

Business Week

By Richard Melcher

WHERE ARE THE ACCOUNTANTS?

Why auditors end up missing so many dangers.

It read like a primer on how to cook the books. In letters to the board of directors of Aviation Distributors Inc. and the Securities & Exchange Commission a year ago, the company's auditors, Arthur Andersen, wrote of sweeping irregularities. The allegations included falsified shipping documents and purchase orders--problems so great that Andersen could no longer attest to the accuracy of three earlier years of Aviation Distributors' financial reports.

Andersen resigned from the account. The move set in motion a quick chain of events, from the delisting of the \$39 million company from the NASDAQ SmallCap market (it's now traded over the counter) to the resignation of President and ceo Osamah S. Bakhit.

It all seems so straightforward--a perfect example of the role accountants are supposed to play in keeping the financial system honest. The problem is, it doesn't seem to happen as often as it should. As one apparently prosperous company after another saw earnings crumble in the wake of an accounting scandal over the past year, the auditors--at least in their public statements--often acted as surprised as investors to see years of previously reported profits go up in smoke. None of the major firms has emerged unscathed.

To take just one of the headline screamers, how did auditor Andersen miss the red flags at Sunbeam Corp. last year, when inventories began piling up and accounts receivables soared? Chief Executive Albert Dunlap had never been exactly reticent about his desire to do all he could to keep his high-octane stock levitating. So shouldn't someone have noticed when the company reported surging sales of heating blankets in the summer and barbecue grills in the late fall?

Yet at a board meeting on June 9, a partner at Andersen assured Sunbeam directors that the 1997 numbers complied with standard accounting procedures. Four days later, the scheme unraveling, Dunlap was fired. Sunbeam later acknowledged it was booking sales before the goods were actually delivered to stores. Today, the sec is investigating Sunbeam's accounting. The company is expected to restate results for part of this year, 1997, and perhaps 1996. Andersen says it doesn't comment on clients.

Unfortunately, auditors seem to have allowed more and more of their clients to undercut the trustworthiness of their reported numbers with aggressive, albeit often legal, accounting for everything from restructuring or acquisition write-offs to the way sales are booked.

"WITHIN THE RULES." Certainly, no one would argue that auditors face an easy task. And give them their due: Auditing firms are resigning more accounts than ever, according to Public Accounting Report newsletter. And much of the problem stems from the fact that

those generally accepted accounting principles give management wide latitude in how it puts together the books.

Consider what auditors suggest is an altogether typical set of circumstances leading to aggressive accounting. Executives face missed earnings expectations or a tight bank-lending covenant, and their bonuses hang in the balance. Suddenly, environmental or other legal liabilities are minimized, or inventory depreciation gets stretched out, or a big push is made to drum up end-of-quarter sales.

If the company's competitors pursue similar practices, executives are prone to ask auditors to follow the leader. "Everybody's doing it" becomes the rule--or the excuse--as lowest-common-denominator accounting takes hold. Rather than pushing their clients to uphold higher standards, accountants sometimes acquiesce in a race in which those most willing to stretch the rules define the industry standard. The bottom line: Too often, auditors "opine on what is acceptable, not what is appropriate," says Katherine A. Schipper, accounting professor at the University of Chicago Graduate School of Business.

Sure, there is a raft of industry requirements to detect fraud. But auditors sometimes have resisted some past efforts to toughen standards. An industry panel recommended four years ago that accounting firms not just verify that numbers meet GAAP requirements but that they go a step further and flag a company when its disclosures and estimates are aggressive. But the idea has been only "minimally" embraced by companies and auditors, says Donald J. Kirk, executive-in-residence at Columbia University and former chairman of the Financial Accounting Standards Board, who led the panel.

FOOT IN THE DOOR. Those tendencies clearly have the Securities & Exchange Commission worried--and there are indications that the agency is determined to force changes. Spurred by the recent bookkeeping disasters, the sec is sending a message that it expects more from the Big Five auditing firms--Andersen, Ernst & Young, Deloitte & Touche, PricewaterhouseCoopers, and kpmg Peat Marwick. In recent meetings, regulators have warned partners that as the economy slows, corporations will be under even more pressure to stretch rules to meet their earnings numbers. The fear is management will "build more optimism into financial reporting, and they want us to make sure we are appropriately tough," says Deloitte Chairman and ceo J. Michael Cook.

But the sec's concerns go much deeper than that. Top agency officials, as well as some corporate directors and investors, worry that the explosion of nonauditing services at the Big Five, such as general consulting and merger advisory work, might create an incentive to go easy on auditing clients. Nonauditing services now make up more than 50% of revenues at the Big Five, according to Public Accounting Report. As the sec's top accountant, Lynn Turner, puts it: "When an audit partner at a major firm is faced with a tough decision, can the partner make that decision based solely on his or her judgment about what is best for investors, without worrying about the impact on career or compensation?"

A year ago, the sec signaled its concern by pushing for the formation of the Independent Standards Board. Made up of auditors and outsiders, the isb plans to issue guidelines and rulings to help the industry police the conflicts created by its nonauditing business. Senior partners readily admit that auditing is intensely price-competitive and often serves as a wedge to get in the door to sell other products. But they deny that standards have suffered

and say firms have safeguards to protect auditors' autonomy. Says Gregory A. Jonas, Andersen's managing director for financial statement assurance: "It's important that it's understood that those who stand up to pressure are rewarded as much as those who bring in new clients."

Another concern for regulators is the coziness that can develop between auditors and their clients. For reasons of career diversification and pay, many auditors switch over to the corporate finance staffs of their old clients. Corporate books end up being audited by the executives' former partners. Robert S. Miller, who was brought in to clean up a mess at Waste Management Inc., believes that may have been one factor behind the alleged accounting irregularities that led the company to restate six years of earnings downward by \$1.75 billion. Many finance executives had come from Andersen, he says, creating "too much of a close relationship between senior auditors and senior managers."

The Big Five try to head off those problems by rotating a partner off an account every seven years and having a second partner, not involved in the audit, sign off on each account. But auditors will need to do more if they hope to regain investors' confidence. Corporate boards could go a long way toward helping by making sure audit committees consist of truly independent businesspeople. Critics suggest having companies disclose how much of an audit firm's fees are for nonauditing work. "Let the public know whether the audit is the dog or the tail," urges accounting analyst Abraham J. Briloff.

There are signs that the increased scrutiny--plus fear of lawsuits--is pushing the Big Five to step up their vigilance. Andersen will soon institute a scale for spotting fraud or overaggressive accounting--for example, comparing market earnings expectations with management's ability to meet them. Already, the firm is encouraging auditors who spot oddities such as unsupported journal entries to dig for deeper problems. "You find out these things are like cockroaches: If you see one you're reasonably sure there are others," says Jonas.

But as long as corporate managers continue to look for ways to stretch the numbers, more problems are inevitable. "Investors have to understand that the safety net a clean-audit opinion provides can have big loopholes," warns Lawrence Revsine, an accounting professor at Northwestern University. Still, investors should expect better--from auditors and from the managers and board members who employ them.

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