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Statement of the Shadow Financial Regulatory Committee

On

The Responsibility of Independent Auditors to Shareholders of Publicly Traded Corporations

May 6, 2002

The trial of one of the big five public accounting firms, Arthur Andersen, for destruction of documents related to the audit of Enron, begins today in Houston. Andersen's present problems follow restatements of Enron's financial reports and those of well-known corporations audited by several major audit firms. These include the reporting of over $500 million in bogus income by CUC before it merged with HFS in 1997 to become Cendant, $114 million of inflated revenue from false sales by Informix in 1995 and 1996, and improper accounting for expenses by Waste Management in the 1990s that required a $1.2 billion adjustment in 1998. When these and similar accounting "irregularities" came to light, stock prices dropped and investors lost billions. Is this evidence that the nation's system of financial accounting and auditing is broken? Can financial reports audited by firms of independent accountants be trusted?

Investors rely on the integrity of corporate financial statements. Although they can and do obtain valuable information about a company from many sources, audited financial statements provide them with important information. The audit should assure investors that the numbers and notes presented in the statement have been carefully and professionally examined. This audit should conform to Generally Accepted Audit Standards (GAAS) and financial reports should conform to Generally Accepted Accounting Principles (GAAP). As such, Certified Public Accountants are gatekeepers for investors, providing investors with assurance that the financial statements prepared by management can be relied upon.

Are Accounting Standards the Problem?

Enron's failure has put the spotlight on several important shortcomings with GAAP. One is the accounting for Special Purpose Entities (SPEs). Enron used thinly capitalized (3% of assets) partnerships to misrepresent its actual financial situation. Its managers recorded income from transactions with these entities as though they were independent, but they were actually controlled by Enron. This is not a shortcoming of GAAP, because GAAP forbids companies from booking profits unless these result from arm's length transactions. The fault here was Andersen's, which, in fulfilling its responsibility as gatekeeper, should have known or learned that the SPEs were not independent.

Enron guaranteed debt incurred by the SPEs. When it became liable for this debt, the market was shocked, because investors did not know the extent to which Enron was obligated. This situation brought to light a shortcoming of GAAP, which could be adjusted to deal with this situation. GAAP also could, and we believe should, be changed to require corporations to report in a note details on its contingent liabilities, particularly those where it has guaranteed other parties' loans and other obligations.

Enron also highlighted serious problems with "fair value" accounting for financial instruments. Fair value accounting, which requires revaluation of financial instruments to their estimated present values, has been championed by the SEC and adopted by the Financial Accounting Standards Board. Enron recorded substantial profits from revaluations of energy contracts to so-called fair values and from fair-value estimates of the values of merchant investments. At this time, it is not known whether the procedures used by Enron and accepted by Andersen to determine fair values were reasonable at the time they were made, or were wildly or even fraudulently over-optimistic. This experience, though, leads us to question the wisdom of fair-value accounting in situations where the values are not based on reliable arm's length-transactions.

Most of the major financial accounting problems that give the appearance of a broken system actually result from misapplication of GAAP and fraud, rather than from problems with GAAP itself. If auditors had properly applied existing auditing and accounting standards to Enron, the companies mentioned above and others, many of the accounting surprises would not have occurred.

Is the Problem with the Independent Auditors?

Why did some independent auditors attest to financial statements that were later found to be substantially misleading to investors? One explanation emphasized by the SEC and much of the press is that the auditors' professional judgment was clouded by the fees their firms received for consulting services. However, studies over several decades have, in general, revealed no evidence to support this belief.

Another explanation is that fear of losing audit fees has caused some auditors to go along with aggressive accounting by their clients that resulted in materially misleading financial statements. Or auditors may have become too close to their clients and, as a result, forgotten their role as gatekeepers for investors. If true, a solution would be to increase the cost to auditors of negligently conducting inadequate audits and of allowing clients to violate the basic prescriptions of GAAP.

Proposed Congressional legislation would establish an oversight body to provide this discipline. But the SEC already has substantial authority and responsibility to discipline independent auditors, as provided in Procedural Rule 102(e). Before new legislation is enacted, we should better understand why the SEC has failed to exercise its authority vigorously.

What Now Needs to be Done?

First, we believe that Generally Accepted Accounting Principles are basically sound, but, as Enron shows, need attention in two important areas: requiring disclosure of material contingent liabilities, and prohibiting fair-value revaluations of financial assets unless supported by reliably determined arm's length transactions. Second, incentives for auditors to conduct more effective audits and stand up to clients who would bend or break the accounting rules to produce misleading or fraudulent financial statements should be examined and then strengthened.