Fundamental Causes of the Accounting Debacle at Enron:
Show Me Where It Says I Can't

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1. Fundamental Problem: Rules trump principles leading to, "Show me where it says I can't."

2. Parallels with the Tax Code and the critical differences.

3. Congress: Keep out of accounting rule making

4. Reduce conflicts of interests: Limit the length of auditor engagements--term limits

5. Empower and prod the Audit Committee

6. No need to forbid consulting; the Audit Committee in [5] will have incentive enough for that.

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49
50 Enron bet the farm and lost. It's OK to gamble, but shareholders should know about the size
51 and risk of bets undertaken as well as how the nature of bets changes over time. Why didn't
52 the accounting for Enron's activities do a better job of alerting shareholders to the risks and
53 changes in them?
54
55 **Fundamental Problem**
56
57 *Imagine an asset* (for the moment think of rights to use a patent on a drug that defeats
58 anthrax) *purchased by a dozen different companies for a total of $500 million. Now,*
59 *suppose that the Congress passes laws saying that any other company who so chooses*
60 *can use that patent to produce the anthrax-defeating drug free of royalty to the owners.*
61
62 *What do you suppose the accountants for the firms that had purchased those patents for*
63 *$500 million would do? They would write off the assets to zero, recognizing a collec-*
64 *tive loss of $500 million, before taxes, on their income statements. Would you suppose*
65 *that accountants would need to look into their GAAP rule books to find out if that write-*
66 *off were necessary?* (Not necessary, wouldn't you think—it's obvious.) *If they did*
67 *look and couldn't find such guidance, do you think they'd write off the assets anyway,*
68 *recognizing the attendant losses?* (Of course.)
69
70 What has this to do with the state of accounting reflected in the current Enron/Andersen sham-
71 bles? A lot.
72

In 1980, events paralleling those of the imaginary two paragraphs happened: Congress passed de-regulating legislation liberalizing the granting of trucking rights, effectively giving any trucker the right to carry any commodity between any two points. Prior to that de-regulating legislation, Congress, acting through the Interstate Commerce Commission, had limited those rights. The issued rights traded in the market place and, once purchased by a trucking firm, appeared on the firm's balance sheet at cost. When Congress effectively destroyed the value of those rights by allowing any trucker the right to carry the goods previously protected by monopoly rights, what did the accountants at trucking firms do? They wrote off the value of the trucking rights on the balance sheet, recognizing an amount of loss equal to their then-current book value.

Did the trucking company accountants need a specific accounting rule telling them to write off those trucking right assets? You wouldn't think so, would you? But the Financial Accounting Standards Board (FASB) felt compelled to pass a rule (*Statement of Financial Accounting Standards No. 44,* 1980) saying just that. Accounting rule makers took a first step on the road to the Enron accounting debacle.

Since the early 1980's, an aggressive company's management engages in a transaction not covered by specific accounting rules, accounts for it as it chooses, and challenges the auditor by arguing, "Show me where it says I can't." The auditor used to be able to appeal to first principles of accounting. Such principles suggest, for example, that post-deregulation trucking rights are no longer assets. Now, the aggressive management can say, "Detailed accounting rules cover so many transactions and none of them covers the current issue, so we can devise accounting of our own choosing." And they do.

Accounting rule making has become increasingly detailed as both the SEC and auditors plead with standard setters for specific rules to provide backbone: "Dear FASB or EITF [Emerging Issues Task Force, created by the SEC and the FASB], Give us a rule for this new transaction."

102 So, Enron transfers assets, reporting current profit and debt,[1] then challenges its auditor to
103 "Show me where it says I can't." The auditor can't. The auditor considers nixing the profit
104 recognition but simultaneously considers the consequences of saying, "No" to aggressive
105 management: "We might lose this client."
106
107 The near-majority of the rule-setting FASB comes from high-powered audit practice. These
108 members bring to the Board a mindset that the accounting profession needs, and wants, specific
109 guidance for specific transactions. Three of them can meet privately and can effectively, if not
110 formally, guide, perhaps even set, the agenda for the Board. A minority of the Board has spent
111 careers dealing with fundamental theory. This minority, with more faith in the conceptual basis
112 for accounting, appears to prefer to derive broadly applicable rules from first principles of ac-
113 counting, which the FASB developed in the early 1980s in its conceptual framework. The
114 majority, the members from auditing practice, less interested in deriving rules from conceptual
115 principles, appears to win most of the battles.
116
117 The emphasis on specific rules for specific issues gets more pronounced over time. I concede
118 that these specific rules for specific issues leads to more uniform reporting of the covered trans-
119 actions—all else equal, a good thing. That uniformity comes at the cost: practicing accoun-
120 tants have less need for informed intelligence and judgment. I concede that part of the pres-
121 sure on standard setters for specific rules for specific transactions comes from the current litiga-
122 tion environment and from the SEC. Auditors, in a rational pursuit of a full purse, want unam-
123 biguous rules to stand behind when, inevitably, the trial lawyers sue them for accountant judg-
124 ments and estimates, made in good faith, that turn out to miss the target.
125
126 That some good results from specific rules for specific transactions doesn't make such rules a
127 good idea. These rules have a cost: "Show me where it says I can't," demands management.[2]

[1] In addition, Enron appears to have promised to give Enron shares to the purchaser if the transferred assets later turn into losers. If this were true and the auditor knew about the additional contingency, I suspect the auditor would have not allowed Enron's accounting. I am less confident of these next two: it appears that Enron may have strong-armed the auditors into avoiding the equity method of accounting for investments and into questionably treating some of its derivative transactions as hedges.

[2] Meanwhile, the SEC says, "Show us where it says you can." If the accountant can't show a specific rule, but then goes ahead with some reasoned judgment without getting the accounting treatment pre-cleared, the accountant will find him- or herself in SEC trouble.

128 "Give me more rules for these new transactions," pleads the auditor, "so I can combat aggres-
129 sive management." This cycle continues: the increasing number of specific rules for specific
130 transactions strengthens aggressive management's belief that if a rule doesn't prohibit it, then
131 it's allowed. This, in turn, increases the auditor's dependence on specific rules.
132
133 **What to Do?**
134
135 I want accountants to rely on fundamental, first principles in choosing accounting methods and
136 estimates. I want accountants not to hide behind the absence of a specific rule. Whatever the
137 detailed rules accountants write, smart managers can construct transactions the rules don't
138 cover.
139
140 You might now think about the parallels of the above with our tax collection system, where
141 principles alone cannot suffice. The principle: tax income. The principle requires thousands
142 of pages of tax code, regulations, and court decisions to implement. Can financial accounting
143 be different? I think *yes*. The tax collector and the taxpayer play a zero-sum game—what one
144 pays, the other gets. Financial accounting doesn't have that property and in addition has the
145 auditor to interpret the rule book.
146
147 What else, besides more spine in the auditor, do we need to reduce the likelihood of more ac-
148 counting debacles?
149
150 *Congress: Keep Out of Accounting Rule Making*
151
152 Several times in my professional lifetime, Congress has written rules, or taken steps to influ-
153 ence the rules, with bad outcomes for reported financial results. Moreover, these incidents
154 suggest to those who dislike the about-to-be-required accounting of the wisdom of complaining
155 to Congress. The first occurred in the legislation for investment tax credits in the 1960's. The
156 most recent disaster was in the mid 1990's when Congress pressured the FASB to pull back on
157 its proposals for the expensing of stock option costs. I can think of no offsetting, good out-
158 comes.

159
160 *Reduce Conflict of Interests*
161
162 In recent weeks, we hear about reducing conflicts of interest—two recent ones: reduce the op-
163 portunities of the auditor to do consulting and forbid the auditor from going to work for the
164 audited company. The basic conflict occurs because the audited pays the auditor and, in prac-
165 tice, selects the auditor. In my opinion, everything else has lesser effect.
166
167 *Auditor Term Limits*
168
169 First, let's mandate auditor rotation—term limits for auditors. Seven years ought to do it, may-
170 be five. Let the auditor know that, no matter what, another auditor will take over the job in a
171 few years and will have the incentive to expose a predecessor's carelessness.[3] Mandatory
172 auditor term limits have a cost—audit costs might triple. Not just the actual audit bills, but the
173 costs the audited company incurs to show the new auditor where the inventory records lie in the
174 second file drawer of the cabinet two to the left of the green door in the third room on the right
175 of the outside corridor.
176
177 I imagine that known term limits will induce the Audit Committee to begin the search for the
178 subsequent auditor 18 months or so before the engagement will start and will be able to bring
179 that new auditor into on-board, learn-from-observation mode early in the process. Those who
180 argue against mandatory auditor rotation adduce large transition costs. Suddenly changing au-
181 ditors does cause surprise costs that anticipated, orderly transitions will reduce.
182
183 *Prod the Audit Committee*
184
185 Then, we need audit committees to exercise the power the SEC has given them. Thirty years
186 ago, Rod Hills, then Chairman of the SEC, conceived the powerful modern audit committee.
187 He has written that the audit committee's most important job is to make the independent, attest-

[3] Talk about professional peer review. This will be real peer review, not the pap we get now.

188 ing auditor believe that the auditor's retention depends *solely* on the decision of the audit com-
189 mittee. Most often, it doesn't work that way.
190
191 Most audit committees consist of independent, smart, but financially illiterate, members, with
192 rarely more than one financial expert.[4] (If you don't believe me, look at the accounting qualifi-
193 cations of the audit committee of any large company you follow. Then, look at how seldom the
194 large corporations change auditors.) Audit Committees usually depend on management to re-
195 commend the independent auditor and changes in the auditor. The auditor learns to take its
196 guidance from management, not from the audit committee. The SEC has provided power to
197 the audit committee; now, it can help empower the audit committee by mandating auditor term
198 limits and having the audit committee report on its independent search to find the replacement
199 and its independent contacts with the auditor after engagement.
200
201 Some of my colleagues doubt that the country has enough independent, knowledgeable people
202 to staff corporate America's audit committees and ask them to do the job Rod Hill set for
203 them.[5]
204
205
206 *Consulting Conflicts*
207
208 Management typically views audits as adding no value, purchased merely because regulation
209 requires them. Hence, management typically wants the most cost/effective job it can get to
210 satisfy the regulations. This doesn't mean the cheapest audit. Capital markets will guide a
211 company in the S&P 500 not to hire me to do its audit, but to hire one of the Big Five, because
212 the resulting savings in the cost of funds more than offsets the higher invoice cost. Once that

[4] How do I know they are often illiterate? Because I teach them in Directors' College classes where I start with pop quizzes.

[5] At this point, I have three suggestions, all blatantly self-serving. In earlier drafts of this testimony, I failed to flag these as tongue-in-cheek and my friends called me to task for that. Let's consider increasing the pay differential between audit committee board members and the others. Let's encourage potential audit committee members to attend Directors' College at the University of Chicago. Let's educate audit committee members to demand of management a budget to hire its own accounting consultants, such as professors from the University of Chicago, to teach the accounting issues for the company's operations and financial structure.

213 firm decides it needs a Big Five auditor, its Chief Financial Officer will prefer to spend less,
214 not more, for the service. The audit committee worries less about reducing the audit bill.
215
216 The audit committee could say, “We’re going to pay top dollar for a high quality audit.” To the
217 auditor it could say, “Make a decent profit on the audit; don’t count on consulting fees to make
218 up for thin margins on the audit.” This will drive up the cost of both the audit and the consult-
219 ing services, because the outside consultant will not have the head start in understanding the
220 client’s specifics that the auditor has. Management will not like this. The audit committee,
221 charged to be concerned primarily with the audit, should be unconcerned about the higher cost
222 of consulting fees. When did you last hear of an audit committee asking for a higher-priced
223 audit?
224
225 Does this require a regulation forbidding the auditor from consulting? No, we already have
226 regulations empowering the audit committee to act, independent of management. Now, we
227 need the audit committee to act.
228
229 In the current environment, it’s heresy to suggest that we need not to forbid auditors from also
230 providing consulting services. Despite this pressure, I suggest to the Committee that manda-
231 tory auditor rotation, with auditors chosen and beholden to the audit committee, will solve the
232 conflict of interest problem. Forbidding the auditor from all consulting will not produce high
233 quality audits nor deal with the problem of malleable GAAP.
234
235 Another advantage to term limits for auditors is the ease of specifying and enforcing the rule.
236 All proposals to divorce auditing from consulting contemplate exceptions. For example, the
237 auditor can be the most cost-effective preparer of income tax returns. I, and others, see no
238 need to waste resources by having firms different from the auditor do the tax return. Where to
239 draw the line? Let’s don’t mandate one, but let the audit committee decide. I can imagine that
240 the auditor will prefer shorter terms to longer because the sooner the audit is done, the sooner it
241 can undertake consulting engagements.
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