive guidance for evaluating the materiality of an alleged misrepresentation."

[13] Banyi (2004) notes that "As a result of the SEC's initiative, between October 1998 and July 1999, over a hundred publicly traded firms restated quarterly and annual financial reports and capitalized $2.4 billion of the $5.2 billion they had previously written off as IPR&D."

[14] See the slide handout from a February 2, 1999 "In-Process R&D Conference Call" conducted by Morgan Stanley Dean Witter analyst Chuck Phillips. He noted on slide 10: "Based on the theory behind write-offs, SEC is correct in our view. The companies don't have rigorous documentation on they valued in-process r/d. Auditors questioned nothing. Bigger is better was accepted wisdom and market rewarded that behavior."

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Wall Street, it was management who fed that frenzy by providing Wall Street with *management's* expectation for the upcoming quarter. Hence, if management missed the mark for the quarter, it was in reality its own number it had missed. However, that did not stop executives from severely criticizing Wall Street for an unreliable management forecast. This continued practice of providing earnings forecasts fed a "What have you done for me lately" attitude among the Street and investors.

CONGRESS CAN'T HELP ITSELF

Congress and the SEC have had an interest in accounting standard setting since the day the SEC was created. Early in its history, the SEC, over the objection of then Commissioner William O. Douglas, decided to let the private sector accounting profession set the accounting and auditing standards. The SEC would supplement the standards when it determined it was necessary, but the heavy lifting would be left to the private sector.

When the infamous McKesson-Robbins case blew up at the end of the 1930s, the SEC stepped in and demanded changes in the procedures auditors used to check inventories. But it was the auditors who made the changes, not the SEC. In the early 1960s, when the AICPA's Accounting Principles Board (APB) attempted to narrow alternative accounting treatments for the then new investment tax credit, the SEC stepped in, overrode the professionals, and said it would accept an alternative treatment. At the end of the 1960s and beginning of the 1970s, as merger and acquisition activity in the capital markets became very "hot," the APB attempted but failed to narrow accounting practices and eliminate what was often referred to as pooling accounting in favor of purchase accounting. Similarly, after an oil embargo, Congress mandated that the FASB and SEC adopt new accounting rules for the oil and gas industry in 1975.[15] As a result, the FASB narrowed the accounting to one acceptable method in 1977, the successful efforts approach.[16] Unfortunately, the SEC once again interceded and said it would also accept the use of the "full cost" method championed by Arthur Andersen on behalf of the industry. As a result, investors faced increasingly difficult comparisons between companies' successful efforts accounting to those companies using the full cost method.

During the first half of the 1990s, Congress again became more actively involved in accounting standard setting.[17] Initially Congress weighed in against the FASB-proposed standard that required the value of stock options to be reported as an expense in the income statement. Congress intervened despite the fact that the FASB proposal was consistent with the tax treatment required for stock options. After thwarting the FASB's effort on stock options, Congress then opposed FASB projects designed to improve financial reporting for derivatives and mergers and acquisitions. It was as if the stock option debate had served only to "chum the waters" for the sharks attacking the FASB. By taking up the sword of

[15] See U.S. Department of Energy (1979).

[16] Statement of Financial Accounting Standard No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, December 1977.

[17] See letter dated April 28, 1994 from Congressman Markey to SEC Chairman Arthur Levitt. The letter notes the "intense debate" surrounding the FASB's project on accounting for stock options. It states that "attempts to prejudge the outcome of the lengthy process of establishing accounting standards, either by threats to FASB from its private sponsors or by legislation here in Congress, have raised legitimate and important questions about the decision making process itself." In footnote 2 to the letter it notes legislation including H. Con. Res. 98, 103d Cong., (May 11, 1993), S. Cong. Res. 34, 103d Cong. (June 30, 1993), H.R, 2878, 103d Cong. (August 5, 1993), S. 259, 103d Cong. (January 1993), H.R. 2759, 103d Cong. (July 27, 1993) and S. 1175, 103d Cong, (June 29, 1993) as well as letters prepared by the President and two cabinet members to the Senate that addressed the stock options issue. It also states that "In early 1993, a member of the staff of the Subcommittee ... was told that some members of the Financial Accounting Foundation (FAF) ... were threatening to withdraw their funding for the FAF if the FASB went ahead with its proposed rule for stock options."

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the opposition to efforts to improve reporting transparency, members of Congress were able to raise campaign funds from those whose cause they would champion. Individual investors did not have the checkbooks to compete with corporate interests. That left it to the SEC to try to protect investors in the face of staunch opposition from some, but not all, members of Congress.

In the late 1990s, Congress also began to weigh in against different parts of Levitt's 1998 plan referred to above. For example, Senators Phil Gramm and John Kerry opposed the SEC's efforts to clean up abuses related to revenue recognition and the IPR&D fiasco.[18] The Senate Banking committee, under the leadership of Gramm, held hearings related to the FASB's efforts to develop more transparent accounting for derivatives and mergers. The SEC and Levitt had pushed for better standards for derivatives after investors lost large sums of money in companies such as Procter & Gamble and Gibson Greeting Cards. In response to the increase in merger and acquisition activity, the SEC staff had written to the FASB asking it to redo the existing APB standard.

Even Federal Reserve Chairman Alan Greenspan got into the act by writing a letter in opposition to the FASB's proposal that financial instruments such as derivatives be reported at their fair value. It was only when Chairman Levitt convinced Greenspan that his letter was being circulated on Capitol Hill by Congress members who believed they should intervene in setting accounting standards that Greenspan wrote a second letter, noting Congress should not interfere with the private sector standing-setting process.[19]

The ensuing Congressional hearings did pressure the FASB, which agreed to compromises demanded by some members of the Financial Executives Institute (FEI) such as General Electric.[20] As a result, several alternative accounting treatments for derivatives were permitted, allowing companies to avoid using fair values to report certain transactions. In turn, the FASB had to build greater complexity into the final standard than the exposure draft had contained. This included building "fences" around the alternative accounting methods to prevent them from being manipulated and abused. Of course, such guidance had not been provided earlier in FASB, Statement No. 80, *Accounting for Futures Contracts* (FASB 1984). But then again, many companies had failed to follow the more principled approach in Statement No. 80.

Ultimately, it was the investors who took a back seat as the FASB issued its new standard on accounting for derivatives, the often-criticized Statement No. 133 (FASB 1998). But in a strange way, Statement No. 133 was exactly what business had asked for. It permitted companies to avoid reporting the volatility in financial instruments that actually occurs every hour of every day. The statement also created a lot of complexity at the companies' requests, which some companies, such as Fannie Mae and AIG, would avoid by simply not following the rule, with the blessing of their independent auditors.

[18] See Levitt (2002). Levitt notes Gramm and other lawmakers interceded with respect to Staff Accounting Bulletin No. 101 on Revenue Recognition: "Gramm called several times and wrote letters seeking a postponement" (Levitt 2002, 121). One of the letters Gramm wrote was also signed by Senator Kerry.

[19] The Statement of Congressman John D. Dingell at the Subcommittee on Commerce, Trade, and Consumer Protection Hearing on "FASB Derivative Accounting Standards," July 22, 2003 states: "The FASB and SEC met strong opposition from key Senators and Representatives, as well as the Chairman of the Federal Reserve Board and Comptroller of the Currency. Legislation was introduced in the Senate to authorize the bank regulators to exempt banks from any final FASB Standard."

[20] SEC Chairman Levitt testified at U.S. House Committee on Energy and Commerce Subcommittee on Telecommunications and Finance hearings on Derivative Financial Instruments on May 25, 1994. Hearings on derivatives were initially spurred on when companies such as Procter & Gamble, Air Products Chemicals, Inc., Gibson Greetings, Marion Merrell Dow, and the Arco pension fund suffered large losses on investments in derivatives. Hearings in Congress continued; for example, the Senate Committee on Banking, Housing and Urban Affairs subcommittee on Securities held a hearing on "SEC and FASB Accounting Rules" on March 4, 1997.

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ACCOUNTING FIRMS WANT IN, TOO

In the 1990s, the international accounting firms were lobbying Congress to support a new accounting paradigm for the "New Economy." The firms argued they should be permitted to broaden their scope of services to meet the needs of their clients in the New Economy. In essence accounting firms became a "partner" to their clients while telling investors they were "independent." The trade organization for the profession, the American Institute of Certified Public Accountants (AICPA), even published a booklet that highlighted how accounting firms could leverage an audit into broader business services.

However, the SEC had earlier become concerned about whether the accounting firms were serving the interests of investors or their own business interests. In 1994, the SEC Chief Accountant gave a speech in which he indicated some accounting firms were acting as cheerleaders for companies they audited.

The AICPA published a 1997 White Paper highly critical of the SEC independence rules (AICPA 1997). In lieu of those rules, the AICPA proposed a new framework for determining the independence of auditors, based on whether the auditors, *not investors*, believed there were risks to an auditor's independence. As would later be revealed, Ernst & Young (E&Y) apparently failed to believe a very significant business relationship it had with PeopleSoft, whom it audited, would impair its independence. Likewise, KPMG apparently did not believe its independence was impaired when it sold illegal and abusive tax shelters to companies it audited, as well as to members of audit committees it served. All of the major accounting firms were found to charge contingent fees, which had been explicitly prohibited by the SEC in 2000. Such examples cause one to wonder exactly what it would take to cause one of these big audit firms to determine that its independence was compromised.

In the summer of 1998, the SEC learned through an anonymous letter that individuals in the Tampa office of PricewaterhouseCoopers (PwC) had violated the very simple and long-standing rule that an auditor should not own stock in a company the firm audited. After a relatively short investigation, the SEC settled with PwC. Part of the settlement was a requirement for a more in-depth independent investigation. During the course of the investigation, it came to light that the PwC independence violations were not confined to one office, but rather were firm-wide, including international offices. The violations involved all levels of personnel right up to the highest levels within the firm.[21] In addition, as would later be highlighted in another SEC enforcement action against PwC, the violations of independence rules were much broader than just owning stock in a company the firm audited, including other inappropriate business practices. In one instance, the SEC staff found individuals issuing "side letters" to contracts for services, with terms and conditions that were inconsistent with the independence rules of the SEC and the profession. Some side letters involved contingent fee arrangements that would later become an issue for the Public Company Accounting Oversight Board (PCAOB).

As the SEC dug deeper into the PwC mess, it came to believe that this was not just a matter affecting PwC. Rather, it appeared to be a profession-wide issue. That led the SEC staff to issue a number of letters to the profession in 1998 and 1999 urging them to comply

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[21] SEC News Release 2000-4 (SEC 2004a), *Independent Consultant Finds Widespread Independence Violations at PricewaterhouseCoopers*. The release notes that "on January 14, 1999, the Securities and Exchange Commission, in an investigation that remains ongoing, issued an Opinion and Order Pursuant to Rule 102(e) ... In the Matter of PricewaterhouseCoopers LLP (Securities and Exchange Act of 1934 Release No. 40945), which censures PWC ... The independent consultant's report discloses that a substantial number of PWC professionals had violations."

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with the independence rules and ensure the firms had systems in place to monitor that compliance. Unfortunately, all the major firms lacked adequate compliance monitoring systems both in the U.S. and internationally.

In December 1999, the SEC staff met with the private sector overseer for the profession, the Public Oversight Board (POB). Armed with a draft report on the investigation of PwC that would soon be issued, the SEC staff urged the POB to undertake its own investigation of the profession.[22] Understanding the damaging picture that the report painted, the POB agreed to do so in January 2000. However, on May 3, 2000, in a letter from the AICPA Director of the SEC Practice Section to the Executive Director of the POB, the accounting profession cut off funding to the POB for its investigation.[23]

While the PwC enforcement matter was brewing, another issue affecting the consulting activity by auditing firms also was developing. As the U.S. capital markets were gaining strength and a degree of irrational exuberance in 1998, the valuations of consulting firms also were increasing—upward to five times revenue. As partners in the audit firms started to focus on this untapped source of value and wealth, they began to develop strategies for monetizing their consulting practices. At least one Wall Street banker started approaching the accounting firms to gauge their interest in selling or taking public some interest in their consulting divisions.

In late summer of 1998, KPMG submitted a request to the SEC staff that the firm be allowed to sell a minority interest in its consulting business. In turn, KPMG then wanted a ruling that would allow it to view that business as unaffiliated and independent from the auditing firm. Such an arrangement would result in the better of two worlds. The audit firm would have a controlling interest in a consulting firm, and the consulting firm would be able to sell services on an unregulated basis to any company audited by the audit firm.

The SEC staff engaged in significant discussions regarding this issue. They told KPMG that to be considered independent from the auditing firm, and therefore not be considered part of that firm for purposes of applying the independence rules, KPMG would initially have to sell an 80 percent stake, agree to sell the remaining interest owned over a period of time, and not control the economics or governance of the consulting business. KPMG argued the firm should not have to dispose of such a significant portion of its consulting business, as getting out of any interest in consulting should be viewed as a good thing. However, the SEC staff was concerned the firm was not giving up control, and would in fact exert control over an entity that would then be portrayed to the public as independent. This disagreement with the SEC led to great animosity on the part of KPMG executives toward the SEC. But if KPMG in 1998 had accepted the SEC's terms, as E&Y would do

[22] A letter from the SEC Chief Accountant to the Chairman of the POB on December 9, 1999, stated that "we *strongly* recommend that the POB undertake a *special review* of SECPS member firms' current compliance with SEC and profession independence rules" (Turner 1999b). A letter of the same date was sent by the Chief Accountant to the Chairman of the AICPA SEC Practice Section, stating: "Nearly a year ago, we expressed concern to the SECPS that firms with public company audit clients practicing before the Commission may lack sufficient worldwide quality controls to assure their independence under the applicable Commission and professional rules. In the time since that letter, the SEC staff has identified additional, troubling examples that suggest not only a lack of sufficient global safeguards, but also a systematic failure by partners and other professionals within certain firms to adhere to even their own firm's existing controls."

[23] Letter dated May 3, 2000 from David Brumbeloe, Director, SEC Practice Section, AICPA to Jerry Sullivan, Executive Director, POB which states: "The SEC Practice Section (the 'Section') will not approve nor authorize payment for invoices submitted by the Public Oversight Board (POB) or its representatives that contain charges for the special reviews until such time that the Section and POB determine that such reviews will take place" (Brumbeloe 2000). On May 5th and 8th, 2000, the CEOs of PWC and E&Y respectively, sent letters to the Chair of the POB renouncing the AICPA letter.

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at a later date, then KPMG would have been able to sell its consulting practice for hundreds of millions more than it did, under the same terms and conditions it eventually agreed to in 2001.

In the fall of 1998, PwC was in the opposite camp from KPMG, arguing it should not have to give up its consulting business. PwC, as did others, believed that a consulting business contributed to a better audit. In essence, "More Knowledge, More Know How" became the motto of some in the profession. This argument also would be used to oppose the notion that periodic rotation of auditors was advisable.

As a result of these strongly held and differing views among the profession, in late 1998, the SEC staff asked the Independence Standards Board (ISB), which had been newly formed just the year before, to undertake a project to evaluate the form and structure of accounting firms, including the scope of services they should be permitted to provide.[24]

Just a year later in December 1999, certain public members of the ISB requested a meeting with Chairman Levitt. During that meeting, those members urged the SEC to undertake rule making, including rules addressing what services an auditor should be able to provide to a company the firm audits.[25] The ISB board members indicated this was a major public policy issue, and they questioned whether the ISB, as opposed to the SEC, would be able to attract enough public comment on the issue. That was just the type of public process the audit firms did not want, as most investors would oppose expanding the services an auditor could provide to companies it audited. In subsequent meetings with all the public ISB members, as well as the Chairman of the POB, in January and February 2000, these individuals suggested the SEC consider an approach that would ban most consulting.

This same approach had been recommended by certain members of another group, the POB Panel on Audit Effectiveness. Sometimes referred to as the O'Malley Panel in reference to its Chairman, Shaun O'Malley, the POB Panel on Audit Effectiveness had been formed as part of the Levitt plan.[26] Its formation resulted partly because of concerns of SEC Chief Accountant Michael Sutton and others, who believed that auditors were reengineering their audits, eliminating the need to document the work they performed, reducing the quality of the audit, and also reducing the likelihood that errors in financial statements would be detected. Certainly cases such as Sunbeam and Cendant gave credence to that concern.

During this same time, SEC enforcement cases such as Waste Management and W. R. Grace showed that auditors were finding problems with their clients' financial reporting. However, when the auditors had learned of errors in the financial statements, they failed to get the errors corrected before issuing their "clean opinions." In another case, the SEC staff had challenged the accounting for loan losses at a large international bank. A partner in the auditor's national office told the Chief Accountant that he did not agree with the

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[24] The request was formalized in a letter dated January 7, 1999 from the Chief Accountant to the Chairman of the ISB (Turner 1999a). The letter requested the ISB add the Form of Structure and Practice of Independent Auditors, Valuation Services, Mutual Fund Audits and Investments, Legal Advisory Services and Executive Compensation, and Actuarial Consulting to its agenda.

[25] SEC Release Nos. 33-7993; 34-44557; FR-50A states: "In late 1999, the ISB members faced significant issues regarding the evolving alternative business structures being used by accounting firms and the nature and scope of non-audit services that the firms could perform ... The public members of the ISB recognized that these were significant public policy issues that required input from a wider and more diverse audience than the ISB has been able to attract. These members, therefore, asked the Commission to assume this project" (SEC 1999b).

[26] A letter from the SEC Chief Accountant to the Chairman of the POB on September 28, 1998 requested the establishment of a panel to examine the level of testing, level of staffing, the business risk model, and other issues affecting the "efficacy of the audit process" (Turner 1998).

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bank's accounting, but had not told the bank to correct it. All too often the SEC staff had run across such examples, raising the specter that, indeed, auditors were showing both a lack of independence and a lack of spine.

These two trends set the stage for a knockdown battle between the SEC and many in the accounting profession throughout 2000. It was a battle that would also split the accounting profession, with E&Y and PwC being supportive, in general, of the SEC's efforts, while Arthur Andersen, Deloitte & Touche, and KPMG staunchly opposed the Commission.[27] As the year began, the SEC announced they would be rewriting the rules that governed when an auditor would be considered to be independent. At the same time, the O'Malley Panel was moving forward with its work, including considering ways to improve the quality of audits, and the oversight of audits of public companies. While the Panel was working on its report (POB Panel on Audit Effectiveness 2000), the POB was gearing up to conduct a "special examination" of the independence of audit firms, due to the problems found within PwC.

Unfortunately, a number of events started to impact the outcome of all of these developments. First, the AICPA issued a letter to the POB stating its funding for its special examination of the independence of the Big 5 accounting firms was being cut off.[28] This was the first time the independence of the private sector overseer had been challenged. But then again, it was the first time the POB had decided to undertake an examination of the firms using its own staff rather than relying on another accounting firm to do the inspection. Ultimately, the SEC would enter into an agreement with the major accounting firms to do an inspection of their independence systems in what became known as the Auditor Look-Back Testing Program.[29] Accounting firms would stall the POB investigation until after the 2000 elections when a new SEC Chairman would be appointed, and ultimately it was never completed.

In reality, the POB-sponsored firm-on-firm peer reviews, which had *never* resulted in a negative or qualified report on one of the major international accounting firms, and had engrained a culture in which one firm agreed not to tell on the other. These findings were now coming to light. The final, "clean" peer review report on Arthur Andersen, issued by Deloitte & Touche after Enron had imploded, would, in the minds of many, confirm the fallacy of this system. Unfortunately, this approach to private sector oversight also had been challenged more than 20 years earlier after the scandals of Penn Central, Equity Funding, and National Student Marketing. Indeed—as Yogi Berra said—"It was deja vu all over again."

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[27] See Peel (2000).

[28] Letter dated May 3, 2000 from David Brumbeloe, Director, SEC Practice Section, AICPA to Jerry Sullivan. Executive Director, POB which states: "The SEC Practice Section (the 'Section') will not approve nor authorize payment for invoices submitted by the Public Oversight Board (POB) or its representatives that contain charges for the special reviews until such time that the Section and POB determine that such reviews will take place" (Brumbeloe 2000). On May 5th and 8th, 2000, the CEOs of PWC and E&Y respectively, sent letters to the Chair of the POB renouncing the AICPA letter.

[29] SEC Press Release 2000-77, June 7 (SEC 2000. The release stated: "The purposes of the reviews are to examine investments held by certain of the accounting firms' partners and managers during a period of at least nine months ending March 31, 2000 and to determine whether those individuals or their immediate family members held financial interests in audit clients of the firm. The reviews also would determine whether the accounting firms themselves held financial interests in their audit clients during the same period. Participating firms will hire independent outside counsel to oversee the reviews. Firms will disclose violations to the SEC and to the audit committees of their clients.

The participating firms also have agreed to design and implement, subject to oversight of the Public Oversight Board, systems, procedures, and internal controls previously specified by the Commission's Chief Accountant." (See letters on the SEC website at: http://www.sec.gov/offices/account/calt129a.htm and http://www.sec.gov/offices/account/calt501c.htm.)

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The SEC proposed new independence rules at the end of June 2000.[30] Of course, even before then, the accounting firms had gone directly to members of Congress with their checkbooks in hand, lobbying them to intercede on their behalf. Because it was an election year, some members simply could not help themselves and turn away the contributions. In April, two months before the SEC issued its proposed rules, and the week before Levitt was scheduled to make a major address on the issue, the initial Congressional letters, in what would become a constant flow of correspondence, began to arrive at the SEC.[31] It appeared as if some letters from Congress reflected input from, or were edited by, the accounting firms. And of course, the letters had a constant theme built around the New Economy that supposedly Congress, but not the regulators, understood. For example, in a letter dated July 21, 2000, a bipartisan group of senators including Charles Schumer, Evan Bayh, and Robert F. Bennett stated, "The SEC would be limiting auditing firms' expertise just when auditors appear to need it most in order to fully assess today's sophisticated New Economy companies. The broader issues of the New Economy require further study by Congress before the SEC implements this rule."

The CEO of one of these so-called sophisticated New Economy companies, Ken Lay of Enron, also sent a letter to the SEC on September 20, 2000. He noted:

> Enron has successfully utilized its independent audit firm's expertise and professional skepticism to help improve the overall control environment within the company ... While the arrangement Enron has with its independent auditors displaces a significant portion of the activities previously performed by internal resources, it is structured to ensure that Enron management maintains appropriate audit plan design, results assessment, and overall monitoring and oversight responsibilities. Enron's management and audit committee are committed to assuring that key management personnel oversee and are responsible for the design and effectiveness of the internal control environment and for monitoring independence.

Unfortunately, all of that reliance on the company's auditor did not benefit investors. In fact, ultimately the Enron financial statements were found to be in such disrepair that they never were corrected and restated.

Another very significant event was taking place at the SEC. In early 1999, the CEO of E&Y, Phil Laskaway, approached the SEC and asked if the agency would be willing to work with it to establish a mechanism it could use to sell its consulting arm. E&Y wanted to create a structure that would work and avoid the run-in with the SEC that KPMG had experienced. At the SEC, Levitt saw a benefit in finding a way for audit firms to dispose of their consulting practices without impairing their independence on companies they audited.

Negotiations among Laskaway and his general counsel, the general counsel of the SEC, and the SEC Chief Accountant and his general counsel continued throughout 1999. At the SEC's request, these meetings also included the discussion of a new structure for oversight of the accounting profession. The SEC wanted E&Y's input on a structure that would work for the profession, as the SEC did not believe the current structure was effective. The starting point for these discussions was draft legislation that had been proposed by Congressman Markey during the debate on litigation reform in 1995, as well as the original legislation that had been introduced in Congress in 1978.

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[30] SEC Proposed Rule, Revision of the Commissions Auditor Independence Requirements, Release Nos. 33-7870, 35-27193, IC-24549, IA-188, June 30, 2000.
[31] See Byrnes and McNamee (2000).

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Despite lobbying efforts by some firms to have Congress cut off the SEC's funding for the rule-making effort, the SEC did finalize new rules setting standards for the determination of auditor independence.[32] The final rules reflected a compromise reached with all of the major accounting firms, with the exception of the lone holdout, KPMG. In the end, the compromise was made possible when PwC was unable to sell its consulting practice to Hewlett Packard in November 2000 and realized that the pure ban on consulting it had favored would no longer be in its best interest. At the same time, Phil Laskaway, in a very statesman-like role, overruled his fellow partners who wanted the restrictive ban on consulting and agreed to the final compromise. While the final rules did not ban all of the services the SEC initially proposed, the rules did move a long way in that direction and would certainly set the stage for what was about to happen. The new independence rules also would incorporate necessary changes to bring the rules more in line with the reality of large international firms, with thousands of very mobile employees with working spouses.[33]

CHANGING TIMES

In February 2001, Levitt left the SEC as administrations changed in Washington, D.C. And while the sentiment in Washington was changing, a foundation had been built upon which transparency in financial reporting and the elimination of conflicts could be established. New rules enhancing the independence of auditors had been adopted. New guidance had been put in place to stop some of the games people were playing with financial reporting including manipulation of reserves, revenue, and materiality. And enforcement actions, such as fraud charges against Arthur Andersen, the Waste Management auditors, were being completed.

In the summer of 2001, the experiment that had begun with the creation of the ISB came to a merciful end when the SEC, AICPA, and members of the ISB and major accounting firms met in New York and agreed to cease the operations of the ISB.[34] With the major independence rule making accomplished by the SEC, there was little to be gained by maintaining the ISB. Caught between the desire of the accounting profession for rules that would permit it to provide a broader range of services, and the desires of the SEC for greater auditor independence, the ISB had found it could appease neither group.

As the fall of 2001 approached, one could easily see there were still problems that affected financial transparency in the capital markets. Many of the same problems were just as visible as when Congress first introduced a version of SOX in 1978. And it did not take 20/20 vision to see them with clarity in 2001. These included:

1. Serious conflicts that affected the independence and judgments of auditors and Wall Street analysts.
2. A weak self-regulatory system for auditors that resulted in one firm reviewing another, with an unspoken code of "Don't tell on me, and I won't tell on you."
3. Financial management that failed to accept responsibility or accountability for financial statements and disclosures they provided to investors.

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[32] In a letter dated October 6, 2000 from Senators Barbara Boxer and Paul Wellstone to Senator Judd Gregg, Chairman of the Senate Committee on Appropriations, they wrote: "We write to urge you to oppose any rider to the FY 2001 Commerce, Justice, State appropriations bill that would prevent the Securities and Exchange Commission from moving forward on new auditor independence rules" (Boxer and Wellstone 2000).

[33] Final Rule: Revision of the Commission's Auditor Independence Requirements. Release Nos. 33-7919; 34-43602; 35-27279; IC-24744; IA-1911; FR-56], November 21, 2000.

[34] See SEC (2001).

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4. Financial reporting standards that had been compromised before they were even issued, and that failed to reflect economic reality.
5. Weak governance including a total lack of independent governance of the major accounting firms.
6. The availability of votes of some (too many) members of Congress to serve the views of well-funded special interests. Unfortunately, there are no well-funded investor organizations.

AND THEN THERE WAS ENRON, TYCO, ADELPHIA, PARMALAT, GLOBAL CROSSING, QWEST, WORLDCOM ... FOLLOWED BY HEALTH SOUTH, BRISTOL MYERS, FANNIE MAE, AIG ...

The shortcomings in accounting and financial reporting were highlighted through the scandals that began to unfold in the fall of 2001. At Enron, the reported numbers had been contrived based upon accounting standards that did not meet a common sense test, including the 3 percent rule for SPEs. At the same time, Arthur Andersen's independence from Enron appeared compromised by its large consulting fees, which were not as large as the fees the firm earned at Waste Management. Likewise, the clean inspection report Andersen received from the self-regulatory system of the AICPA in 2001 became more questionable as problem audits at Global Crossing, Qwest, and WorldCom came to light.

And it was not just Andersen. PWC had audited Tyco; Deloitte was the auditor for Adelphia; KPMG had audited Xerox; E&Y was the auditor for Health South and still fighting lawsuits over the audits of Cendant. Indeed, the many shortcomings of the profession, which had led the SEC to push for reforms both in the 1970s as well as the 1990s, were now getting a lot of ink and headline news on the front pages of major newspapers all across America. These shortcomings included among others:

1. The lack of an effective and independent regulatory and standard-setting scheme for auditors of public companies, which had a mission to serve and protect investors. Unfortunately, the accounting profession had rejected many reforms of the POB that had been recommended by the O'Malley Panel.[35] These included giving the POB funding that could not be cut off, the ability to conduct inspections when it deemed them necessary, overseeing the setting of the auditing and independence standard-setting process, and the inclusion of a forensic auditing phase on each audit. The profession also rejected requests by the SEC to strengthen a number of standards including one for auditing revenues and reserves and one addressing the need for audit documentation.[36]
2. Shortcomings in the independence of auditors who had become too cozy with the executives who hired and paid them. The auditor independence standards were the result of compromises forced on the SEC by Congress and the accounting firms not only in 2000, but also in the 1970s at the time of prior scandals.
3. A lack of accountability and responsibility on the part of well-paid business executives responsible for ensuring the preparation of accurate financial statements and disclosures. In fact, many of these executives had failed to make the necessary investments in the financial infrastructure of their companies, leading to inadequate books and records and

[35] See U.S. General Accounting Office (2002).
[36] Letter dated December 9, 1999 from SEC Chief Accountant to the Chair of the AICPA Auditing Standards Board requesting additional guidance be provided on auditing revenue recognition and "the need for more in-depth guidance in auditing standards and other ASB literature on auditing loss accruals (i.e., 'reserves')."

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weaknesses in internal controls that almost guaranteed significant risks of errors in the financial statements existed.

4. An accounting standard setter that had to go hat-in-hand for funding to the very companies that often opposed its standards and its quest for greater transparency for investors. The FASB's deficits would leave it with a serious financial crisis before the decade ended.
5. A lack of congressional funding for the SEC so severe by 1999 that the SEC was having difficulty keeping up with reviews of initial public offerings and had no staff left to review the quarterly and annual reports of companies such as Enron. This despite the fact the SEC projected it would collect fees of $2.294 billion in 2001 versus the $423 million in funding Congress was providing.[37] In essence, Congress had put the SEC in handcuffs while supporting those opposed to reforms.
6. A lack of sufficient penalties for white-collar crime. This became evident as the CEO of Sunbeam settled with the SEC for pennies on the dollar compared to stock profits and compensation he had received.[38] And of course, he settled with the SEC without any admission of guilt, while the company he had run into the ground lay in ruins and bankruptcy.
7. A lack of engaged and knowledgeable audit committee members who would hire, evaluate, and—when necessary—fire the auditors.

CONFIDENCE LOST, TRUST RESTORED

One thing investors demand is certainty in the market place. When certainty starts to disappear, so do investors. And so it was as Enron was followed by one scandal after another. As investors' losses reached into the hundreds of billions, investors took their cash and withdrew from the U.S. capital markets which lost trillions in capitalization.

A strong case for legislation such as SOX had been made by the scandals of the 1970s and by the misreporting of the savings and loan institutions and cases such as ZZZZ Best during the 1980s. Yet despite the occurrence of frauds again in the 1990s in companies such as Cendant, Sunbeam, HBO McKesson, Micro Strategy, and Xerox, Congress was unwilling to help protect investors from manipulative schemes permitted by numerous conflicts in the financial and accounting communities. In fact, Congress opposed many proposed reforms, including reforms they would ultimately be forced to adopt. When the losses from WorldCom and 30 other companies totaled over $900 billion dollars, Congress finally was willing to act.[39] It was unfortunate, in light of earlier warnings, that Congress was so slow in reacting. It was too little, too late for those investors and company employees who lost their investments, jobs, and pensions. On the other hand, it was not too late to begin fixing what had become a widespread, systemic problem that was spreading like a bad case of cancer.

Members of the Senate Banking Committee recognized there were problems even before Enron filed for bankruptcy in 2001, and began to create a strategy for addressing investor concerns. That strategy would evolve into 10 days of public hearings during February and March 2002. The committee staff began work in December 2001 and in February 2002, Senators Dodd and Corzine had introduced legislation, much of which had been taken from the 1978 congressional legislation, the legislation the SEC staff had worked on

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[37] Agency Resources and Industry Growth. U.S. Securities and Exchange Commission. March 2000. The SEC report notes: "Between 1982 and 1999, $5.7 billion more in fees was collected than was appropriated."

[38] See SEC (2002).

[39] See Glass Lewis & Co. LLC (2005a).

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with E&Y during 1999, and the SEC's 2000 proposed independence rules.[40] In fact, this new legislation included very little that had not been previously debated and discussed among members of Congress and the SEC. Even the more controversial SOX Section 404 on internal controls had been initially introduced in Congress in 1986, passed by the U.S. House of Representatives as part of the 1990 Crime Bill, and then reintroduced as part of SOX.[41]

The public outcry increased during the first half of 2002, reaching a deafening roar when WorldCom imploded in June. Congress and the White House finally realized doing nothing was no longer an option. As a result, they adopted the legislation passed by the Senate rather than the House's watered-down version of reforms. And Congress passed the Senate version overwhelmingly, with no one in the Senate and just three of the 435 members of the House voting against the legislation now known as SOX.

SOX originated in both the scandals of the 1972/1973 bear market as well as the recent scandals. It was legislation intended to prevent a future repeat of history, while recognizing the lessons of past mistakes. Ninety million Americans invested in the markets had suffered losses in their investment accounts because of corporate executive malfeasance, conflicts that favored insiders and gatekeepers over investors, and a lack of oversight. The time had come in the summer of 2002 for the principles embodied in the legislation. These principles include:

1. An independent regulator that serves investors while overseeing the accounting profession, inspecting audits, and setting auditing standards that will contribute to higher quality audits. Many of the ideas proposed by the O'Malley Panel in August 2000 are embodied in the SOX legislation creating the new Public Company Accounting Oversight Board (PCAOB).
2. Adoption of exactly the same independence standards the SEC proposed in June 2000. The compromise achieved by the SEC in 2000 provided the basis for Congress to go further and adopt the SEC's original proposals that the accounting firms had wasted so much time and energy opposing.
3. The creation of adequate funding for the SEC to do what the public expects from it—the protection of investors through effective regulation and a strong enforcement program.
4. Funding for the accounting standard setter, thereby enhancing its independence.
5. Enhanced financial disclosures of off-balance-sheet transactions and debt, the likes of which Enron failed to disclose to investors.
6. Establishment of accountability for executives who are responsible for the accuracy of financial reporting to investors. This includes (1) ensuring companies have adequate books and records and internal controls from which they can generate accurate financial reports, (2) codes of ethical conduct the executives will be held to, as well as (3) meaningful penalties for those who fail in their responsibilities.
7. The creation of independent and financially literate audit committees that now hire and fire the independent auditor. This also includes greater communication between the audit committee and auditor, increasing the likelihood that the audit committee will be better informed, and auditors will be held more accountable.

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[40] The Investor Confidence in Public Accounting Act of 2002 (S. 2004). March 7, 2002.

[41] Comprehensive Crime Control Act of 1990, H.R. 5269. An amendment to the legislation was passed in the House on October 5, 1990 requiring a report by management on internal controls and an audit report on management's assessment. Since a comparable section of the legislation was not included in the Senate version of the bill, it was not included in the final legislation.

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Since the passage of SOX, additional evidence has become available that demonstrates the strong case for this legislation. This includes:

1. Investor losses in just 30 smaller companies with less than $100 million in market capitalization, aggregated $311 billion as their stock price declined during the bursting of the market bubble from 2000 to 2002. Twenty-two of the 30 companies had to restate their financial statements.[42] Needless to say, the dot.com and "New Economy" era proved that when investors act with irrational exuberance and fail to do the requisite homework, they can suffer large losses even in small companies.
2. Companies reporting restatements, which had reached a record "high" of 158 in the year Levitt gave his "Numbers Game" speech, soared to 1,295 by 2005, including many foreign companies listing on U.S. stock markets.[43] Many restatements resulted from auditors' testing internal controls and finding not only that controls were weak, but the numbers they produced were also inaccurate.
3. The PCAOB has reported that during 2005, 15 percent of all companies with over $75 million in market capitalization that implemented the provisions of SOX 404 for the first time reported material weaknesses in their internal controls.
4. Of those companies reporting material weaknesses in their internal controls, only one out of eight had reported a deficiency as recently as the quarter preceding the filing in which the material weakness was disclosed, often as a result of the independent audit. And only one out of 12 had done so at the end of the preceding fiscal year-end.[44] In essence, the self-reporting in certifications many a CEO and CFO had been making since August 2002 were inaccurate. It is unfortunate the SEC, which had twice proposed greater reporting on internal controls, in 1978 and 1988, had declined to adopt those proposals.[45] Likewise, it was unfortunate that Congress did not adopt the SOX 404 legislation that the U.S. House of Representatives had passed as part of the 1990 Crime Bill. Perhaps earlier passage would have prevented at least some of the recent white-collar crimes that have cost Americans billions in losses.
5. The disclosure of accounting firms' involvement in such activities as promoting illegal tax shelters and "Travelgate" where expense reports were "padded" unbeknownst to those they were sent to, destruction of audit documents at several auditing firms, and withholding of important information from courts of law.
6. Financial statements that failed to reflect the reality of the extensive obligations for and expenses resulting from promises of pensions and health care, especially in sectors such as automotive and airline industries.
7. Financial statements in which long-standing and well-understood accounting rules for leases, and the less-than-complex portions of the standards on accounting for financial instruments were ignored by both the financial management preparing the statements, and the supposedly independent auditor that gave "clean" opinions on their compliance with GAAP.
8. Revelations of backdating of stock options grants by executives who tend to be rather well compensated in relation to the rest of America, with an opportunity for even greater wealth at the expense of investors for whom the executive supposedly works.

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[42] See Glass Lewis & Co., LLC (2005b).
[43] See Glass Lewis & Co., LLC (2006).
[44] Lord & Benoit March 31, 2006 comment letter to the SEC Advisory Committee on Smaller Public Companies, Re: File Number 265-23.
[45] Securities Act Release No. 15772 (April 30, 1979) (44 FR 26702) and Securities Act Release Nos. 33-6789 (July 26, 1988) (53 FR 28009).

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> Of course this revelation means that certifications as to the accuracy of financial statements and internal controls are probably no longer worth the value of the paper they were written on and financial statements in all likelihood will require restatement.[46]

IN SEARCH OF CONTINUOUS IMPROVEMENT

The reforms embedded in SOX, the listing requirements of stock exchanges, and best practices adopted by corporate America should not be viewed as a final product, especially given continuing revelations of corporate and financial reporting malfeasance. Instead, these reforms represent an evolution that is ongoing. And while the uninformed often criticize SOX for having been adopted by Congress in haste, the reality is it is a product of much debate over a period spanning more than two decades.

As more Americans place their hard-earned dollars to work in the capital markets, the importance of the transparency of companies and all other participants in the U.S. and international capital markets will grow. And those markets that provide greater transparency with which investors can make more informed decisions, thereby increasing their returns, in the long run will be rewarded with greater sources of capital. Further reforms that enhance transparency, quality of financial reporting and disclosures, and investor protections will be a constant in a market that strives for continuous improvement. No doubt some of these reforms will be adopted during times of normal market activity. However, others will be adopted when a crisis in confidence in the markets brings about a demand for change, as has often been the case.

Reforms that remain to be achieved in financial reporting and disclosures include:

1. Analysis that is focused on the creation of long-term, rather than short-term, shareholder value. This will require executives to exercise discipline and to stop providing short-term earnings guidance, as has been recommended by the Chamber of Commerce. Only these executives, not Wall Street, can bring about this change.
2. A requirement for the companies to disclose Key Performance Indicators (KPIs). KPIs provide information useful to investors in assessing the long-term financial prospects and health of a company. In 2004, the SEC urged companies to disclose such information on a voluntary basis; but as is usually the case requests for voluntary disclosures are not heeded.[47]
3. Greater inclusion of investors in the standard-setting process and as members of the FASB, EITF, and international standard setters. At this time, only one member of the FASB is from the investor community. Instead, the FASB which often lacks a sense of urgency, is composed of mostly trained accountants from either accounting firms, industry, or both, individuals with the types of backgrounds that for more than four score years have written the accounting standards. Today's standards have become overly complex due to the alternative accounting methods the FASB continues to insist on

[46] In a letter dated January 30, 2003 from 40 members of the U.S. House of Representatives to the FASB, expressing concern about and opposition to the project on accounting for stock options, the members, led by Congressman Dreier and Eshoo, stated: "The public interest will not be served by an accounting standard that results in the disclosure of inaccurate corporate financial information and a flawed picture of company performance." It is somewhat ironic that over 50 companies have now been found to have abused the prior accounting standard resulting in inaccurate financial information being provided to investors. Yet these same members of Congress have been remarkably silent during this latest financial scandal.

[47] SEC Release 33-8350 [FR-72], Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, December 19, 2003. The SEC Interpretive Release states that "companies should identify and discuss key performance indicators, including non-financial performance indicators, that their management uses to manage the business and that would be material to investors."

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permitting, standards that seemingly must be more than 100 pages long, with interpretations that bring to mind the tax regulations, standards that are so lax that companies and their auditors can pick a number, any number, as they determine key assumptions used in measuring amounts reported in the financial statements, and standards that are almost impossible to interpret and implement at times without the help of the national offices of the national accounting firms. But enough is enough—now is the time for a change in who controls the pen, both in the U.S. as well as internationally.

And at the same time, the Financial Accounting Foundation (FAF) must be changed from a constituent-based board, where several of the members are chosen based on whom they represent, to a board selected from the best-qualified candidates with a demonstrated record of public and board service. The FAF, FASB, and IASB need to recognize the investor as their customer and adopt a mission statement that makes them paramount. Otherwise, market forces will eventually dictate they be replaced with someone who does make investors "priority one."

4. New and improved objective-based accounting standards issued in a timely manner, as opposed to decades from now, which do not require the national office of an accounting firm to interpret and implement. The FASB and IASB should also adopt a standard similar to that of the SEC which notes that material information should be disclosed if necessary to prevent the financial statements from being misleading, even if a specific rule does not require it.[48] In addition, accounting standards should set forth the general objectives of the standard up front and reflect economic reality, and require:
   a. Inclusion on the balance sheet of financings arising from transactions such as leases and asset securitizations. Credit-rating agencies already adjust the balance sheets for such deficiencies and it is time that balance sheets be presented that do not require such adjustments by their users.
   b. Reporting the total amount of pension and health care liabilities projected to have been earned to date, including state and local municipalities accessing the capital markets.
   c. Reporting of both the historical cost and fair values of assets and liabilities on a consistent basis, along with realized and unrealized gains and losses. Analysts should be able to tell from a financial statement how much value has been created over the cost of the asset, how well management has done on stewardship, and how well management achieved the budgets and goals it set for the year and long term.
   d. Greater visibility of key assumptions affecting the financial statements, including reporting of how historical results varied from earlier estimates and assumptions.
   e. Changing the format of the income statement to present results from ongoing operations that are within the control of management, and for which they are held accountable, as well as separate sections for reporting financing costs and changes in the fair values of assets and liabilities that have not yet been recognized, separate from those recognized.

[48] In the case of *U.S. v. Simon*, April 18, 1969, the U.S. Court of Appeals for the Second Circuit upheld the trial judge's jury instructions that said "the 'critical test' was whether the financial statements as a whole 'fairly presented the financial position of Continental ... and whether it accurately reported the operations.'" The judge had rejected the plaintiff's argument that the defendant could be found guilty only if the financial statements did not fairly present the financial condition in accordance with GAAP. Likewise, the drafters of the Sarbanes-Oxley Act of 2002 specifically rejected the argument that the certifications of CEOs and CFOs should be done based on whether the financial reporting was done in accordance with GAAP, as opposed to a standard that requires them to state the financial statements are fairly presented based on their knowledge of the facts.

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f. Inclusion of more information and detail on cash flows, as well as use of the direct method of reporting cash flows.

5. Establishment of independent corporate governance for the major international auditing firms that is modeled after the requirements that currently exist for corporate boards of public companies. These accounting firms' marketing of abusive illegal tax shelters, billing of companies they audit for unsubstantiated expenses, knowingly issuing clean opinions when auditors were aware of errors in financial statements, and making misrepresentations to courts all cry out for the need for better governance. Such governance should have the same elements of independence, and authority over compensation as do boards of public companies.
6. Greater transparency on the part of the auditing firms. This includes the timely filing of publicly available annual financial reports with the PCAOB that provide transparency consistent with that required of public companies today. With only 4 of these firms auditing the vast majority of public companies today, and having been granted a public franchise by Congress, it is important the public and regulators remain better informed about the economics and financial health of these entities.
7. Greater and timelier transparency on the part of the PCAOB. The inspection reports the PCAOB has issued on the major accounting firms have been publicly disseminated almost a year after inspections occurred and over a year after the audits were performed. Such tardiness is unacceptable from the investing public's perspective and is indicative of an organization that places investor's interests as a lower priority. In addition, the PCAOB, which to date has placed enforcement in the back seat, either needs to move it back into the front seat or let the SEC remain in the driver's seat on such actions. It would even be better if the SEC and PCAOB worked hand-in-hand on enforcement actions, with the PCAOB sharing with the SEC information it received from deficient inspections and the SEC also sharing data and evidence it received with the PCAOB.
8. Improvements in the information auditors provide to investors through their audit reports. Reports issued by auditors 100 years ago provided greater information content than those currently presented to investors. Those earlier reports set forth in general terms the audit work performed on accounts such as revenues, inventories, accounts payable, and investments, and noted any material exceptions that had been identified.
9. A requirement that auditors search for, and find fraud unless:
   a. The amounts involved are immaterial, or
   b. The auditor was misled through false documents and representations provided by management and nothing else in the way of a red flag came to the auditor's attention as a result of an audit performed in accordance with generally accepted auditing standards. Needless to say, frauds at companies such as Parmalat, Enron, WorldCom, and Qwest, resulting in multibillion dollar restatements, have left investors wondering what the auditors were actually doing.
10. A requirement for mandatory rotation of auditors every ten years, during which period the auditor could not be fired unless the company first received the permission of the PCAOB to make the change. During the period from 2003 through June 2006, approximately 4,800 public entities have changed auditors.[49] This does not include any of the 2,000-plus changes in auditors that resulted from the demise of Arthur Andersen. Such a firm rotation requirement could alleviate the need for partner rotation every five years.

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[49] Unpublished research by Glass Lewis & Co. LLC. The numbers include 892 for 2003, 1,582 for 2004, 1,596 for 2005, and 780 through June 30, 2006.

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11. A catastrophic cap on auditor's liability tied to a measure such as an amount equal to 15 times the amount of the audit fee. However, such a cap would *only* be adopted provided auditors agreed to demands of investors for improved reports, a new fraud standard, mandatory rotation of audit firms, and improved governance. The liability cap would not be available for an auditor that had knowingly signed false financial statements as occurred in some of the recent financial frauds. While some continue to oppose liability caps, it is important to note that under the current regime, investors recovered less than 2.3 cents on every dollar of loss in 2004.[50] And auditors were the subject of only five new securities class-action suits in federal courts in 2005.[51] Given that this existing system has served neither investors nor auditors well, it is time to change it to one that works for all.
12. An increase in the financial expertise on audit committees. Today, less than 10 percent of audit committee members are former CFOs, corporate controllers, or CPAs.[52] An increase in the number of such individuals serving on audit committees would enhance their oversight capabilities.
13. A significant upgrade to (major overhaul or replacement of) the SEC's EDGAR system that provides investors with:
    a. Enhanced search capabilities;
    b. Data tagged using XBRL or a similar application, that are aggregated and tagged in a consistent and comparable fashion by all companies within a common industry and that can be accessed, searched, and easily downloaded into financial models.
14. Financial statements and disclosures written in plain English, which may be a lot to ask of an accountant, but certainly is achievable.
15. Professional Schools of Accountancy that can provide accountants with an education comparable with that of lawyers and doctors. We cannot continue to teach using an approach that is, for the most part, out-dated and incapable of adequately covering the necessary materials. If one looks back at the history of the medical or legal profession, its members were not trained in the professional schools they are today. And certainly, the complexities of the medical profession and practice have increased, just as has our own profession. But the difference is that those professions have changed their schools from undergraduate programs to advanced degrees with specializations. If we are to gain equal stature with these professions, through better prepared and educated entrants, then we too need to rethink our education system and the need for professional schools. It is what the Cohen Commission recommended almost 30 years ago and it is long overdue.[53]

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[50] Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Large Settlements. February 2005. NERA Economic Consulting. Page 8.

[51] Securities Class Action Filings—2005: A Year In Review. Cornerstone Research. Page 16. 2005.

[52] Spencer Stuart 2005 Board Index. Page 17.

[53] The Commission on Auditors' Responsibilities: Report, Conclusions and Recommendations. Pages 88–89. AICPA 1978. In a statement that remains most appropriate today, the report noted: "The desirability of establishing separate schools of accounting in universities has received increasing attention in recent years ... Whether the argued improvement in the recognition and prestige of accounting and control over curriculum will be realized and whether the problems of appropriate balancing of courses and faculty can be overcome cannot be determined with certainty in advance. However, the gradual and successful development of separate graduate professional schools in law, medicine and other fields suggest that such problems are capable of solution ... The importance of instilling in students an appropriate professional attitude and the need to expose them to the pressures and problems of public accounting practice during the formal education process support the need for graduate professional schools of accounting similar to law schools ... Our review of major audit failures that have caused public accounting firms difficulty indicates that problems have resulted largely from the exercise of poor judgment under conditions of stress and pressure."

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IN THE END

Today, the capital markets are on the rise once again. In good times, people have short memories. This, in turn, has once again emboldened those who first opposed reforms in the 1970s that would protect investors and who, more recently, opposed the passage of SOX. Just as during the 1970s, they are pushing for a "roll back" of the reforms that just four short years ago, were mandated by public opinion and overwhelmingly adopted by Congress, reforms that helped to restore certainty and investor confidence necessary for orderly capital markets.

The efforts to eliminate necessary protections for the 90 million Americans who have placed their money in the market have been moved to new venues and rely on new strategies, as the issue has moved into the U.S. court system. It is now up to a profession whose business is justice to make a determination as to what reforms will survive the challenge. But in the end, it will be history that acts as judge—and provides a final verdict on SOX.

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