Ethics in accounting: financial reporting scandals

Introduction

> The first thing is character, before money or anything else. – J. P. Morgan

Integrity is of utmost importance for a successful career in business and finance in the long run. Some believe that the world of finance lacks ethical considerations. Whereas the truth is that such issues are prevalent in all areas of business.

The business environment in much of the world is reeling from the revelation of several financial scandals in the past few years. The optimism of the turn of the century has been replaced by scepticism and distrust. It will be discussed as to how we landed ourselves in this situation, what is being done to correct it, and what the future holds for us. Though Enron has been used as the poster-child for this purpose, breakdowns in accounting and corporate governance in Enron as well as in other companies will be discussed.

Some companies that have encountered financial reporting problems will be discussed along with the role of auditors (including Andersen’s role in Enron), the regulatory environment, some of the causes of the problems, and the current and possible future outcomes.

Ethics and Accounting

Ethics (maintaining fair and true statements) is a key part of financial reporting. For shareholders to trust a company with money, they must feel confident in the company’s financial reporting. Financial reporting presents all data relating to the entity’scurrent, historical and projected health meaning investors and shareholders rely upon the financial data available for making informed and educated decisions. To help entities comply with business regulations and maintain financial reporting, shareholders can trust the existing organizations designed to monitor different aspects of the accounting world. Primary organizations are Securities and Exchange Committee (SEC), the Financial Accounting Standards Board (FASB) and the Public Company Accounting Oversight Board (PCAOB). These three bodies together ensure financial reporting is fair, reliable, and available to all investors.

The specific importance of ethics in business and in financial reporting is to ensure public and investor confidence in companies. Without a strong code of ethics and adherence to that code, individuals may not be certain their investments are secure. Accounting professionals must have a strong ethical and moral reasoning because their decisions regarding financial reporting can have major consequences for individuals as well as corporations and entire nations. Ethics in the business environment are more than just issues relating to accounting; because ethical practices can and will cross boundary from business practice to what a company may ask its accounting professionals to do in financial recording. The many recent scandals involving accounting and reporting fraud generally began at the CEO and made their way down into the financial records.

Before the Sarbanes-Oxley Act, various financial abuses such as WorldCom, Enron, and Adelphia Communications plagued the American public and affected economic health of the entire nation adversely. Most of these frauds stemmed from unethical accounting practices instituted at the highest levels of the corporations, but carried out in the financial reporting practices of public accounting firms. In December 2001, Enron, which used to be one of the world's leading energy companies once, filed the largest bankruptcy in the history of the U. S., using the retirement accounts of thousands of American workers, to enrich those at the highest levels of the corporation. Using thousands of off-the-records partnerships to hide nearly $1 billion in debt and to inflate profits, company had defrauded shareholders of billions. Due to these scandals, President Bush and Congress were forced to take tough stance in the form of the Sarbanes-Oxley Act in July of 2002.

When ethics seem to be on the downfall in a society, the common man naturally turns to the government for guidance. Various crises in the history of the United States have led to creation of several regulatory bodies and laws. The three entities in the US, mentioned above, work closely together to ensure financial accounting is honest. The SEC, the FASB, and the PCAOB are each an independent entity, but they often work in cooperation in certain areas such as oversight and reporting. While these three bodies work together, they rely on cooperation from member companies and from participation from " whistle-blowers" in companies and public citizens. As the Enron collapse illustrated, there were systemic failures in the private-sector watchdog-groups. The SEC and the PCAOB must work closely together and include way to fast-track criminal cases.

Enron and other financial reporting scandals

Enron was a great symbol of widespread problem in corporate America as its rise was as spectacular as its fall. Enron, formed in 1985 when Internorth purchased Houston Natural Gas was soon being run mainly by Houston Natural Gas executives, with Ken Lay as CEO. In 1990, both Jeffrey Skilling and Andy Fastow were hired. In 1996, Skilling became the President and COO. A meteoric rise in both reputation and stock value came by, with Enron being named as one of Fortunes' most admired companies in 2001 and its stock price peaking at $90. 56 a share as on August 23, 2000. Much of the company's success was credited to the financial wizardry of Fastow. However, company's fall was just around the corner, with Skilling resigning in August of 2001. This was followed by a $1. 2 billion write-off, and the beginning of an SEC investigation in October. By December, Enron had declared bankruptcy and the share price was $. 26 per share.

If Enron had been a lone case, concern would have dissipated quickly and confidence in capital markets would not have plumped. But it was not so. Before Enron, there were companies such as Waste Management and Sunbeam — not significant by themselves, but they should have acted as a warning of what was to come. After Enron the disclosures kept coming. WorldCom was caught capitalizing expenses. While Enron was trying to outsmart the accounting and capital market regulators, WorldCom made accounting errors that even novice accounting students would know were inappropriate. A disturbing aspect of many of these scandals is the collusion among many executives.

An important observation is that all of these scandals can't be attributed to one factor alone. Each one was different. Hence it can be concluded that the solution is not easy to find. There is no single accounting practice that made these entities vulnerable to executive excesses.

What these scandals had in common was a culture that was pervasive in corporations. A culture had come in that made it permissible to lie to shareholders and the markets. “ The ends justify the means” became the corporate mantra. Also, the watchdogs, the auditors had turned a blind eye with their focus just on their consulting businesses. They were not as vigilant as they should have been in audits.

The auditor’s role in ensuring fair play

Auditors are supposed to protect the public from the types of abuses that have been seen in the past. Even though financial statements are responsibility of management, the shareholders hire auditors for the protection of their interests and to add credibility to financial information provided by the firms. To be credible, auditors need both expertise and integrity. Expertise assures if there is a financial reporting irregularity, the auditor has the capacity to discover it. Integrity assures that auditors will disclose any irregularity they may find. These two qualities are essential. They are also multiplicative that is if either is missing, other has no value. It has been found that both were missing in many cases. Expertise was missing as audits had come under cost cutting measures of firms. This happened often at the cost of quality. Integrity was gone when auditors forgot that the first allegiance of a professional is to the public. Seldom did auditors betray management for the benefit of the public. Hence, even if they did discover reporting problems, rather than reporting them to the public they often helped management devise ways around the reporting problems.

Auditors fell into this position (probably not because they were incompetent or unethical but) because of the cultures in major accounting firms.

Andersen, Enron's auditor, is a classic example. There were good auditors who got caught up in an economic struggle leading to undue focus on revenue generation. An audit firm having the highest reputation for competence and integrity compromised on its values as that was the only way its partners thought to be economically competitive.

In the more recent Satyam case in India, the fraud started at the top level management and reached the financial records. The role of Pricewaterhouse, Satyam's auditor, is also controversial in the said scandal.

Causes of financial reporting problems

The regulatory environment had not changed suddenly then why did the financial reporting problems surface at the time, is a question to be pondered upon. There are many reasons, not one that dominates.

It was a confluence of circumstances that opened eyes to the problems. The bursting of the bubble economy was a major reason these financial abuses came to light. When everything was seemed bright, nobody questioned companies' financial reports. In accounting the lack of relevance of historical cost accounting and even the basic traditional accounting framework were being discussed. The " new economy" was not to last forever. And when it did not last, investors began to ask tough questions. For many of the questions, there were no answers — only denials and cover-ups.

In the auditing profession, audits had become loss leaders. The balance sheets and income statements had lost value, so auditing of the statements was not important. Thus, many audits became hasty and more of a formality. No one was willing to pay for quality audits, so many audit firms believed there remained no sense in competing on the basis of quality. Cost drove audit decisions. Lower cost even with lower quality was the norm.

The passivity of corporate boards was also a contributor. This was worsened by the growing number of complex financial transactions, most of which were beyond understanding of board members, who had gained their experience before such instruments came into being. Even a former accounting professor heading Enron's Audit Committee, a person of utmost integrity, had difficulty understanding the implications of the company's financial manoeuvring.

Finally, the biggest culprit is the corporate culture. Focus was laid on short-term gains forgetting about all long-run considerations. Also the executive scorecard became focused on salary. Many players had become greedy — executives, investors, and attorney, among others — but more than that was the need to compete on the basis of compensation.

Implications for accounting educators

The perpetrators of most of financial reporting scandals are former students, graduates of accounting or MBA programs. So educators must ask themselves: What are they doing wrong and what must they do to fix the problems?

The first obvious reaction is to emphasize ethics in business and accounting curricula. This is important. Educators in a business ethics class can not dissuade someone who is inclined to commit a fraud from doing so. But it is also true that most perpetrators did not at the onset set out to commit a fraud. They simply got ended up on a slippery zone.

Also, the most disappointing aspect about most of the scandals is the number of people who, (though not personally involved) knew what was happening and still did nothing. Exceptions to the rule are some courageous whistle blowers, many of whom were products of university accounting programs. Thus, the focus of ethics classes should be to recognize and analyse the situations that can lead to compromise on one's ideals and values, and to promote the reporting of inappropriate behaviour. This can be best done in context because ethics issues come up in context, with you imagining yourself in the real situation. It is easy to go into an ethics class and give the answer that the instructor wants. It is an altogether different thing to put one's self in a case situation with conflicting pressures, and determine the appropriate action when ethics is only one of the many factors impacting your decision.

Conclusion

The accounting profession is in the middle of a challenging time. A reputation gained over years and decades can be lost in a day. Accountants were thought of as persons of high integrity working at an uninteresting job. In the current scenario the job has gotten more interesting, but at the cost of their reputation for integrity. It is essential to win back the trust of the public and maintain their belief in the importance of accounting. The road to restoring integrity of accountants today is a long one. The job will neither be quick nor easy, with the new series of financial reporting scandals that have come up.

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