Order Code RS21530
Updated September 15, 2004

CRS Report for Congress

Received through the CRS Web

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. The law strengthened regulation of auditors, required corporate management to certify the accuracy of their firms' financial statements, and increased penalties for a number of fraud-related offenses. (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 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 second choice to head the PCAOB, William McDonough, was former president of the Federal Reserve Bank of New York, and was widely respected in the markets. He took office on June 11, 2003, and under his leadership the PCAOB has gotten up and running without further controversy or mishap. 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 change in accounting methods, in this view, even though it would not require one dollar of additional cash expenditure by companies that issue options, would have real (and undesirable) economic consequences.

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. 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]

In April, 2003, the Financial Accounting Standards Board (FASB[2]), proposed requiring the expensing of options and began its normal process of public comment and deliberation. FASB appeared to be on course to adopt a final standard by the end of 2004, but Congressional action may result in a delay.

H.R. 3574, which passed the House on July 20, 2004, by a vote of 312-111, would prevent FASB from adopting an options accounting standard in 2004. The major provisions of the bill include the following:

- Section 2 requires companies that report to the SEC to record as an expense the fair value of options issued to the CEO and the four other most highly-paid individuals in the company. (Under current SEC rules, total compensation, including stock and options, for these five individuals must be disclosed in the annual proxy statement.) Options granted to other executives and employees could continue to be treated under current accounting rules, that is, disclosed in the footnotes with no effect on the bottom line.

- Section 2 also provides that in determining the fair value of an option to be expensed, the company shall assume that the volatility of the underlying stock is zero. This provision would result in many options having a value of zero, and thus the bottom line impact of many expensed options would also be zero.[3]

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[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)

[2] FASB is a private sector body that formulates accounting standards for companies that are regulated by the SEC. The SEC has statutory authority to set accounting standards, but generally defers to FASB. FASB standards are recognized as official by the SEC, and are therefore mandatory for companies that sell stock or bonds to the public and must file periodic financial reports with the SEC.

[3] Many stock options can be exercised only at a stock price above the current market price at the time the option is issued. The point is to create an incentive: executives' options become valuable only if the market price of the stock rises to the option's exercise price, which is good for all shareholders. But, if the assumption is zero volatility — that the share price will never

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- Section 2 would, however, permit companies to treat options as an expense voluntarily, as many have begun to do since the Enron scandal.

- Section 3 prohibits the SEC from recognizing any FASB standard relating to the expensing of options until an economic impact study had been completed by the Departments of Commerce and Labor. The study would be due one year from enactment of the bill.

- Section 4 requires the SEC to adopt rules mandating that companies' financial statements include more extensive and transparent discussions of the extent and economic impact of their option plans.

Other legislation before the 108th Congress would affect the tax treatment of certain stock options. Section 342 of H.R. 2, as amended and passed by the Senate on May 15, 2003, would have imposed 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). This provision was not included in the bill as enacted, but similar tax provisions appear in H.R 4520 (passed the House on June 17, 2004) and S. 1637 (passed the Senate on May 11, 2004).

Derivatives Accounting and Disclosure

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 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.

Since the Enron failure, several energy derivatives dealers have admitted to making "wash trades," which lack economic substance but give the appearance of greater market volume than actually exists and facilitate deceptive accounting (if the fictitious trades are reported as real revenue). In 2002, energy derivatives trading diminished to a fraction of

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[3] (...continued)
move — those options will never come "into the money" and their accounting value will always be zero.

pre-Enron levels, as major traders (and their customers and shareholders) re-evaluated the risks and utility of unregulated energy trading. Several major dealers have withdrawn from the market entirely.

Internal Enron memoranda released in May 2002 suggest that Enron (and other market participants) engaged in a variety of manipulative trading practices during the California electricity crisis. For example, Enron was able to buy electricity at a fixed price in California and sell it elsewhere at the higher market price, exacerbating electricity shortages within California. The evidence to date does not indicate that energy derivatives, as opposed to physical, spot-market trades, played a major role in these manipulative strategies. Numerous firms and individuals have been charged with civil and criminal violations related to the manipulation of energy prices in California and elsewhere.

Even if derivatives trading was not a major cause, Enron's failure raises the issue of supervision of unregulated derivatives markets. Would it be useful if regulators had more information about the portfolios and risk exposures of major dealers in derivatives? Although Enron's bankruptcy appears to have had little impact on energy supplies and prices, a similar dealer failure in the future might damage the dealer's trading partners and its lenders and could conceivably set off widespread disruptions in financial and/or real commodity markets.

Legislation considered during the 108th Congress would have given (among other things) the Commodity Futures Trading Commission (CFTC) more authority to pursue fraud (including wash transactions) in the OTC market and to require disclosure of certain trade data by dealers in energy derivatives. In 2003, the Senate twice rejected legislation (S.Amdt. 876 and S.Amdt. 2083) that would have increased regulatory oversight of energy derivatives markets by the CFTC and FERC.

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 staff study appeared in July 2003. Its general tenor was that principles-based accounting held promise in the long term, but the SEC has not made a fundamental transformation of accounting into a short-term priority.