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The Jihad Against Accounting Fraud

Speech by Donald L. Luskin

I'm honored to be here at the Cato Institute's annual Club 200 Retreat. But I have to say, I think it's unfair that *other* guest speakers get to talk about exciting things like biotechnology. But Bill Niskanen is going to make *me* talk about... *accounting.*

I suppose that could be because I don't know anything about biotechnology. But I do know a lot about accounting. I guess the good news is that right now lots of people actually think that accounting is interesting.

After Enron and WorldCom, accountants and auditors are suddenly the most interesting people in the world. They are portrayed by politicians and the media as great criminal masterminds -- the Osama bin Ladens of capitalism. And congress and the media have their own private war on terrorism aimed at them.

But Enron and WorldCom and the other cases of large-scale accounting fraud aren't the whole reason for that. Let's say there have been maybe a dozen cases like that. Out of about 16,000 public companies, that's an incidence of only 7/100 of one percent. That means that accounting if purer than Ivory soap -- Ivory is 99-44/100% pure, and accounting is 99-93/100% pure.

Yet *this* was enough to drive senators and congressmen of both parties, and every media pundit in America -- even the two or three of them who hadn't been on Enron's advisory board -- into a frenzy of fear and vengeance. During the summer it turned into a game of "can you top this?" Who could be the toughest on "corporate crooks"? When it was all over, President Bush signed the Sarbanes Oxley Act -- and happily, too. A free-markets Republican president signed the most sweeping financial regulatory legislation in memory.

I'm sure I don't need to explain to this group the political motivations involved. What I want to focus on is why the issue of accounting fraud proved to be so powerful. I contend that it's for reasons that go beyond just a 7/100 of one percent incidence of fraud.

I think it's because Americans are disappointed and angry that the boom times of the 1990s are over. Many are pissed off that they bought stocks at $250 a share three years ago that are now trading at $2.50 a share. With the economy in recession, and after the blow of September 11, America wants its boom back, and it doesn't know how to get it. And those investors who paid $250 a share sure don't know how to get their money back. They wonder, pronouncing to themselves the four most tragic words on Wall Street: "what was I thinking…?" And the only possible answer is, "Someone must have lied to me."

It's not just formerly irrationally exuberant busted day-traders who think that, either. I talk to the biggest professional investors in America every day, and many of *them* think the same thing.

They see restructuring charges that seem to occur every quarter getting booked as "non-recurring items." They see gains in the pension fund getting booked as operating income. They see the cost of stock options getting booked at zero. All of those "lies" perfect "truths" under generally accepted accounting principles. But add it up, and if you're in a bad mood to begin with, you could start to think that it's all a big fake. As a Morgan Stanley strategy report last week put it, it's "lies, damn lies, and S&P earnings."

If you're in a better mood, you could say it's just putting the best face on things -- and it's the job of the diligent investor to see through all that. In the case of every one of the accounting "lies" I just mentioned, the information typically provided in financial statements is more than adequate to allow you to see the worst face on things, if that's what you want to do.

In fact, I encourage all of you to go through the exercise of reading Enron's last annual report -- the last one they filed before the wheels came off. Enron was an exception case of fraud from top to bottom -- a classic "long con," the "big store." But even at that, while no doubt the Arthur Andersen firm helped them cover up plenty, the footnotes to the financial statements were enough to tip off any reasonably sentient analyst to the reality of those famous special purpose entities and related party transactions.

Here's a choice one: "In 2000, Enron sold a portion of its dark fiber inventory to the Related Party in exchange for [$100 million]. Enron recognized gross margin of $67 million on the sale."

In other words, Enron sold $33 million worth of dark fiber to itself for $100 million and booked a $67 million profit. Does that sound reasonable to you? No… and I'm not saying it is reasonable. I'm saying you could have learned about it before it was too late. But to do that you had to actually read the footnotes. Back then nobody did, apparently. There is none so blind as he who cannot see. And you can't cheat an honest man.

But the goal of Sarbanes Oxley is to make it so that you don't have to read the footnotes, or anything else. Because from now on, if a CEO or CFO does anything less than "fairly presents, in all material respects, the financial condition and results of operations," he pays a $5 million fine and goes to jail for 20 years. That's the same sentence the American Taliban John Walker Lindh got for treason.

Like so many laws, this one sounds good when you say it fast -- why shouldn't a CEO go to jail for fraud? But, also like so many laws, this one is rife with devilish details and unintended consequences.

These penalties are in Section 906 of Sarbanes Oxley. It takes up less than half a page of text, appearing on page 126 of this 130-page law. It was a last minute add-on. According to a senior Securities and Exchange Commission staff official I spoke to, "some very sleepy senators decided to add Section 906." She added: the people who wrote this law are "idiots."

First, Section 906 took effect the moment that Bush signed the Act on July 30. It requires that financial statements be certified by the CEO and CFO *when filed*. That gave most of the 16,000 public companies in America just two week's warning. The normal quarterly filing deadline was August 14.

Second, there are no objective standards for exactly what CEO's or CFO's are actually certifying. What does "fairly" mean? What is "material"? Is it enough if you comply with generally accepted accounting principles? What if you don't think those are "fair" -- should you violate them? Who knows -- but the CEO or CFO who guesses wrong is a felon.

Third, there's no "to the best of my knowledge" safe harbor. The penalties -- the $5 million and the 20 years -- are only for CEO's and CFO's whose violations are "knowing." But penalties are determined in a separate trial phase from guilt or innocence. That means that a CEO won't *go to jail* unless his violation is "knowing," but he could still be found guilty of a felony. After explaining this part to me, my SEC source asked, "Did I mention the 'i'-word already?"

Fourth, Sarbanes Oxley contains an entirely separate section -- Section 302 -- that instructs the SEC to go through its normal rules-making process to come up with procedures for CEO and CFO certification. And now they have done that. So now there are two entirely separate certification laws, each with different requirements.

My SEC source tells me that the SEC and the Department of Justice want congress to go back and amend Section 906 to remove these confusions. But as she put it, "There's an election coming up, and they're too busy doing Martha Stewart."

Out of up to 16,000 public companies, who knows how many of them were unaware that the certification requirement existed, with the law having been in effect just two weeks when the first deadline arrived? Who knows how many will have certified financials that will be found later not to be "fair" (since no standards of fairness were established)? Who knows how many will contain mis-statements that are "material" (since no threshold of materiality was specified)?

For every unknown in Section 906, a Sword of Damocles now hangs over the heads of every public company CEO and CFO. How would you like to be the CEO of Citigroup, signing off that the accounting for your banks in the Congo -- to pick a foreign subsidiary at random from their latest 10-k -- is "fair" and that you've included everything that is "material"?

When bad laws like this create such risk for CEO's and CFO's, good men and women aren't going to want to be CEO's and CFO's any more. If this goes on, these callings will only attract the monastic, the power-mad, or the corrupt. Basically, the same kind of people who go into politics.

So who will profit now from the phone-book length financial statements that will result from Sarbanes Oxley's pursuit of perfect truth in accounting? I doubt investors will -- they didn't read financial statements before, and they probably won't read them in the future when they're five times as long.

And no amount of accounting truth is going to keep companies from making mistakes, or keep investors from betting on companies that make mistakes. All the accounting disclosure in the world isn't going to make it a good idea for there to be a public company with a market cap of $1 billion dedicated to selling dog food on the Internet.

The one sure winner will be the US Treasury. There's a reason why there isn't always a lot of information in financial statements on special purpose entities and related party transactions. It's because their business purpose is simply to minimize taxes -- and a noble purpose that is. Now, Sarbanes Oxley forces companies to reveal that purpose -- it's "material" and "fair," right? And if you don't, you go to jail. But to do so is to sign a confession for the Internal Revenue Service. What a surprise -- the legislative war on corporate crooks just happens to end up effectively creating a corporate tax hike.

This isn't the only tax hike. The other is the proposal to change the basis on which companies can deduct the expense of stock options. Under current tax law, companies can treat the "exercise value" of options as a business expense, handling it just like any compensation costs. When I say "exercise value," I mean the value that an option-holder gets when he exercises an option. If the option is issued at 10, and the stock is at 50, then the exercise value is 40 -- that is, 50 minus 10. That's what the option-holder pays taxes on, and that's what the company treats as an expense on its tax returns.

But Senate Bill 1940, introduced by Michigan's Carl Levin and Arizona's John McCain, would change all that. Under this bill, a company would only be able to treat as a business expense for tax purposes any option expense it had also declared on its financial statements under generally accepted accounting principles.

It's all dressed up as being about accounting integrity, forcing companies to report their options expense in their income statements. But here's the gotcha. If you do what most companies do now and report zero options expense, you get zero tax deduction. But the only alternative under GAAP is to report the Black Scholes value of the options when they are issued. That's lower than the value of the options years later when they are actually exercised -- and that means a lower tax deduction.

Last year this difference would have cost Cisco $1.6 billion in higher taxes. It would have cost Sun Microsystems $700 million, and Oracle $1 billion. Don't even ask about Microsoft. This isn't just a matter of accounting appearances. This is a vast tax increase, taking money right out of the hands of the smart people in Silicon Valley and shipping it off to the stupid people in Washington. Can you think of a better way to wreck the economy?

The provisions of Senate Bill 1940 got dropped from Sarbanes Oxley at the last moment, thanks to the principled intervention of Senator Phil Gramm -- but I guess he could afford to be principled, since he's retiring this term. But Levin and McCain will be back. Yet another argument for term limits!

So don't be naïve about this. Very little of the legislative jihad against accounting fraud is really about accounting.

It's about letting losers off the hook for the stupid mistakes they made at the top of the bull market, and finding a scapegoat for them. It's about political power -- subjective, ambiguous laws that criminalize CEO's, CFO's, accountants and auditors at the arbitrary discretion of government authorities. And it's about taxes. It's always about taxes.

Here's what I think we ought to be doing. Let's return the power to discipline public companies back to that entity most easily able to do it -- the market. Once upon a time, when CEO's, CFO's, accountants or auditors made a mess of things, vigilant opportunistic investors could organize hostile takeovers and throw the rascals out.

Remember the "barbarians at the gate" who liberated RJR Nabisco from entrenched management and returned it to its shareholders? That was but one of dozens of self-corrective hostile takeovers sponsored by activist investors like Kohlberg Kravis Roberts, and fueled by Michael Milken's junk bonds. But an end was put to that in the last great wave of financial regulation, which culminated in Milken's imprisonment and the collapse of his firm, Drexel Burnham Lambert. And once the cat was out of the way, the mice had a field day -- and that's what brought us to the sorry state we are in today.

So now, instead of adding new regulations of the type that created our problems in the first place, let's free the market to discipline *itself* again like it used to.

You wonder why the Dow Jones is below 8,000? It's not because of the recession -- we're slowly recovering. It's not because of Iraq -- we've been there before. It's because of *this* -- the legislative jihad against accounting fraud amounts to a war on capitalism, and the long-term implications for growth and productivity are terrifying. And our Republican president is too busy on other matters -- and too popular -- to bother to stop it.

About the Author

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