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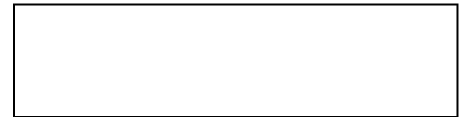

FEATURE

Dirty Rotten Numbers

Enron has made us shine a light on the books of America's public companies. Now, if your company carries even a hint of bad accounting, the stock will be savaged.

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By Andy Serwer

In E.B. White's classic children's book Charlotte's Web, there's a scene in which Templeton the rat has just stuffed himself with the garbage left behind after a fair. "What a night," he says. "What feasting and carousing. Never have I seen such leavings, and everything well ripened and seasoned with the passage of time and the heat of the day. Oh it was rich, my friends, rich." That's what happens at the end of a fair or a carnival. After all the crowds and the excitement, what remains is nothing more than half-eaten cotton candy and assorted other trash. And so it is with the 1990s bull market. The tech-stock hawkers, mindless speculators, and clueless dot-commers have pulled up their stakes, and what we're left with is a bunch of smelly debris. The problem is, our digestive tracts aren't like Templeton's. We can't eat this stuff.

There's something terribly rotten with American business right now, and it's making a lot of us sick. All the new-economy lying and cheating that went on back in the '90s has come back to bite us in the you-know-what. And now it's judgment day. No more excuses. No more extended deadlines, extra lines of credit, or skeevy numbers. No more "just trust us." No more b.s. Even as Wall Street gazes hopefully at signs of a recovery, the market is ruthlessly separating the haves (as in, your numbers are on the level) from the have-nots (your numbers stink!). "It's sell first and ask questions later on anything that doesn't look clean," says Steve Galbraith, chief investment officer at Morgan Stanley.

Obviously, the trigger event here was the Enron scandal, which would give even Templeton the rat indigestion. Yes, Enron may have been a rogue operation, but its collapse has forced us to shine a halogen light on the books of America's public companies, and what we're seeing sure ain't pretty. In the last couple of days of January alone, stocks of Tyco, Cendant, Williams Cos., PNC, Elan, and Anadarko were brutally punished for alleged or acknowledged accounting problems.

The price we, the public, pay for all this is absolutely mind-boggling. Former SEC chief accountant Lynn Turner, who's now teaching at Colorado State University, estimates that over the past six years, the cost to investors--in terms of stock market losses--of financial restatements is well over $100 billion. And that doesn't include Enron, which is in a league of its own. As Turner points out, the cost of Enron's failure is roughly six times the $15 billion loss suffered from Hurricane Andrew.

But the ultimate cost could be much larger. If Wall Street's growing anxiety about the quality of corporate earnings leads to lower multiples, CEOs will face increased pressure to maintain earnings by cutting back on things like capital spending, dealing a potentially lethal blow to the recovery. "I'm deeply worried about the effect of Enron on business confidence," says the CEO of a major technology company.

It is an environment that disturbs even the most seasoned Wall Street hands. "It's hard for me not to be angry," says Goldman Sachs' CEO, Hank Paulson, with regard to Enron and others that cross the line. "It's an issue of reputational impairment. Accounting is the lifeblood of our capital markets system, and we have a great need for improvement." Arthur Levitt, former head of the SEC, is even blunter: "America's investors have been ripped off as massively as a bank being held up by a guy with a gun and mask."

Companies Under the Gun

Company	
Tyco	It's impossible to tell from the financial statements just how much of the conglomerate's earnings growth is being generated from its continual stream of acquisitions--and how much is actually sustainable.
Williams Cos.	Management admits it's in a fog about how to account for more than $2 billion in debts owed by a former subsidiary. No sign yet of a fourth-quarter earnings release.
J.P. Morgan Chase	Investors are only now discovering that the bank may lose billions from its dealings with Enron. The company's financial statements provide no mention of the exotic offshore vehicles that it used to do business with the fallen energy company.
Calpine	Last year the SEC instructed it to change the way it presents Ebitda in its annual report.
RSA Security	In 2001 the company began booking sales as soon as its software was shipped to distributors--why wait until an end user actually purchased it? The SEC is investigating whether the change was adequately disclosed to investors.

Setting a Good Example

Company	
Boeing	Instead of burying stock compensation expenses deep in the footnotes, Boeing actually puts them in the income statement.
Amerada Hess	The oil company chooses to expense unsuccessful exploration costs as soon as they're incurred rather than spread them out over several years.
FPIC Insurance	Insurance companies can manipulate earnings by playing with reserves for claims. FPIC recently adopted a more conservative approach to setting up reserves--a method that lowers today's earnings.
Synopsys	Some software companies boost earnings by booking all the revenues from a multiyear contract as soon as the product is shipped. Synopsys instead books revenues evenly throughout the contract's life.
Wal-Mart	A new accounting rule involving goodwill amortization will increase the 2002 earnings of many companies--management talent has nothing to do with it. Wal-Mart has already fessed up and disclosed the earnings boost the rule change will give it.

So what's going on here? Have we entered a new era of corporate moral decay? Why is this happening now? And what in the world can be done to fix this mess?

First, understand that dodgy accounting, or bad numbers, or whatever you want to call it, covers a multitude of sins. There are companies that, with or without

the help of auditors, commit out-and-out fraud. Less egregious but almost as deadly to shareholders are companies that screw up unintentionally and are forced to restate their numbers. And then there are companies--and this is the largest club, including many of America's bluest of blue chips--that bend and stretch accounting rules to make their numbers prettier. It's not fraud--it's even legal--but it's deceptive.

No one can calculate how many companies are playing loosey-goosey with their books right now. We can only count them when they get caught, or when they restate earnings, or when a journalist or an analyst (God forbid!) raises a red flag. What's clear, however, is that there is more bad accounting out there than ever before. According to Michael Young, a lawyer at Willkie Farr & Gallagher, 116 companies needed to correct or restate their financial statements in 1997. By 2000 that number had more than doubled, to 233. Last year was probably worse. In a separate, confidential survey of big-company CFOs, some two-thirds said they had been pressured by their bosses to misrepresent financial statements. Only 55% said they had successfully resisted.

How did things get so wiggy? Declining corporate ethics definitely plays a role. "Today is significantly different from the 1950s," says Berkshire Hathaway CEO Warren Buffett, who has long been critical of accounting ruses. "Back then there was less disclosure, but the disclosure you had was accurate. In the 1960s you started to have more games being played. Conglomerates were trying to pump up their stock to use it as currency in takeovers, but old-line America didn't do it. It was still the good guys vs. the bad guys. It's not like today, where too often otherwise high-grade companies start with a number [for quarterly earnings] and work backward. Situational ethics has reared its ugly head."

Changes in the bean-counting business certainly haven't helped matters. In the late 1970s the federal government pushed the accounting profession to abandon a code of conduct that prevented accounting firms from undercutting one another on price or even soliciting a company that used another of the Big Eight (now Big Five) firms. The FTC said this was anticompetitive (which it was), but it also protected accounting firms from CFOs who didn't like being told no. Under the new rules, if the auditor doesn't play ball with an aggressive CFO, it is much easier for the company to tell the auditor bye-bye.

But the single biggest reason behind the recent spate of God-awful accounting has got to be the rise of the cult of the shareholder. Simply put, over time so much focus has been placed on levitating companies' stock prices that many executives will do almost anything--legal or otherwise--to make it happen.

The cult of the shareholder began during the takeover and LBO boom of the 1980s, when corporate raiders forced CEOs to "maximize shareholder value." The explosion of stock options in the 1990s created millions of employee shareholders dependent on rising stock values. Then there are retirement accounts. (God love them!) Newfangled 401(k)s often became loaded up with company stock, making the daily gyrations of share prices a nationwide infatuation.

Let's not forget about senior management, which was increasingly paid in stock and options, and often compensated based on the performance of its stock or the company's earnings growth. Says Harvey Goldschmid, a Columbia Law School professor who worked with Levitt at the SEC: "Previously the CEO's job was much more secure. Today, with CEOs that much more accountable for their stocks' performance, they are under greater pressure to keep the share price up." And for one group of acquisitive companies, a high stock price was even more important. Cisco, Tyco, and others bought dozens of companies in the late 1990s, almost always with stock. The higher the stock price, the more companies they could swallow.

Of course Wall Street was a willing accomplice in all this. Analysts' reports became compromised by the banking side of their firms, looking to protect lucrative relationships with clients. According to Frank Partnoy, a law professor

at the University of San Diego, as late as October 2001, 16 of 17 securities analysts covering Enron rated it a strong buy or a buy. Scary stuff.

The earnings guidance game, of course, is another facet of the corruption of independent analysis. Companies guide the analysts to a number and then magically beat it by a penny. The most adroit at this technique was Cisco, which until recently "beat" the Street estimate by 1 cent, quarter after quarter. That brings us back to what Buffett said about backing into quarterly earnings. If your company did 23 cents in Q1 '98, and you told the Street you were growing at 17%, then you damn well better hit 27 cents in Q1 '99! To Buffett this practice practically necessitates cheating. "No large company can grow earnings 15% quarter after quarter like that," he says. "It isn't the way business works."

And so to keep those earnings gains coming, executives have resorted to various gambits. One familiar one is trade loading, or borrowing from next quarter's sales, as Gillette once practiced--shoving razorblades into the channel in quantities that exceeded consumer demand. Or a company tries to book sales that may occur down the road. Some suggest that Verisign, which registers domain names, employs this practice. "You get a domain name for 29 bucks for a year, and then the company asks you if you want to re-up," says a hedge fund manager who has shorted the stock. "Even if you don't pay for the next year, Verisign books your next year's fee as deferred revenue, assuming you will come back." Verisign says it books roughly half of those fees.

How about vendor financing? That's when a company lends money to a customer to buy its product. The big telco suppliers like Lucent and Alcatel got burned by this practice after weak customers went belly-up and simply defaulted on their loans. Another type of vendor financing may be found in the consumer area. Ford, for instance, is heavily into lending customers money to buy its cars and trucks. Let's take a minute and drill down into Ford. Vroom! Vroom! A troubled company right now, but still a great American brand. Makes cars. Sells cars. Simple, right? Maybe not.

More and more, Ford is relying on its financing business. There's nothing wrong with that per se, but (1), many investors may not realize that, and (2), that business has its own pitfalls. In 2000, $28.8 billion, or 16.9% of Ford's $170 billion in revenues, came from its financing business. Last year financing accounted for more than 18.9% of its sales. In the past, financing had been a moneymaker for Ford, but with the company offering 0% financing to boost car sales, this business lost $360 million in the fourth quarter of 2001. So is finance a loss leader for car sales? Not exactly. Sadly for Ford, even with 0% financing, its auto business lost $4.7 billion in the same quarter.

Another ploy is so-called cookie-jar accounting, in which a company sets up reserves and then reverses them later to smooth out its financial returns. There are games that can be played with pension funds to smooth out earnings. For instance, through some mind-numbingly complex accounting maneuvers, a company can inflate its earnings simply by increasing a pension fund's assumed return. IBM has done that recently.

And then there are the games companies play with write-offs to smooth earnings. Called the big bath, it's where a company throws all kinds of expenses into a write-off or restructuring charge, booking costs now, which makes earnings look better down the road. Get this: According to Zacks Investment Research, only 31 companies now in the S&P 500 reported negative nonrecurring items in 1992. In 2000, 247 logged negative nonrecurring items! Twenty-eight of the nation's 1,000 largest companies registered negative nonrecurring items for the past eight quarters in a row. Is it possible companies have made so many bad decisions that they actually require all those write-offs? Well, it is true that today's companies are bigger and more global, and in a more deregulated business environment. And yes, that makes their books more complex, but many of the write-offs are about smoothing, which makes financial statements

even murkier. "When I take a look at a company's annual report, if I don't understand it, they don't want me to understand it," says Buffett.

Of course, the latest accounting wrinkle made famous by Enron is "special purpose entities". The key issues here are, Should these partnerships be consolidated onto a company's balance sheet, and/or are they material enough to report to shareholders? What makes a lot of SPEs tick are derivatives. "At its core Enron was a derivatives-trading firm," writes Partnoy in submitted testimony to the U.S. Senate. According to Partnoy, Enron had $2.7 billion of operating income from derivatives in 1999 and 2000. In the same period its ordinary operations lost $947 million. None of that was readily apparent to anyone except a forensic accountant.

There's a problem here. Generally Accepted Accounting Principles, or GAAP, require a company to show bad stuff. But companies have found a neat way to circumvent GAAP: Keep analysts and investors focused on, well, what companies want them to focus on! One way to do that is by ginning up pro forma earnings like Ebitda--earnings before interest, taxes, depreciation, and amortization--which some observers derisively refer to as "earnings before bad stuff." Originally pro forma was used to help investors. If a company sold a plant and booked a one-time gain, pro forma stripped out the gain to show what the company's operations were actually doing. But now pro forma is used to skew and to hide.

Basically, pro forma earnings allow a company to show investors the quarter through rose-colored lenses. Things like nonrecurring items are ignored. For the first three quarters of 2001, three Nasdaq giants--Cisco, Dell, and Intel--reported combined pro forma earnings of $4.4 billion. What were real GAAP earnings to the SEC? A $1.4 billion combined loss.

One way the sport is played is that soon after the quarter is closed, a company issues a press release with the requisite rosy pro forma numbers. The company's 10-Q, which is filed with the SEC, doesn't come out for up to 45 days after the end of the quarter. Here the company will present its less flowery GAAP numbers, "but by that time, they've got you focused on the next quarter, or so they hope, so it is ignored," says forensic accountant Jack Ciesielski. The SEC seems to be cracking down on this game, however. It recently issued a cease-and-desist order against Trump Hotels & Casino Resorts for issuing a misleading earnings press release.

And where, you may be asking at this point, are the auditors in all of this? Well, some would say, in many instances they are complicit. Bending or stretching rules doesn't entail breaking rules, so auditors are happy to sign off on statements that don't violate the letter of the law. "Hard-and-fast rules, or 'bright lines,' actually encourage this," says Ciesielski, "since it means that accountants can work up something that gets around the rules." In other words, a company can mislead investors--and still be following GAAP to a tee. GAAP's bright lines differ from British accounting regulations, which are less specific but basically require that auditors don't violate the spirit of the law.

Enron shows auditor/client complicity at its absolute worst. The ties there were so close that any notion of an "independent" auditor was lost. Enron hired all sorts of Arthur Andersen employees, and the auditor billed more than $25 million in consulting fees to the company in 2000. "The auditors say the situations are too complicated--well, if the business was so complicated, why did they sign the 10-Q?" asks forensic accountant Howard Schilit. "Auditors should be like referees in football. Sometimes you don't like the zebras, but that's just too bad."

As for who's auditing the auditors, well, that's a good question. Auditor oversight and regulation can only be called byzantine, inefficient, and incomplete. First, the SEC has oversight authority on everything that goes on regarding GAAP and the auditing of publicly owned companies. There is an SEC Practice Section, composed of 1,300 accounting firms, that audits publicly owned companies, establishes quality control requirements for member firms, and reviews

allegations of audit failure. A Public Oversight Board was created to oversee and report on the activities of the SEC Practice Section. The board's members are independent, and it mainly oversees peer reviews that one accounting firm does of another's work. But all of the members of the POB resigned in late January after being slighted by new SEC chief Harvey Pitt, who recommended establishing a new oversight board.

The Financial Accounting Standards Board (FASB) determines what GAAP shall be. FASB's Emerging Issues Task Force (EITF) deals with questions that come up about the interpretation of GAAP. Then there's the American Institute of Certified Public Accountants (AICPA), essentially the industry's trade organization. The Accounting Standards Executive Committee (AcSec) is the AICPA's official voice on financial reporting standards. The Auditing Standards Board (ASB), which worries about auditing procedures, is also part of the AICPA. Whew! Got that? It may be a rat's nest partly by design. After all, the industry has lobbied very effectively over the years (ask Levitt and Turner about that) to block reforms as well as any sort of effective independent oversight.

Okay, so how do we fix this mess? Who do we go after? "This is almost like the war on terrorism," says Schilit. "It's a huge problem that will take time to fix. The culture of the big accounting firms needs to change. People in the firms need to know that this is a public calling. The highest responsibility is to investors."

Here are just a few of the proposals being bandied about. Turner suggests that auditors should be required to rotate clients after several years. He also suggests that companies be required to file an 8-K (an SEC report of a noteworthy corporate event) if and when a CFO leaves the company, explaining why he left. (Think Andy Fastow and Enron here for a minute!) Harvey Goldschmid, the Columbia law professor, proposes an independent accountancy board (with teeth!) for the auditing community. Arthur Levitt agrees with Goldschmid and adds, "The independent board must have subpoena power."

Then there is a move afoot to bar firms from doing both audit and consulting work for the same client. Recently four of the five biggest audit firms (Deloitte & Touche is the holdout for now) announced they were taking steps to move in that direction, saying they would no longer do certain technology consulting for clients whose books they audit. And separately, Disney recently became the first major company to say that it will no longer allow its auditor to do consulting work.

But perhaps the best place to focus attention is on the audit committee of boards of directors. Warren Buffett proposes that the audit committee have a Q&A session with auditors (for a list of his suggested questions as well as others' proposals for reform, see The System's Broke). "You can't meet on an audit committee for two hours twice a year and really know what's going on," says Buffett. "Auditors most of the time will know--put them on the spot." And Buffett wants these questions and answers to go into the minutes unfailingly.

Then there is the question of jail time for those convicted of willful fraud. Almost everyone interviewed for this story thought that was a good idea. Both Buffett and Goldschmid point out that jail time may not always deter burglars, but it does tend to have a particularly healthy effect on white-collar crime. "I think it's going to happen, and I think it will change behavior," says Buffett. Yes, executives have gone to jail for past abuses, but not the highest-profile ones like an Al Dunlap.

And there is one last option. Doing nothing. What would be the impact of that? Well, it could be that investors lose faith in our financial system. We may already be seeing some of that in the short term. "If that were the case, investors would require a greater risk premium for stocks," says Levitt. What does that mean? A risk premium in bonds is easy to understand. There, investors demand a greater yield for a riskier investment. But in stocks a higher-risk premium is expressed as lower stock prices. In other words, you would pay less for a riskier

stock relative to its earnings or dividends. So a lack of confidence would keep stock prices down.

For now, what's being called Enronitis shows no sign of abating. Reports of companies with accounting issues have been literally flooding the wires. At the top of the list was the Tyco, which like Enron was once a darling of Wall Street and is now fighting for its credibility. Sources said that as of late January Tyco was looking to arrange a capital infusion--maybe, for example, the sale of a large amount of preferred stock to a buyer of unquestioned reputation. (The company did secure a $1.5 billion bridge loan.) CIT (now called Tyco Capital), a finance company Tyco bought last year, requires constant access to capital. Whenever word begins to spread about weakness in a corporation, the financing arm feels it first and hardest. And then, when the financing arm can't raise money, that sends a very large signal about the whole corporation.

A signal that Wall Street is now hearing loud and clear.

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