FINANCIAL ACCOUNTING THEORY

Seventh Edition

William R. Scott

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William R. Scott
University of Waterloo

PEARSON
Toronto

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Preface

This book began as a series of lesson notes for a financial accounting theory course of the Certified General Accountants' Association of Canada (CGA). The lesson notes grew out of a conviction that we have learned a great deal about the role of financial accounting and reporting in our society from securities markets and information economics-based research conducted over many years, and that financial accounting theory comes into its own when we formally recognize the information asymmetries that pervade business relationships.

The challenge was to organize this large body of research into a unifying framework and to explain it in such a manner that professionally oriented students would both understand and accept it as relevant to the financial accounting environment and ultimately to their own professional careers.

This book seems to have achieved its goals. In addition to being part of the CGA program of professional studies for a number of years, it has been extensively used in financial accounting theory courses at the University of Waterloo, Queen's University, and numerous other universities, both at the senior undergraduate and professional master's levels. I am encouraged by the fact that, by and large, students comprehend the material and, indeed, are likely to object if the instructor follows it too closely in class. This frees up class time to expand coverage of areas of interest to individual instructors and/or to motivate particular topics by means of articles from the financial press and professional and academic literature.

Despite its theoretical orientation, the book does not ignore the institutional structure of financial accounting and standard setting. It features considerable coverage of financial accounting standards. Many important standards, such as fair value accounting, financial instruments, reserve recognition accounting, management discussion and analysis, employee stock options, impairment tests, hedge accounting, derecognition, consolidation, and comprehensive income, are described and critically evaluated. The structure of standard-setting bodies is also described, and the role of structure in helping to engineer the consent necessary for a successful standard is evaluated. While the text discussion concentrates on relating standards to the theoretical framework of the book, the coverage provides students with exposure to the contents of the standards themselves.

I have also used this material in Ph.D. seminars. Here, I concentrate on the research articles that underlie the text discussion. Nevertheless, the students appreciate the framework of the book as a way of putting specific research papers into perspective. Indeed, the book proceeds in large part by selecting important research papers for description and commentary, and provides extensive references to other research papers underlying the text discussion. Assignment of the research papers themselves could be especially useful for instructors who wish to dig into methodological issues that, with some exceptions, are downplayed in the book itself.

This edition continues to orient the coverage of accounting standards to those of the International Accounting Standards Board (IASB). As in previous editions, some coverage of major U.S. accounting standards is also included.

I have retained the outline of the events leading up to the 2007–2008 securities market meltdowns, since these events have raised significant questions about the validity of many economic models, and continue to have significant accounting implications. Ramifications of these events are interwoven throughout the book. For example, one outcome of the meltdowns is severe criticisms of the efficient market hypothesis. Nevertheless, I continue to maintain that investors are, on average, rational and that securities markets, while not fully (semi-strong) efficient, are sufficiently close to efficiency (except during periods of bubble and subsequent liquidity pricing) that the implications of the theory continue to be relevant to financial reporting. Critical evaluation of these various criticisms and arguments is given. Nevertheless, I have moved from Chapter 3 to the Instructor's Manual the lengthy outline of the diversified portfolio investment decision that was included in previous editions, replacing it with a much abbreviated discussion.

The Conceptual Framework retains its role as an important component of this book. As it is further developed, this framework will be an important aspect of the financial accounting environment. Its relationships to the theory developed here are critically evaluated. While extensive discussion of alternate theories of investor behaviour is retained, this book continues to regard the theory of rational investors as important to helping accountants prepare useful financial statement information.

The book continues to maintain that motivating responsible manager behaviour and improving the working of managerial labour markets is an equally important role for financial reporting in a markets-oriented economy as for enabling good investment decisions and improving the working of securities markets.

I have updated references and discussion of recent research articles, revised the exposition as a result of comments received and experience in teaching from earlier editions, and added new problem material. I also continue to suggest optional sections for those who do not wish to delve too deeply into certain topics.

Summary of Major Changes

Below is a comprehensive list of major changes made to the seventh edition of *Financial Accounting Theory*:

- Thorough review of recent academic accounting research, with updated explanations and discussion of important papers added throughout the text. The text represents the current state of academic accounting theory as published in major research journals up to about mid-2013.
- Increased attention to contract theory (replacing positive accounting theory), with Chapter 8 rewritten to fully explain the roles of reliability and conservatism of accounting information in securing efficient corporate governance, borrowing, and stewardship.
- Extensive discussion and evaluation of criticisms of securities market efficiency and investor rationality following the 2007–2008 securities market meltdowns. Much accounting research relies on these concepts. The important assumptions of rational expectations, common knowledge, and market liquidity that underlie market

efficiency theory are explained and discussed. The text concludes that relaxation of these assumptions is needed if accountants are to better understand the working of securities markets and the information needs of investors. The text also concludes that accounting-related securities anomalies, typically claimed to result from investor non-rationality, can also be consistent with investor rationality once these assumptions are relaxed. Theoretical and empirical papers supporting these conclusions are outlined (Chapters 4 and 6).

- New and proposed accounting standards, including for financial instruments, derecognition, consolidation, leases, and loan loss provisioning, are described and evaluated. Discussion of the Conceptual Framework is updated throughout the book.
- Discussion of standards convergence and the possibility of U.S. adoption of International Accounting Standards is updated to take recent developments into account (Chapter 13).
- Recent research using sophisticated computer software to evaluate the information content of the written and spoken word is explained and evaluated. The text includes coverage of research papers using this methodology to study the informativeness of Management Discussion and Analysis (Chapter 3) and of executive conference calls (Chapter 11).
- New problem material is added throughout the text, including numerical problems of present value accounting, decision theory, and agency. Other new problems are based on embedded value, earnout contracts, outside directors, bail-in bonds, delegated monitoring, ESO repricing, and Sarbanes-Oxley Act. Discussions and problem materials derived from recent accounting scandals (Groupon, Olympus Corp., and Satyam Computer Services) are also added.
- Discussion of whether information risk is diversifiable, and thus of the extent to which firms benefit from superior accounting disclosure, is updated in the light of recent research (Chapter 12).
- The lengthy explanation of portfolio theory, included in all previous editions, is moved to the Instructor's Manual, replaced by a much shorter explanation of portfolio diversification (Chapter 3).
- Discussion and illustration of Management Discussion and Analysis (Chapter 3) and of Reserve Recognition Accounting (Chapter 2) are updated.

SUPPLEMENTS

Instructor's Solutions Manual

The Instructor's Solutions Manual includes suggested solutions to all the end-of-chapter Questions and Problems. It also offers learning objectives for each chapter and suggests teaching approaches that could be used. In addition, it comments on other issues for consideration, suggests supplementary references, and contains some additional problem

material taken from previous text editions. The Instructor's Manual is available in print format and also available for downloading from a password-protected section of Pearson Education Canada's online catalogue (www.pearsoned.ca/highered). Navigate to your book's catalogue page to view a list of supplements that are available. See your local sales representative for details and access.

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I thank the large number of researchers whose work underlies this book. As previously mentioned, numerous research papers are described and referenced. However, there are many other worthy papers that I have not referenced. This implies no disrespect or lack of appreciation for the contributions of these authors to financial accounting theory. Rather, it has been simply impossible to include them all, both for reasons of space and the boundaries of my own knowledge.

I am grateful to Carolyn Holden for skilful, timely, and cheerful typing of the original manuscript in the face of numerous revisions, and to Jill Nucci for research assistance.

At Pearson Canada I would like to thank Gary Bennett, Vice-President, Editorial Director; Claudine O'Donnell, Managing Editor, Business Publishing; Megan Farrell, Acquisitions Editor; Kathleen McGill, Sponsoring Editor; Rebecca Ryoji, Developmental Editor; Jessica Hellen, Project Manager; Marg Bukta, Copyeditor; Raghavi Khullar, Production Editor; Proofreader, Sally Glover; and Claire Varley, Marketing Manager.

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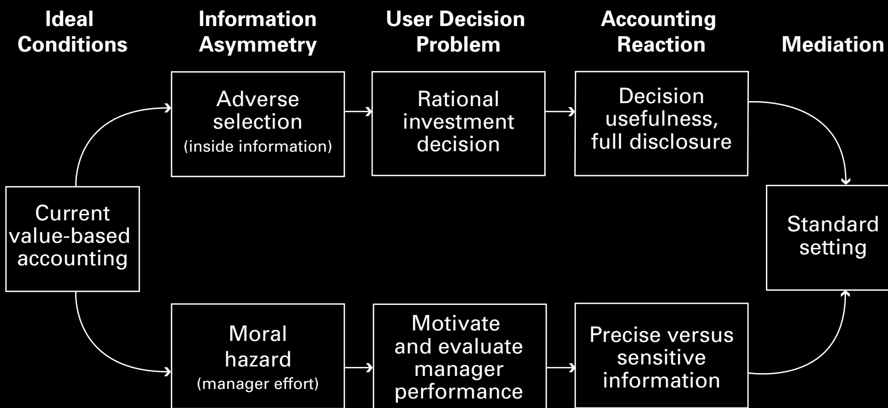
William Scott

Chapter 1
Introduction

Figure 1.1 Organization of the Book



1.1 THE OBJECTIVE OF THIS BOOK

This book is about accounting, not about how to account. It argues that accounting students, having been exposed to the methodology and practice of accounting, need to examine the broader implications of financial accounting for the fair and efficient working of our economy. Our objective is to give the reader a critical awareness of the current financial accounting and reporting environment, taking into account the diverse interests of both external users and management.

1.2 SOME HISTORICAL PERSPECTIVE

Accounting has a long history. Our perspective begins with the double entry bookkeeping system. The first complete description of this system appeared in 1494, authored by Luca Paciolo, an Italian monk/mathematician.[1] Paciolo did not invent this system—it had

developed over a long period of time. Segments that developed first included, for example, the collection of an account receivable. "Both sides" of such a transaction were easy to see, since cash and accounts receivable have a physical and/or legal existence, and the increase in cash was equal to the decrease in accounts receivable. The recording of other types of transactions, such as the sale of goods or the incurring of expenses, however, took longer to develop. In the case of a sale, it was obvious that cash or accounts receivable increased, and that goods on hand decreased. But, what about the difference between the selling price and the cost of the goods sold? There is no physical or legal representation of the profit on the sale. For the double entry system to handle transactions such as this, it was necessary to create *abstract* concepts of income and capital. By Paciolo's time, these concepts had developed, and a complete double entry system, quite similar to the one in use today, was in place. The abstract nature of this system, including the properties of capital as the accumulation of income and income as the rate of change of capital,[2] attracted the attention of mathematicians of the time. The "method of Venice," as Paciolo's system was called, was frequently included in mathematics texts in subsequent years.

Following 1494, the double entry system spread throughout Europe. It was in Europe that another sequence of important accounting developments took place. The Dutch East India Company was established in 1602. It was the first company to issue shares with limited liability for all its shareholders. Shares were transferable, and could be traded on the Amsterdam Stock Exchange, also established in 1602. In subsequent years, the concept of a joint stock company, with permanent existence, limited liability, and shares traded on a stock exchange, became an important form of business organization.

Obviously, investors needed financial information about the firms whose shares they were trading. Thus began a long transition for financial accounting, from a system enabling a merchant to control his/her own operations to a system to inform investors who were not involved in the day-to-day operations of the firm. It was in the joint interests of the firm and investors that financial information provided by the firm was trustworthy, thereby laying the groundwork for the development of an auditing profession and government regulation.

In this regard, the English 1844 Companies Act was notable. It was in this Act that the concept of providing an audited balance sheet to shareholders first appeared in the law, although this requirement was dropped in subsequent years[3] and not reinstated until the early 1900s. During the interval, voluntary provision of information was common, but its effectiveness was hampered by a lack of accounting principles. This was demonstrated, for example, in the controversy over whether amortization of capital assets had to be deducted in determining income available for dividends (the English courts ruled it did not).

In the twentieth century, major developments in financial accounting shifted to the United States, which was growing rapidly in economic power. The introduction of a corporate income tax in the United States in 1909 provided a major impetus to income measurement and, as noted by Hatfield (1927, p. 140), was influential in persuading business managers to accept amortization as a deduction from income.

Nevertheless, accounting in the United States continued to be relatively unregulated, with financial reporting and auditing largely voluntary. However, the stock market crash of 1929 and resulting Great Depression led to major changes by the U.S. government. The most noteworthy was the creation of the Securities and Exchange Commission (SEC) by the Securities Act of 1934, with a focus on protecting investors by means of a disclosure-based structure. The Act regulates dealing in the securities of firms that meet certain size tests and whose securities are traded in more than one state. As part of its mandate, the SEC has the responsibility to ensure that investors are supplied with adequate information.

Merino and Neimark (MN; 1982) examined the conditions leading up to the creation of the SEC. In the process, they reported on some of the securities market practices of the 1920s and prior. Apparently, voluntary disclosure was widespread, as also noted by Benston (1973). However, MN claimed that such disclosure was motivated by big business's desire to avoid disclosure regulations that would reduce its monopoly power.

Regulations to enforce disclosure would reduce monopoly power by better enabling potential entrants to identify high-profit industries. Presumably, if voluntary disclosure was adequate, the government would not feel that regulated disclosure was necessary. Thus, informing investors was not the main motivation for disclosure. Instead, investors were "protected" by a "two-tiered" market structure whereby prices were set by knowledgeable insiders, subject to a self-imposed "moral regulation" to control misleading reporting. Unfortunately, moral regulation was not always effective, and MN referred to numerous instances of manipulative financial reporting and other abuses, which were widely believed to be major contributing factors to the 1929 crash.

The 1934 securities legislation, then, can be regarded as a movement away from an avoidance-of-regulation rationale for disclosure toward one supplying better-quality information to investors as a way to control manipulative financial practices.[4]

One of the practices of the 1920s that received criticism was the frequent appraisal and/or overstatement of capital assets, the values of which came crashing down in 1929.[5] A major lesson learned by accountants as a result of the Great Depression was that values are fleeting. The outcome was a strengthening of the historical cost basis of accounting. This basis received its highest expression in the famous Paton and Littleton (1940) monograph *An Introduction to Corporate Accounting Standards*. This document elegantly and persuasively set forth the case for historical cost accounting, based on the concept of the firm as a going concern. This concept justifies important attributes of historical cost accounting, such as waiting to recognize revenue until objective evidence of realization is available, the use of accruals to match realized revenues and the costs of earning those revenues, and the deferral of unrealized gains and losses on the balance sheet until the time comes to match them with revenues. As a result, the income statement shows the current "installment" of the firm's earning power. The income statement replaced the balance sheet as the primary focus of financial reporting.

It is sometimes claimed that the Paton and Littleton monograph was too persuasive, in that it shut out exploration of alternative bases of accounting. However, alternative

valuation bases have become more common over the years, to the point where we now have a **mixed measurement system**. Historical cost is still the primary basis of accounting for important asset and liability classes, such as capital assets, inventories, and long-term debt. However, if assets are impaired, they are frequently written down to a lower value. Impairment tests (also called ceiling tests) for capital assets and the lower-of-cost-or-market rule for inventories are examples. Under International Accounting Standards Board (IASB) standards, capital assets can sometimes be written up over cost if their value has increased. Generally speaking, standard setters have moved steadily toward current value alternatives to historical cost accounting over the past number of years.

There are two main current value alternatives to historical cost for assets and liabilities. One is **value-in-use**, such as discounted present value of future cash flows. The other is **fair value**, also called **exit price** or **opportunity cost**, the amount that would be received or paid should the firm dispose of the asset or liability. These valuation bases will be discussed in Chapter 7. When we do not need to distinguish between them, we shall refer to valuations that depart from historical cost as **current values**.

While the historical cost lesson learned by accountants from the Great Depression may be in the process of being forgotten by standard setters, another lesson remains: how to survive in a disclosure-regulated environment. In the United States, for example, the SEC has the power to establish the accounting standards and procedures used by firms under its jurisdiction. If the SEC chose to use this power, the prestige and influence of the accounting profession would be greatly eroded, possibly to the point where financial reporting becomes a process of "manual thumbing," with little basis for professional judgment and little influence on the setting of accounting standards. However, the SEC usually chose to delegate most standard setting to the profession.[6] To retain this delegated authority, however, the accounting profession had to retain the SEC's confidence that it was doing a satisfactory job of creating and maintaining a financial reporting environment that protects and informs investors and encourages **well-working capital markets**—where, by "well-working," we mean markets on which the market values of assets and liabilities equal, or reasonably approximate, their real underlying fundamental values.

Thus began the search for basic accounting concepts, those underlying truths on which the practice of accounting is, or should be, based. This was seen as a way to convince regulators that private sector standard setting bodies were capable of high quality accounting standards. Also, identification of concepts, it was felt, would improve practice by reducing inconsistencies in the choice of accounting policies across firms and enable the accounting for new reporting challenges[7] to be deduced from basic principles rather than developing in an ad hoc and inconsistent way. Despite great effort, however, accountants never did agree on a set of accounting concepts.[8, 9]

As a result of the lack of concepts, accounting theory and research up to the late 1960s consisted largely of *a priori* reasoning as to which accounting concepts and practices were "best." For example, should the effects of changing prices and inflation on financial statements be taken into account, and, if so, how? This debate can be traced back at least as far as the 1920s. Some accountants argued that the current values of specific assets and

liabilities held by the firm should be recognized, with the resulting unrealized holding gains and losses included in net income.[10] Other accountants argued that inflation-induced changes in the purchasing power of money should be recognized. During a period of inflation, the firm suffers a purchasing power loss on monetary assets such as cash and accounts receivable, since the amounts of goods and services that can be obtained when they are collected and spent is less than the amounts that could have been obtained when they were created. Conversely, the firm enjoys a purchasing power gain on monetary liabilities such as accounts payable and long-term debt. Separate reporting of these gains and losses would better reflect real firm performance, it was argued. Still other accountants argued that the effects of *both* specific and inflation-induced changes in prices should be taken into account. Others, however, often including firm management, resisted these suggestions. One argument, based in part on experience from the Great Depression, was that measurement of inflation was problematic, and current values were very volatile, so that taking them into account would not necessarily improve the measurement of the firm's (and the manager's) performance.

Nevertheless, standard setters in numerous countries did require some disclosures of the effects of changing prices. For example, in the United States, Financial Accounting Standards Board Statement of Financial Accounting Standards No. 33 (1979) required supplementary disclosure of the effects on earnings of specific and general price level changes for property, plant and equipment, and inventories. This standard was subsequently withdrawn. However, this withdrawal was due more to a reduction of its cost effectiveness as inflation declined in later years than to the debate having been settled.

The basic problem with debates such as how to account for changing prices was that there was little theoretical basis for choosing among the various alternatives, particularly since, as mentioned, accountants were unable to agree on a set of basic accounting concepts.

During this period, however, major developments were taking place in other disciplines. In particular, a theory of rational decision making under uncertainty developed as a branch of statistics. This theory prescribes how individuals may revise their beliefs upon receipt of new information. The theory of efficient securities markets developed in economics and finance, with major implications for the role of information in capital markets. Another development was the Possibility Theorem of Arrow (1963), which demonstrated that, in general, it is not possible to combine differing preferences of individual members of society into a social preference ordering that satisfies reasonable conditions. This implies that there is no such thing as perfect or true accounting concepts, since, for example, investors will prefer different accounting concepts than will managers. Arrow's theorem demonstrates that no set of concepts will be fully satisfactory to both parties. Instead, concepts must be hammered out strategically through negotiation and compromise to the point where both parties are willing to accept them even though they are not perfectly satisfactory to either side. The difficulties that accountants have had in agreeing on basic concepts are thus not surprising. Without a complete set of basic concepts, accounting standards, which, ideally, are derived from the concepts, are subject to the same challenges.

These theories, which began to show up in accounting theory in the latter half of the 1960s, generated the concept of **decision useful** (in place of true) financial statement information. This view of the role of financial reporting first appeared in the American Accounting Association (AAA)[11] monograph *A Statement of Basic Accounting Theory*, in 1966. The joint **Conceptual Framework** of the IASB and the Financial Accounting Standards Board (FASB; 2010), which is the most recent statement of basic accounting concepts, is based on decision usefulness. That is, it states that the objective of financial statements is to provide information to assist investors to make investment decisions. Henceforth, we will usually refer to this document as the Conceptual Framework, or, if the context is clear, the Framework. It is discussed in Section 3.7.

Equally important was the development of the economics of imperfect information, based on a theory of rational decision making. The theory recognizes that some individuals have an information advantage over others. This led to the development of the theory of agency, which has greatly increased our understanding of the legitimate interests of business management in financial reporting and standard setting.

These theories suggest that the answer to which way, if any, to account for changing prices outlined above will be found in the extent to which they lead to good investment decisions. Furthermore, any resolution will have to take the concerns of management into account.

In Canada, the development of financial accounting and reporting has proceeded differently, although the end result is basically similar to that just described. Financial reporting requirements in Canada were laid down in federal and provincial corporations acts, along the lines of the English corporations acts referred to above. The ultimate power to regulate financial reporting rests with the legislatures concerned. However, in 1946, the Committee on Accounting and Auditing Research, now the Accounting Standards Board (AcSB) of the Canadian Institute of Chartered Accountants (CICA), began to issue bulletins on financial accounting issues. These were intended to guide Canadian accountants as to best practices, and did not have force of law. In 1968, these were formalized into the *CICA Handbook*. At first, adherence to these provisions was voluntary but, given their prestigious source, they were difficult to ignore. Over time, the *Handbook* gained recognition as the authoritative statement of Generally Accepted Accounting Principles (GAAP) in Canada. Ultimately, provincial securities commissions and the corporations acts formally recognized this authority. For example, in 1975, for federally regulated companies, the Canada Business Corporations Act required adherence to the *CICA Handbook* to satisfy reporting requirements under the Act. The end result, then, is similar to that in the United States and many other countries, in that the body with ultimate authority to set accounting standards has delegated this function to a private professional body.[12]

Subsequently, several notable events had a major impact on financial accounting and reporting. One such set of events followed from the stock market boom in the late 1990s and its collapse in the early 2000s. During the collapse, share prices of many firms, especially those in the "hi-tech" industry, fell precipitously. For example, while the share

price of General Electric Corp., a large U.S. conglomerate firm, fell from a high of about US$55 in August 2000 to a low of about US$21 in October 2002, that of telecommunications firm Nortel Networks fell from a high of about US$82 to a low of 44 cents over the same period.

A contributing factor to the market collapse was the revelation of numerous financial reporting irregularities. Frequently, these involved revenue recognition, which has long been a problem in accounting theory and practice. In a study of 492 U.S. corporations that reported restatements of prior years' incomes during 1995–1999, Palmrose and Scholz (2004) report that revenue restatements were the single most common type of restatement in their sample. In part, this problem is due to the vagueness and generality of revenue recognition criteria. For example, under International Accounting Standard 18 (IAS 18),[13] revenue from the sale of goods can be recognized when the significant risks and rewards of ownership have been transferred to the buyer, the seller loses control over the items, the revenue and related costs can be measured reliably,[14] and collection is reasonably assured. Revenue from services is recognized as the work progresses. Revenue recognition criteria in the United States are broadly consistent with the above, although, at present, they differ somewhat across industries. Revenue can be recognized when it is "realized or realizable" and earned, where earned means the firm has done what it has to do to be entitled to the revenues.[15]

During the boom of the late 1990s, many firms, especially newly established ones with little or no history of profits, attempted to impress investors and enhance their stock prices by reporting a rapidly growing stream of revenue. Subsequently, when the boom collapsed, much recognized revenue proved to be premature and had to be reversed.

Theory in Practice 1.1

In July 2002, Qwest Communications International Inc., a large provider of Internet-based communications services, announced that it was under investigation by the SEC. Its share price immediately fell by 32%. In February 2003, the SEC announced fraud charges against several senior Qwest executives, alleging that they had inflated revenues during 2000 and 2001 in order to meet revenue and earnings projections.

One tactic used was to separate long-term sales of equipment and services into two components. Full revenue was immediately recognized on the equipment component despite the obligation to honour the service component over an extended period. A related tactic was to price services at cost, putting all profit into the equipment component, which, as just mentioned, was immediately recognized as revenue despite a continuing obligation to protect the customer from risk of obsolescence on the equipment "sold." Yet another tactic was to recognize revenue from the sale of fibre-optic cable despite an ability of the purchaser to exchange the cable at a later date. In retrospect, Qwest's revenue recognition practices were premature, to say the least.

In June 2004, the SEC announced settlements with some of the officers charged. One officer, for example, repaid $200,000 of "ill-gotten gains," plus a penalty of $150,000, and agreed to "cease and desist" from any future violations.

Numerous other, even more serious, failures of financial reporting also came to light. Two of these are particularly notable. Enron Corp. was a large U.S. corporation with initial interests in natural gas distribution. Following substantial deregulation of the natural gas market in the United States during the 1980s, Enron successfully expanded its operations to become an intermediary between natural gas producers and users, thereby enabling them to manage their exposures to fluctuating natural gas prices. For example, it offered long-term fixed-price contracts to public utilities and natural gas producers. Subsequently, Enron extended this business model to a variety of other trading activities, including steel, natural gas, electricity, and weather futures. Its stock market performance was dramatic, rising from US$20 in early 1998 to a high of about US$90 per share in September, 2000. To finance this rapid expansion, and support its share price, Enron needed both large amounts of capital and steadily increasing earnings. Meeting these needs was complicated by the fact that its forays into new markets were not always profitable, creating a temptation to disguise losses.[16]

In the face of these challenges, Enron resorted to devious tactics. One tactic was to create various special purpose entities (SPEs). These were limited partnerships formed for specific purposes, and effectively controlled by senior Enron officers. These SPEs were financed largely by Enron's contributions of its own common stock, in return for notes receivable from the SPE. The SPE could then borrow money using the Enron stock as security, and use the borrowed cash to repay its note payable to Enron. In this manner, much of Enron's debt did not appear on its balance sheet—it appeared on the books of the SPEs instead.

In addition, Enron received fees for management and other services supplied to its SPEs, and also investment income. This investment income is particularly worthy of note. By applying current value accounting to its holdings of Enron stock, the SPE included increases in the value of this stock in its income. As an owner of the SPE, Enron included its share of the SPE's income in its own earnings. In effect, Enron was able to include increases in the value of its own stock in its reported earnings! In 2006, financial media, reporting on a five-and-a-half-year jail sentence of Enron's chief accounting officer for his part in the Enron fraud, revealed that $85 million of Enron's 2000 reported operating earnings of $979 million came from this source.

Of course, if the SPEs had been consolidated with Enron's financial statements, as they should have been, the effects of these tactics would disappear. The SPE debt would then have shown on Enron's consolidated balance sheet, fees billed would have been offset against the corresponding expense recorded by the SPE, and Enron's investment in its SPEs would have been deducted from its shareholders' equity.

However, the SPEs were not consolidated, seemingly with the agreement of Enron's auditor. But, in late 2001, Enron announced that it would now consolidate, apparently in response to an inquiry from the SEC. This resulted in an increase in its reported debt of some $628 million, a decrease in its shareholders' equity of $1.1 billion, and large reductions in previously reported earnings. Investors quickly lost all confidence in the company. Its share price fell to almost zero, and it filed for bankruptcy protection in 2001.

A second major abuse involved WorldCom Inc., a large U.S. telecommunications carrier. During the years 1999 to 2002, the company overstated its earnings by about $11 billion. Almost $4 billion of this amount arose from capitalization of network maintenance and other costs that should have been charged to expense as incurred—a tactic that overstated both reported earnings and operating cash flow. Another $3.3 billion of overstatement arose from reductions in the allowance for doubtful accounts. Again, when these abuses came to light, investor confidence collapsed and WorldCom applied for bankruptcy protection in 2002.

These, and numerous other, reporting abuses took place regardless of the fact that the financial statements of the companies involved were audited and certified as being in accordance with GAAP. As a result, public confidence in financial reporting and the working of capital markets was severely shaken.

One result of the reduction of public confidence was increased regulation. The most notable example is the Sarbanes-Oxley Act, passed by the U.S. Congress in 2002. This wide-ranging Act was designed to restore confidence by reducing the probability of accounting horror stories such as those just described. The Act did this by tightening the audit function and improving **corporate governance**, where by corporate governance we mean those policies that align the firm's activities with the interests of its investors and society. For example, creation of an audit committee of the Board of Directors is a corporate governance policy to tighten the audit function by improving communication between the Board and the firm's auditor, particularly where the auditor has concerns about the manager's operation of the firm's accounting and reporting system.

To improve corporate governance, a major provision of Sarbanes-Oxley was to create the Public Company Accounting Oversight Board (PCAOB). This agency has the power to set auditing standards and to inspect and discipline auditors of public companies. The Act also restricts several of the non-audit services offered by auditing firms to their clients, such as information systems and valuation services. Furthermore, the auditor now reports to the audit committee of the client's board of directors, rather than to management. The audit committee must be composed of directors independent of company management. In Canada, the Canadian Public Accountability Board (CPAB), created in 2003 by federal legislation, has a similar role.

Other provisions of Sarbanes-Oxley include a requirement that firms' financial reports shall include "all material correcting adjustments" and disclose all material off-balance-sheet loans and other relations with "unconsolidated entities." Furthermore, the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) must certify that the financial statements present fairly the company's results of operations and financial position. The Act required these two officers, and an independent auditor, to certify the proper operation of the company's internal controls over financial reporting, with deficiencies, and their remediation, publicly reported. (These requirements were relaxed somewhat in 2007.) Similar regulations are in place in Canada, except that officers' certification of internal controls need not be attested to by an independent auditor.