



Company accounts

Badly in need of repair

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Enron and others have shown how easy it is to manipulate companies' financial statements. Can it be made more difficult?

BODO SCHNABEL, the boss of Comroad, a navigation-technology company listed on Germany's Neuer Markt, treated his accounts with wild abandon. In 1998 the company invented two-thirds of its total revenues and backed them up with the name of a non-existent client in Hong Kong. By 2000, 97% of Comroad's revenues came from the imaginary company, the existence of which its auditor, KPMG, did not bother to verify.

Comroad is just one of a series of accounting scandals that have badly damaged investors' confidence in financial statements. Companies such as Waste Management, Cendant, Xerox and, of course, Enron, have lied wholesale to investors who have now become suspicious of all accounts. The share price of General Electric (GE), the world's biggest company by market capitalisation, has fallen by some 23% this year, due in part to concerns about its accounting methods (see [article](#)). Blacklists have circulated round the City of London and Wall Street. One listed all companies whose chief financial officers had been recruited from one of the Big Five accounting firms.

Many investors now believe that companies can manipulate their accounts more or less at will, with the aim of producing profits that increase steadily over time. Provisions are bumped up in good years and later released, or the value of an acquisition is slashed; there are plenty of tricks. In the dotcom years, finance directors resorted to so-called pro-forma numbers, which strip out negative items from the income statement.

The primary purpose of financial statements is to show the underlying economic performance of a company. The balance sheet provides a snapshot, at a moment in time, of the assets, liabilities and capital of the business; and the income statement, or profit-and-loss account, shows the difference between total revenues and total expenses. The auditors vouchsafe that these present a fair view, acknowledging the subjective nature of some of the measures behind the accounts. The independence of the auditors guarantees, in theory, that "fair" is just that.

Somewhere along the line, though, things seem to have gone wrong. "Our financial reporting model is broken," said Joseph Berardino, former head of Andersen, Enron's auditor, last year. Designed in the 1930s for an industrial age, financial statements, he argued, look backwards to historic costs; they give investors little clue about the future. Companies cannot include internally-produced software, drugs or brands in their balance sheets because they are intangible assets. That has led to an increasing gap between the value of companies as measured by the stockmarket and



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the value measured by their accounts (their book value), although the difference has contracted of late along with the market values of technology companies (see chart 2).



Off-balance-sheet holes

Accounts certainly rely too heavily on historic costs. But what concerns investors far more is the stuff that lurks beyond the balance sheet. Although numbers recorded on the balance sheet are often misleading, investors can adjust them by using information that companies are obliged to disclose elsewhere. The worrying thing about so-called "off-balance-sheet" items is that they can appear suddenly out of nowhere, without warning. There may be clues in the footnotes, but few people pay close attention to these impenetrable bits of legalese.

Special-purpose entities (SPEs) are a sort of non-consolidated, off-balance-sheet vehicle that have some legitimate uses, such as, for example, the financing of a research and development partnership with another company. They can, however, also be used to shove nasty liabilities and risks into corners where, with luck, nobody will see them. At the moment, investors are assuming that they are being used mostly for the latter purpose.

In November 2000, Enron restated its financial statements, reducing its profits by \$591m over four years and increasing its debts by \$628m. Most of the restatement came from the consolidation of two SPEs. America's standard-setter, the Financial Accounting Standards Board (FASB), points to Enron's restatement as evidence that it was the energy trader's disobedience that was the problem, not the rules on special-purpose entities.

Another of Enron's special-purpose vehicles, however, called LJM2, stayed off its balance sheet in accordance with FASB standards. And there are many more SPEs out there, notably off the balance sheets of companies which securitise (ie, repackage and sell on to investors) large chunks of their assets.

Another example of off-balance-sheet deceit is the dry-sounding yet potentially dangerous phenomenon of commitments, a variety of contingent liability. A company commits itself to a future contingent payment but does not account for the liability. Telecoms-hardware manufacturers, for example, often guarantee bank loans to important customers in return for buying their products. That is fine so long as the business is healthy, but if a company enters into such a transaction purely to lubricate its own cashflow, the commitment can become a risk. At the moment, according to American, British and international accounting rules, many varieties of commitments are mentioned only in footnotes since there is, in theory, only a low probability that they will crystallise.

Operating leases, through which a company agrees to rent an asset over a substantial period of time, make up most off-balance-sheet financing. Airlines use them to clear their accounts of large numbers of aircraft. The practice helps to avoid tax, but it also results in a drastic understatement of the airlines' debt, according to Trevor Harris, an accounting analyst at Morgan Stanley Dean Witter. In 1997, one-third of the aircraft of the five biggest American airlines were treated as operating leases rather than as assets.

Needless to say, this is all done in accordance with accounting rules. Standard-setters have come up with hundreds of pages of rules on operating leases, but they have failed to get companies to admit what any analyst knows: that airlines reap the economic risks and rewards of their aeroplanes and ought to treat them as assets.

Unlike off-balance-sheet financing methods, most of which date from the last 15 years or so, the trick of recognising revenue too early (or booking sales that never materialise) is an old one. Global Crossing, a

bankrupt telecoms-equipment company now under investigation by the Federal Bureau of Investigation and the Securities and Exchange Commission (SEC), is accused of swapping fibre-optic capacity with a competitor as a way to manufacture revenue. And according to the SEC, Xerox, a photocopier company, wrongly accelerated the recognition of equipment revenue by over \$3 billion. Standard-setters admit that no country has adequate rules on the recognition of revenues. A solution in the meantime may be to look at cash, which is far harder to disguise or invent. Comroad duped its auditor about its revenues, but it could not conceal the fact that its cashflow was negative.

The standard-setters

A different sort of problem lies in the very nature of American accounting standards. Companies always think of new ways to get round the rules, and the standard-setters' job is really an unending attempt to catch up. But the body of accounting rules in America has become both too detailed and too easy to circumvent. Until the 1960s, standards were simple and based on broad principles. With the advent of class-action lawsuits against companies whose share prices had tumbled, however, audit firms demanded detailed, prescriptive rules to help them in court. As a result, accounting standards in America have multiplied into vast tomes.

America's web of accounting rules, or generally accepted accounting principles (GAAP), date from the 1930s and are now produced by FASB, a private-sector body staffed by accountants. Elsewhere, accounting standards are set by private-sector groups or, in some cases, especially in Europe, directly by governments. Accounting rules outside America lean more towards principles, particularly in Britain, where the importance of providing a "true and fair" view of a company's performance overrides specific rules.

Fights over new accounting standards do not usually grab headlines. But companies care a lot about changes to accounting rules, since at one swoop their numbers may fall under a far harsher light. They lobby intensively behind the scenes, often with the help of one of the Big Five audit firms. Whether or not a standard-setter has the ability to withstand pressure depends on its legal status, the independence of its funding, and the country's overall culture of corporate behaviour and influence.

FASB is under attack over Enron's demise. Its efforts to sort out consolidation accounting, an issue directly relevant to the energy-trader's downfall, had been going on for 20 years, or for a large part of its 29-year history, with no conclusive result. The argument centres around when a company must add all the assets and liabilities of a related entity into its books. Harvey Pitt, the chairman of the SEC, has criticised FASB for taking so long to make up its mind.

The board has tried hard to address off-balance-sheet abuses. Too many times, though, it has run up against corporate pressure applied through Congress, not least in the case of special-purpose entities, the trick that Enron used. In 1999-2000, FASB was moving towards a concept of effective control rather than ownership to determine whether or not a special-purpose entity should be consolidated into a company's accounts. If the more subjective idea of control is used for standards on consolidation, as it is in Britain and elsewhere, it is easier for an auditor to exercise his judgment and insist that an entity be brought on to the balance sheet.

But FASB's initiative would have created difficulties for companies that rely on such entities. Richard Causey, Enron's former chief accountant, wrote in to object. So did Philip Ameen, head of Financial Executives International, a corporate lobby group, and a top financial officer at GE, itself a heavy user of SPEs. In January 2001, nine months before Enron went bankrupt, FASB announced that it was putting the project on hold.

In the 1970s, Congress mostly left FASB alone, with one big exception: oil and gas accounting. In 1978, the oil and gas industry persuaded it to stop the SEC from forcing any company to use an unflattering method of accounting for drilled holes. Congress became involved in accounting issues again during the savings-and-loan crisis of the late 1980s. The result was that the industry's bad-debt problems dragged on for longer than they might have done.

In recent years, the most blatant political intervention in the standard-setting process has been over the stock options that many companies grant to their employees. In 1993, FASB proposed that companies should account

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for stock options as expenses. The following year, Congress threatened to take away its standard-setting powers if it did not water down its proposal. In the end, FASB settled for footnote disclosure. Under heavy pressure, says Lynn Turner, a former chief accountant of the SEC, "they had no choice but to fold, like a cheap tent."

Another problem, says Mr Turner, is that a lot of standard-setting power has been given to the Emerging Issues Task Force (EITF), an offshoot of FASB whose mission is to respond quickly to new accounting problems. The EITF was set up in 1984 with a membership drawn from industry and the accounting profession. Whereas a key part of FASB's mission is to serve the public interest, the EITF has no explicit duty to shareholders or the public.

As far back as the late 1980s, the SEC asked the EITF to look at special-purpose entities, worried that they might lead a company to become overly leveraged without investors realising it. At a meeting in 1990, the group voted unanimously to do nothing to change the status quo. After an appeal from the SEC's chief accountant, Edmund Coulson, three EITF members agreed to change their vote.

The outcome, eventually, was a rule by which a company can keep a special-purpose vehicle off its balance sheet as long as an independent third party owns a controlling equity interest equivalent to at least 3% of the fair value of its assets. That number, post-Enron, is now judged to be too low, and FASB may raise it to 10%.

Mr Turner believes that the EITF should be given an explicit mandate to serve the public interest. Its rulings should be approved by FASB as a matter of course. At present, part of FASB's controlling board of trustees comes from industry groups and its funds from audit firms, industry and financial groups. A new bill from Congressman Billy Tauzin, aiming to boost the independence of FASB, would hand the responsibility for its funding to the Treasury, which would levy compulsory fees on companies and accounting firms.

In Britain, a series of business scandals in the 1980s, most notoriously Polly Peck, a conglomerate which manipulated its foreign-exchange earnings, convinced the corporate world that accounting rules had to get better. The Accounting Standards Board (ASB), set up in 1990, declared war on off-balance-sheet chicanery. It produced a new rule, FRS5, which requires the substance of an entity's transactions to be reported in its financial statements, regardless of legal form.

The ASB has recently enraged businesses in Britain with a new standard, FRS17, which will force them to disclose and recognise the full effect of pension-fund gains and losses. Companies hate the standard because it will bring the volatility of financial markets into their earnings. They have tried hard to get politicians involved, says Mary Keegan, the standard-setter's chairman, but the ASB has not come under government pressure to scrap or change the standard.

A new private-sector standard-setter in Japan, the Financial Accounting Standards Foundation, gives investors some hope of better standards there. Its predecessor, the Business Accounting Deliberation Council, appeared powerless to pass any standard that would damage the suffering Japanese economy. Japan's accounting rules contain loopholes that allow companies to hide the economic substance of their performance. For instance, the recent guideline on fair-value accounting, which decrees that companies must show equity holdings at their market value, also contains a provision that allows them to avoid writing down shares if they think that they will soon recover in value.

Do the right thing

If accounting standards are to improve, it is probably the International Accounting Standards Board (IASB), originally established in 1973, which will lead the way. America does not yet recognise its rules; companies that wish to raise capital in American markets must still reconcile their accounts with GAAP. But the IASB gained a lot of influence in 2000 when the European Commission decided that all companies in the European Union must report according to its standards by 2005.

When he was head of the ASB, Sir David Tweedie, now chairman of the IASB, successfully fought off attempts by business to influence the standard-setting process. He is determined to do so again. He believes, for instance, that the effect of giving stock options to employees should be counted in companies' accounts, not just mentioned in footnotes, as they are at the moment. The IASB will soon publish a draft proposal for a global standard on stock-option accounting. Like FASB, it will face strong opposition, including, crucially, from the European Commission, which wrote this January to say that it would prefer the IASB to concentrate on better

disclosure of stock options rather than a new conceptual approach.

Sir David also wants to bring in a new international standard on pensions, similar to FRS17. Like FASB, however, the IASB would be better positioned to push through high-quality standards if it did not rely on business and big audit firms for its funding. Earlier this year it was badly embarrassed by an e-mail showing that Enron expected to be able to influence its standards in return for cash.

If accounting standard-setters have their way, financial statements are likely to become far more volatile in the future. Representatives from some of the world's most influential bodies—including those of America, Australia, Britain, Canada and the IASB—have published proposals to value all financial instruments at market value rather than at cost. Bank loans and deposits, as well as traded financial instruments with easily obtainable prices, would be marked to market. Because changes in balance-sheet values would be passed through the income statement each year, this would be sure to make corporate results far jumpier.

Proper accounting for pension schemes, along the lines of FRS17, would have the same effect. The IASB is working on the recognition and measurement of intangibles, as is FASB. Again, if intangible assets are recognised on balance sheets, they will add volatility to income since, on the whole, their value tends to fluctuate more than that of tangible assets.

Changes such as these are the ultimate answer to people who criticise accounts for being industrial and irrelevant. Standard-setters have already started to crack down on off-balance-sheet abuses and they have more backing to do so, post-Enron. Companies will fight against either sort of change. They want their earnings to move gradually upwards, not to jerk around, and they do not want the fact that they use volatile financial instruments to be reflected in their results, even if the volatility is real. Standard-setters should take the views of companies and governments into consideration. But if future Enrons are to be avoided, they must be given the freedom to force companies to reveal far more economic reality in their accounts than they do at present.