

CRS Report for Congress

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Accounting Reform After Enron: Issues in the 108th Congress

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Summary

The sudden collapse of Enron Corporation in late 2001, amid revelations that its public accounting statements had been manipulated and falsified to conceal the company's true financial position, was the first in a series of major accounting scandals involving American corporations. The response of the 107th Congress was to pass the Sarbanes-Oxley Act (P.L. 107-204), sometimes described as the most sweeping amendments to the securities laws since the 1930s. (For a summary of Sarbanes-Oxley, see CRS Report RL31879.)

The 108th Congress is unlikely to consider legislation as far-reaching as Sarbanes-Oxley, but several issues related to accounting reform remain. These include questions of accounting for stock options and financial derivatives contracts, the possibility of replacing our current rules-based accounting system with a principles-based system, and oversight of the implementation of the accounting reforms mandated by the Sarbanes-Oxley Act. This report will be updated as events warrant.

Background

The wave of corporate accounting scandals that began in 2001 with Enron may have no precedent in U.S. history; certainly there has been nothing comparable in the post-World War II era. Dozens of large and well-respected firms have admitted to manipulating their published financial statements. In the extreme cases, hundreds of millions in reported profits were based on sham transactions with no economic substance. The watchdogs meant to protect public investors — independent auditors, boards of directors, Wall Street analysts, and regulators — were not an effective bar to corporate management bent on artificial inflation of financial results.

The costs of the accounting scandals have been high. Firms have gone into bankruptcy, thousands of workers have lost their jobs and retirement savings, and investors in stocks, including pension funds and other nonprofit organizations, have suffered major losses. The legislative response was swift: in July 2002, Congress passed the Sarbanes-Oxley Act (P.L. 107-204), a sweeping reform of accounting regulation.

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Sarbanes-Oxley Act Implementation

Congress's intent in passing Sarbanes-Oxley was to restore confidence in financial markets by increasing corporate accountability, enhancing public disclosures of financial information, and strengthening corporate governance. More severe criminal penalties for securities fraud were also enacted. The Securities and Exchange Commission (SEC) has adopted more than a dozen final rules to implement the Act's provisions. These rules raise standards of accountability for corporate executives, boards of directors, independent auditors, and corporate attorneys.

The most difficult phase of implementation has been the launching of the Public Company Accounting Oversight Board (PCAOB), created by Sarbanes-Oxley. The PCAOB's mission is to regulate the auditors of publicly traded companies and to ensure that corporate financial statements are subject to tough, outside scrutiny and that the auditor-client relationship is free from commercial conflicts of interest. The first nominee for PCAOB chairman withdrew after it became known that he had served as a director of a company under SEC investigation for securities fraud. This incident also led to the resignation of SEC Chairman Harvey Pitt. The new choice to head the PCAOB, William McDonough, is former president of the Federal Reserve Bank of New York, and is widely respected in the markets. He will take office on June 11, 2003. It remains to be seen whether the PCAOB will become the effective regulator that Congress intended.

Accounting for Stock Options

Accounting for stock options is a long-standing controversy. Under current accounting rules, stock options granted to executives and employees are generally not counted as a cost to the company, unlike other forms of compensation. (For more on options accounting, see CRS Report RS21392, *Stock Options: The Accounting Issue and Its Consequences*, by Bob Lyke and Gary Shorter.) Grants of options must be disclosed in footnotes to financial statements, but do not affect the bottom line. Companies are thus able to issue options without reducing their reported profits. Most accountants believe that options should be "expensed," or charged against earnings, as a matter of principle and consistency. However, an argument in favor of the status quo is that options enable cash-poor, startup companies to attract and retain skilled employees and managers they could not afford otherwise. In this view, compensation via options fosters growth and innovation, and if options were counted as a cost and reported profits reduced, high-tech and other growing firms would have less appeal for investors and would face a higher cost of capital.

The post-Enron scandals have sharpened the dispute. Critics of current accounting rules now argue that some companies have been too generous with options, and that executives with huge personal stakes in the company's share price have strong incentives to practice deceptive accounting to conceal bad news from the market. In April, 2003, the Financial Accounting Standards Board (FASB) proposed to require the expensing of options. H.R. 1372 calls for enhanced disclosure while imposing a three-year moratorium on changes in the accounting treatment of stock options.

Much of the support for expensing options comes from those who believe that current executive pay is excessive, and that this excess is one of the root causes of the corporate scandals. The growing disparity between CEO and rank-and-file pay was widely reported during the 1990s. More recently, many CEOs have come under fire for crafting lavish retirement packages for themselves while their firms have cut back on pension benefits for ordinary workers.

Alan Greenspan, in 2002 congressional testimony, noted that grants of options, designed to align management's interests with those of the shareholders, "perversely created incentives to artificially inflate reported earnings in order to keep stock prices high and rising.... The incentives they created overcame the good judgment of too many corporate managers."¹ Problems of power relations in public corporations are beyond the scope of accounting reform. But if resistance to growing CEO pay and benefits widens, accounting solutions — rules requiring comprehensive and comprehensible disclosure — may be part of the policy response.

Section 342 of H.R. 2, as amended and passed by the Senate on May 15, 2003, would impose an excise tax on stock-based compensation, including stock options, received by executives involved in certain corporate "inversion" transactions (where companies move their corporate domicile to a foreign tax haven, such as Bermuda, to reduce their U.S. taxes).

Derivatives Accounting

Financial derivatives are instruments without an intrinsic claim on any corporate or financial asset. Instead, their value is linked to the price of some other asset or financial indicator — an interest rate, stock index, or commodity price. Some derivatives markets (such as the futures exchanges) are regulated, others (the "over-the-counter" market) are not. Enron was a major dealer in unregulated derivatives, and, although that company's worst problems lay elsewhere, some now believe that unregulated derivatives should be subject to disclosure and reporting requirements, in order to give regulators new tools to prevent or respond to episodes of financial instability or attempts to manipulate market prices.

Derivatives affect accounting statements because they must be assigned a "fair value" at the end of each accounting period, and changes in fair value reported as income. Many over-the-counter derivatives are complex contracts for which no trading market

¹ *Federal Reserve Board's Second Monetary Policy Report for 2002*. Senate Committee on Banking, Housing, and Urban Affairs, July 16, 2002. (S. Hrg. 107- 835)

exists: fair values are calculated according to firms' own valuation models, which critics believe are susceptible to manipulation by traders (whose pay is often linked to portfolio gains or losses) and by companies seeking to "manage" their reported earnings.

H.R. 1109 directs the Commodity Futures Trading Commission (CFTC) to issue rules and regulations for over-the-counter dealers and transactions. S. 509 authorizes the CFTC to regulate over-the-counter energy derivatives.

Principles-Based Accounting

The recent corporate scandals revealed two kinds of problems with our accounting system. One was that companies (and sometimes their auditors) ignored the rules. The other was that the rules themselves are so complex that even when they are followed to the letter, investors may not get a clear picture of a firm's financial condition. Enron created numerous off-the-books affiliates and partnerships, and entered into complex transactions with them. These transactions were not in all cases violations of generally-accepted accounting practices (GAAP), but they did make Enron's financial reports impenetrable to outsiders.

The Sarbanes-Oxley Act called for more stringent enforcement of current rules, but also called for an SEC study of an alternative accounting system, called principles-based accounting. The basic idea is that a system based on a few basic principles requiring accountants to produce a true and fair picture of the economic reality of a company's finances could be more effective than detailed sets of rules, which invite a search for loopholes. FASB's chairman Robert Herz has endorsed the concept of principles-based accounting, noting that under the current rule-based system, "People see the trees and not the forest." Some fear that reduction of complex rules to a few principles could lead to confusion over what is legal and result in selective enforcement, but at this point we can only guess what a principles-based accounting system in the United States would look like. The SEC study is due one year from enactment of Sarbanes-Oxley, in late July 2003.