

Public Company Accounting Reform and Investor Protection Act

No more Enron! No more Arthur Anderson! How much of the current rock bottom situation of our economy today be blamed on the shocking and sensational malpractices of these two companies, which smashed the headlines of every major news media during the last few months? Who is to blame? How do we fix it? In this assignment I will review the Public Company Accounting Reform and Investor Protection Act of 2002, which was recently signed into law by President Bush. The legislation was meant to heal the outrage and disbelief, and rebuild trust for the American financial market.

Is it too little too late? Four years ago Security and Exchange Commission's Chairman Arthur Levitt, addressing the future, hammered on the very same points that the Investor Protection Act of 2002 attempts to make right.¹ In addition to summarizing his thoughts based on a speech he has given at the NYU Center for Law and Business, I will introduce the related ideas of George Soros, the chairman of Soros Fund Management based on his essay published in 2002.² I will also bring ideas of other SEC staff members who have very wisely commented on this problem.

My conclusion? Investor Protection Act of 2002 by itself is not a sufficient mandate for insuring accuracy of future accounting malpractices and other legal misrepresentation of figures many companies have thus far employed.

Role of Financial Reporting on Our Economy

According to Levitt companies' failure to provide meaningful and representative financial information on their financial statements erodes not only the trust between shareholders and the company, but also threatens our economy with consequent price fluctuations. Later in his speech, he emphasizes his genuine concern for the American economy, and argues that the current culture among the corporate managers, auditors, and analysts, and the uniformly agreed accounting hocus-pocus, which ensues among them, undermines the integrity and the number one position of the American financial markets in the world. Levitt believes that the earnings management game negatively influencing the accuracy of company's financial statements will eventually, if not addressed soon, yield to the erosion of faith in capitalism as a viable solution to the efficient allocation of resources in our societies.

The Accounting Hocus-Pocus

Earnings management is generally pursued with five accounting practices. As Levitt puts it these are "big bath" restructuring charges, creative acquisition

¹ Arthur Levitt, "The Number's Game" US Securities & Exchange Commission, [28 September 1998] [cited 26 October 2002]; available from www.sec.gov/news/speech.shtml.

² George Soros, "Why the Markets Can't Fix Themselves" The New Republic, September 2, 2002: 19-21.

accounting, "cookie jar reserves," "immaterial" misapplications of accounting principles, and the premature recognition of revenue.³

The Investor Protection Act of 2002 attempts to disable this tool by requiring each principal financial officer to certify each corporate report containing financial statements. In the event of misapplication of accounting rules, principles, and guidelines, the CEO and the CFO of the company must reimburse the corporation with any additional incentives they have received for the positive impact the falsified figures have made on the bottom line of the financial statements. The fourth summary item dealing with the topic of reimbursement limits the period for which the CEO's and CFO's will be charged back for their bonuses to only 12 months. Is this an appropriate punitive major?

Cookie Jar Reserves

This practice is all about overestimating accruals for items such as sales returns, loan losses, and warranty costs in good times, and using them in bad times. As we have already studied in BUS 781, accruals are adjustments made when the funds have not yet been collected, or paid. Companies manage to project a smooth earnings path by keeping the liabilities portion of their balance sheet higher than it really is at good times, and reducing these liabilities for the bad times.

Misapplication Immateriality

Some companies abuse the flexibility offered by accounting thru the concept of materiality, which suggest that some items may be too insignificant to report with exact precision.⁴ Here Levitt makes the point that companies rely too much on the argument that some items are immaterial, while if properly accounted, the same items may have a significant impact in their earnings.

Premature Recognition or Revenue

The fifth tool of the trade used in earnings management is recognizing revenues before a sale is complete, before the product is delivered to a customer, or at a time when the customer still has options to terminate, void or delay the sale.

Cultural Change

Levitt points to the flexible nature of accounting, which is meant to allow for a consistent and accurate way of financial reporting regardless of the structure of the business, and the new and innovative transactions in which the business may engage. Because accounting is flexible, companies must abide by the highest standards of objectivity, integrity, and judgment at all times. Current climate in the American market, which emphasizes above and beyond all else, the earnings of a company, damages the financial accounting system in the United States. He points out that the illusions in the numbers massaged with earnings in mind are

³ Levitt.

⁴ Levitt.

in the long-term self-destructive. According to Levitt, the misrepresentation, which takes place in the market place, isn't a simple issue over numbers. He ends his speech with an appeal to Wall Street... Americans trust their children's education, their retirement and their livelihood to the misrepresented earnings stated by some corporations.

How does the Act address the need for cultural change? The last item in the summary of the Investor Protection Act "requires corporate chief financial officers to be bound by a code of ethics and requires any change or waiver to the code of ethics to be reported." Is a code of ethics enough to change the culture and climate of the corporate world? Lets consider another company creed intended to direct all the separate opinions, priorities, and passions, which typically surface in a company towards one goal: the mission statement. How many employees really remember their company's mission statement? Obviously corporate culture is established not merely by words, but by well-defined processes, evaluations, and clearly communicated expectations. Recent remarks by SEC Commissioner Roel Campos have emphasized the great importance of specificity and active implementation of the code of ethics: "No matter how well or beautifully the language of the code of ethics reads, if the code is relegated to the back of a policy manual or a cluttered website, it is of no use. I submit that having a code of ethics that is not vigorously implemented is worse than not having a code of ethics. It smacks of hypocrisy...We all know that having rules in life is not enough...For this reason, I urge all CEOs and senior management of reporting companies to live and practice on a daily basis the principles contained in their codes of ethics. Senior management should make it clear to employees through their words and conduct that *ethics matter*. Senior management and boards of directors should establish practices that acknowledge and commend acts of honesty and ethical behavior."⁵

The Act also calls for reporting of any violations to the code of ethics in a fashion that is in my opinion too low profile and probably ineffective. Let us ask ourselves whether potential and current shareholders of companies really read every footnote item in their financial statement. We all know from the Enron scandal that many people who have lost their life savings were trusting employees who fell into the team spirit of their company, relying on a come-back of higher share prices and earnings based on the company's historical performance and their CEO's encouraging and optimistic outlook. I doubt that they were able to understand the financial statements of Enron, let alone the footnotes. The reporting called for in this act does not go far enough in helping corporations alter their general mentality of earnings management, even if it is at the expense of ethical conduct. While second chances are important, so is leading by example. CEO's who are not fired from their leadership positions, or given substantial and preventive measures of financial punishment corrode the culture of integrity, honesty, and ethics of their corporation. Merely recording the ethics violations on

⁵ Roel C. Campos, "Remarks at the Commission Open Meeting Regarding Corporate Ethical Behavior" US Securities & Exchange Commission, [16 October 2002] [cited 26 October 2002]; available from www.sec.gov/news/speech.shtml.

a piece of paper is the equivalent of asking a child to stay after school and write on the board 20 times on the chalk board: "I will not disrupt the class." Without an adequate recourse against violations of the company code of ethics, market fundamentalists may continue to find justifications for considering themselves righteous in pursuing their own narrow interests.

Market Fundamentalism

Can common interest be best served by allowing people to pursue their own narrow self-interests? According to Soros, if your answer to that question is yes, then you are a market fundamentalist, much like George W. Bush and Margaret Thatcher. Soros argues that market fundamentalists are wrong for two reasons.

First, market fundamentalists falsely assume that markets tend toward equilibrium, the optimum point of resource allocation. This assumption is false...⁶ In his discussion of reflexivity versus the idea of equilibrium; Soros explains that price also has an influence on supply and demand. In other words, supply and demand are not independent variables, and are susceptible to influence by price. This rather theoretical concept can best be understood with an example: The demand for initial public offers (IPO's) of dot-coms increased because the IPO prices were so high. Surely, this idea defies the idea of equilibrium where demand and supply are limited, and only thru the balancing of demand and supply, would an optimum price be reached. An objection may suggest that the demand for IPO's were high, because we had not reached the equilibrium yet. In other words, we were below equilibrium. This suggests that economic actors are not rational, but irrational, because they perceived a non-monetary value in owning IPO's, which were overpriced from a rational standpoint.

Second, market fundamentalist falsely equate private interest with public interest, giving the pursuit of self interest a moral quality. Soros explains that on the part of the supporters of the idea of equilibrium, the moral quality introduced here is an oxymoron. The pursuit of rational self-interest is a moral-less concept. Market fundamentalism may be particularly dangerous because it suggests that individuals are somehow righteous in pursuing their narrow self-interests, and in doing so, they advance public interest. The resulting call for lowering government restrictions on the pursuit of self-interest often harms public interest. Consequent environment in which management is rewarded for managing the numbers rather than the business is just as damaging to public interests.⁷

The Need for a Fundamental Change in Attitude

Both Soros and Levitt agree on one point: corporate greed cannot be solved by government mandate alone. As Soros puts it: " Professional standards can be maintained only by the professions themselves..." Again, while the legislation

⁶ Soros.

⁷ Lynn E. Turner, "We're Good But We Can Be Better", [12 August 2001] [cited 26 October 2002]; available from www.sec.gov/news/speech.shtml.

does address the aspect of change within the corporate world thru common-sense standards of ethics, the free-rein corporations have been given in deciding those standards might regenerate into a serious problem in the future.

Then again, even if corporations get the standards right, and come up with a highly plausible code of ethics, can we really trust that their actions will abide by those standards? The conduct of auditing and the careful scrutiny of company's financial records by third party organizations plays a highly critical role in ensuring CEO's and CFO's that major accounting misapplications which may impact the earnings and possibly the share price of the company's stock in the NYSE will be caught, and those directly responsible will be held liable for their lapse of inappropriate conduct. SEC audits the statements of all publicly traded companies every three years. In the words of SEC's Chairman, we can imagine what a difficult task that may be, considering there are about 12,000 which are publicly traded. Perhaps do it more often, and do it better motto is appropriate for the SEC accountants.

Conclusion

The Investor Protection Act of 2002 is useful, necessary, yet not enough. The Act adequately addresses the problem of conflicts of interests between auditors, and other financial and investing services the auditor's company may or does provide to the client. The Act attempts a pre-emptive solution method thru the establishment of a Public Company Accounting Oversight Board, which has the power of sanction and the knowhow to establish standards for some of the troublesome flexibilities of financial accounting. The Act attaches responsibility of wrong-doings to the CEOs and CFOs, clearing-up leadership's past reliance on blaming lower management people in the company for the mistakes which may surface. The Act mandates the disclosure of deviances on the part of the corporation in the case of a waiver or change to the code of ethics. The Act eliviates the hush-hush of trades implemented by executive officers, directors, and principal stockholders within just two days of trade's execution.

On the other hand a few fundemantal aspects should be

The financial figures in companies' financial statements mustn't be patched up by pages and pages of footnotes. The balance sheet of all publicly traded companies are too complicated to understand. Having footnotes on items such as stock options issued to CEO's are inadequate in representing the impact of companies actions to its earnings. The figures in the statements have to be accurately represented, and should be represented in a fair way by all companies. Ratios make the greatest difference in investor decision. Conflict of interests, earnings management, stock options, flexibility of accounting, auditing.