

Common Sense Accounting Reforms

I. Introduction

The California marketplace is plagued by increasing conflict-of-interest problems that lead to inaccurate corporate audits, an upsurge in “earnings restatements”, and a loss of investor confidence.

A clear litmus test of this growing problem is the upsurge in earning restatements. When inaccurate audits are identified, companies are required to produce a restatement of their previously audited financial statements.

In the mid-70s through the early 80s, there were only a handful of restatements issued annually. By 1998, restatements began to spike. In 1999, there were over 200 restatements.

From 1990 through 1997, market value losses due to restatements averaged less than \$1.2 billion per year. The combined total of all market value losses from restatements during that 8 year period was \$9.3 billion. Then in 1998 the market value of losses were over \$17 billion – for just one year – then over \$24 billion in losses for 1999 followed by over \$31 billion in losses for 2000.

During the same time period the number of investors in the stock market has grown to nearly 100 million people or approximately half of the adults in the United States. With so many people invested in the stock market either directly or through mutual funds, retirement accounts and pension plans, any issue that affects investor confidence or the flow of accurate information in the marketplace jeopardizes consumers, investors, and businesses alike.

The regulation of auditors and accountants is a shared federal-state responsibility. The SEC provides federal regulation based on laws passed by Congress, and state regulatory boards license accountants and enforce accounting laws passed by State Legislatures. Congress and State Legislatures have been lax in dealing with the accounting profession, especially the Big Five accounting firms. The SEC has been criticized for

largely deferring its responsibilities to the accountants' major professional association - the American Institute of Certified Public Accountants (AICPA).

Congress is not providing the leadership to provide the reform of the accountant industry necessary to avoid another Andersen/Enron debacle. Most recently, Congress failed to approve a measure that would have required regulation of energy derivatives. Trading of unregulated energy derivatives led to inaccuracies in the financial health of Enron.

Further, the California State Board of Accountancy is being unduly influenced by the profession that it is supposed to regulate. This is true of many of the state-level trade associations of accountants (as well as the national AICPA) which spend most of their time protecting the financial interests of the Big Five accounting firms instead of promoting the broader professional interests of individual accountants.

Finally, accountants support accountability in their profession as a mechanism to help raise investor confidence and assure the fiscal stability of the marketplace. The Society of California Accountants supports a ban on auditors from providing consulting services to their clients.

Recently, the California Legislature held a public hearing on "Accounting Practices: Corporate Audits: Protection of Consumers, Employees and Shareholders." The hearing explored possible reforms of corporate audits and accounting methods in order to help protect Californians from future audit failures as well as enhance the image of the accounting profession in the state.

With all of these issues unresolved and confidence in accountants waning, members of the State Legislature have introduced major reforms of the accountancy profession, including:

- A ban on all "consulting" or non-audit services by auditors when those services jeopardize an auditor's independence.
- A "cooling off" or "revolving door" requirement that prohibits an independent auditor from becoming an employee of a client within two years of completing an audit.

- A "rotation" requirement that prohibits an auditor from auditing the same client for more than four consecutive years.
- A requirement that auditors retain all relevant audit documents and working papers for a minimum of seven years.
- Reforms of the California Board of Accountancy designed to strengthen regulatory and enforcement procedures.

II. Background

When the Supreme Court, in a case concerning Arthur Young (now merged into the Big 5 firm Ernst & Young) said that auditors are "public watchdogs," it meant that auditors are supposed to work on behalf of investors and the public interest. Yet, as the Enron case shows, the lack of auditor independence can lead to catastrophic consequences for investors and the markets.

A recent study by three business school professors at MIT, Stanford and Michigan State concluded that the more consulting services a company bought from one of the Big 5 auditors, the more likely its earnings were to meet or beat Wall Street expectations. This not so surprising feat was accomplished by some accounting slight of hand: hiding debt and recording gains in pension funds as income. The study found that 95% of companies paid their auditors for some consulting services. The more a company paid an auditor, the greater the incident of doctored earnings on the balance sheet.

Without a doubt, the bottom line for Big 5 auditors is their consulting business. For instance, Puget Energy paid PricewaterhouseCooper \$17 million for non-audit fees and just \$534,000 for its audit, and Marriott International Inc. paid \$30 million to Arthur Andersen for non-audit services, compared with only \$1 million for its audit.

Enron paid Arthur Andersen \$25 million for audit services and \$27 million for consulting services, including development of a computerized financial system for conducting Enron's internal audit. Andersen, then, as outside auditor, audited its own work. In 1997, Andersen questioned the validity of Enron's financial statements yet failed to insist on a restatement of its books that would have reduced that year's reported earnings from \$105 million to \$54 million.

Though often technically accurate, these creative accounting practices do not necessarily reflect a company's true operating health.

In 2000, the SEC responded to the fiscal pressures that can compromise auditing judgments with a rule proposal meant to ensure that an auditor's "public watchdog" role could be preserved. Instead of banning the practice of auditor's selling consulting services to their clients the SEC established four principles designed to function as a litmus test for determining whether a conflict of interest exists in an auditor-client-consultant relationship.

These guidelines unrealistically require that the SEC be privy to all aspects of the client-auditor relationship and as a result have done little to hold the Enrons and the Andersens of the world in check. In fact, the SEC recently censured Andersen competitor KPMG once it was revealed that the company acted as an audit accountant while investing heavily in its client.

As a result of waning confidence in the auditor/consultant, investors are demanding, and in many cases getting, more complete financial disclosures. Though the market may be temporarily buoyed by this flood of information we cannot expect companies to regulate themselves and thus the new disclosures will do nothing but further muddy the water. This lack of transparency and investor confidence will continue to plague a hiccupping economy unless more drastic measures are taken.

III. Policy Recommendations

1. Ban Audit Accountants From Selling Consulting Services: Auditors are "public watchdogs," yet many of the largest accounting firms earned more money from selling consulting services to their clients than from audits. The state legislature should ban accountants from selling non-audit related consulting services to their audit clients.

Auditors have grown overly reliant on consulting business from their clients. According to a recent study by University of Illinois professor Andrew D. Bailey, among 563 companies examined under new SEC disclosure rules, only two paid no non-audit fees to their auditor, and, on average, clients reported paying their accountant \$2.69 in fees for non-audit services for

every dollar spent on audit fees. In some cases, however, the imbalance was far greater.

CALPIRG and other consumer groups believe that an outright ban on non-audit services to audit clients is a better solution than allowing some non-audit services subject to unworkable rules.

2. Close The Accountant Revolving Doors And Rotate The Accountants:

Enron's financial department was chock-full of former Arthur Andersen accountants. The California legislature should ban auditors from working for clients for at least two years following an audit. In addition, audit firms should be rotated at least every four years, so companies benefit from a fresh look at their books.

Even though the Enron matter is still under investigation, a June 2001 SEC settlement order concerning Andersen's auditing of Waste Management, Inc, provides ample explanation of the need to close the revolving door. In this case, Arthur Andersen agreed to settle charges without admitting wrong doing, that it had issued "materially false and misleading audit reports on Waste Management, Inc.'s financial statements for the period 1993 through 1996." Andersen paid record civil penalties of \$7 million in the settlement. According to the SEC:

"Andersen regarded Waste Management as a "crown jewel" client. Until 1997, every chief financial officer and chief accounting officer in Waste Management's history as a public company had previously worked as an auditor at Andersen. During the 1990s, approximately 14 former Andersen employees worked for Waste Management, most often in key financial and accounting positions."

3. Protect Employees 401(k) And Pension Investments:

Enron CEO Ken Lay told employees to keep on investing in Enron stock while he was furiously dumping his own holdings. The state legislature should enact legislation guaranteeing greater protections for employee retirement accounts. Employees need to have retirement investments that are diversified across many industry sectors, with investments in their own firm capped to avoid catastrophic consequences of under-diversification. Employees shouldn't be prohibited by management from selling off their company shares. Employees need a guarantee that their retirement accounts are being managed in their own interest, not the company's interest.

4. Accountant Accountability: Accountants who mislead the public and investors by producing inaccurate or misleading audit reports should be criminally and financial liable for their actions.

5. End Financial Conflicts of Interest: California needs to ensure that company boards and members of the California Board of Accountancy and other agencies do not have conflicts of interest.

6. The State Should Support Public Interest Accounting: The State of California should only do business with companies whose audits are conducted by accountants licensed in the state.

VI. Current State Reform Legislation

Legislation: SB 1527 Burton (D)

Status: Introduced, 2/20/02 and referred to Senate Judiciary Committee.

Description: Senate President Pro Tem John Burton introduced this bill. It requires a CPA firm to provide assurance by certifying they will not provide non-audit services or have a financial interest in any non-audit services provided to an audit client who is publicly traded. Failure to comply constitutes unprofessional conduct and results in suspension of certificate.

Legislation: AB1995 Correa (D)

Status: Introduced, 2/25/02. 3/12/02, referred to Committee on Business and Professions.

Description: Bans accountants from performing auditing and consulting services to the same client.

Legislation: SB 2023 Figueroa (D)

Status: Introduced, 2/22/02. 3/12/02, referred to Committee on Business and Professions.

Description: Amends current accountancy statute mandating a firm subject to peer review to undergo an initial review prior to the first registration expiration date of January 1, 2004. The bill also requires firms who are subject to peer

review meet all professional standards for attest services. If it is discovered that during the review the attest engagement or other documents are not in accordance with standards, the bill gives the peer review oversight committee and the board access to all relevant documents. Additionally, it gives them the authority to take necessary action to assure future compliance with professional standards.

Legislation: AB 2873 Frommer (D)
Status: Introduced, 2/25/02. 3/12/02, referred to Committee on Business and Professions.
Description: Requires retention of audit documentation for seven years; rotation of auditors every four years/

Legislation: AB 2970 Wayne (D)
Status: Introduced 2/25/02.
Description: Requires a two year period before auditors can be employed by an audit client.