Opinion

Financial Reporting Integrity

IMA MEMBERS SPEAK OUT

By Pervaiz Alam, CPA, Norman Meonske, CPA, and Michael A. Pearson, CMA, CPA

Survey respondents agree companies need to be responsible for the reliability of their numbers, and the U.S. Congress should stay out of trying to improve the integrity of financial reporting.

Given the continuing corporate accounting scandals, we wanted to find out what members of IMA think should be done to increase the integrity of financial reporting. To obtain their views, we conducted a survey at the 28th Annual Professional Development Conference sponsored by the Ohio Council of IMA and Kent State University covering the appropriate roles of various financial reporting participants. Our questionnaire featured 20 statements describing possible responsibilities, actions, and functions of reporting companies, external auditors, and others involved in the financial reporting process. Sixty-seven percent of the respondents are management accountants, 53% work at multinational firms, 75% are CPAs, and 15% hold a CMA.

Their reactions and comments show they are clearly concerned about the impact of accounting scandals on our society and our profession. Although there's strong agreement on a few issues, the debate continues, which is good because it should ultimately lead to some positive changes.

THE REPORTING COMPANY

Reactions to eight statements pertaining to the role of reporting companies appear in Table 1. Virtually everyone agrees that management should bear primary responsibility for ensuring the reliability of company financial statements. And more than half of the respondents agree important facts concerning underlying economic conditions are frequently not reported in company financial statements.

The causes of improper financial reporting are undoubtedly numerous, but

TABLE 1: Role of the Reporting Company

	PERCENT OF RESPONDENTS				
	STRONGLY AGREE	AGREE	NEUTRAL	DISAGREE	STRONGLY DISAGREE
1. The management of a company should bear primary responsibility for ensuring the reliability of its financial statements.	73	24	1	1	1
2. Currently, important facts concerning underlying economic conditions are frequently not reported in company financial statements.	10	45	27	16	0
3. Compensation plans that link salary and bonuses with reported earnings cause company managers to manipulate accounting numbers.	23	52	14	11	0
4. The reporting of earnings expectations by financial analysts causes company managers to manipulate accounting numbers.	18	56	16	9	0
5. No member of a company's management should be a voting member of a company's board of directors.	12	32	21	30	5
6. The audit committee of a company's board of directors should consist solely of individuals independent of the company's management.	39	33	11	16	1
7. The societal role of company audit committees needs to be strengthened.	21	49	23	6	0
8. Company audit committees should have the power to hire and fire external auditors.	17	47	14	20	1

Note: Percentages don't always add up to 100 because some individuals didn't respond to every statement.

TABLE 2: Role of the External Auditors

	PERCENT OF RESPONDENTS				
	STRONGLY AGREE	AGREE	NEUTRAL	DISAGREE	STRONGLY DISAGREE
1. A company's external auditors should bear the primary responsibility for ensuring the reliability of the company's financial statements.	2	9	13	59	17
2. A company's external auditors should provide a high level of assurance that company financial statements are free of material fraudulent misstatements.	37	51	5	6	1
3. Firms should not be permitted to provide external auditing services and consulting services to the same client company.	13	32	14	34	6
4. Firms that provide external auditing services should not be permitted to provide consulting services to anyone.	1	6	6	54	32
5. Firms should not be permitted to provide external auditing services and internal auditing services to the same client company.	26	35	14	20	3
6. Requiring publicly owned companies to obtain external auditing services from a different firm every five years is a good idea.	3	20	14	44	18

Note: Percentages don't always add up to 100 because some individuals didn't respond to every statement.

many believe compensation plans and earnings expectations are at fault: Three-quarters of the respondents agree that compensation plans linking salary and bonuses with reported earnings cause company managers to manipulate accounting numbers, and almost that same proportion say the reporting of earnings expectations by financial analysts causes company managers to manipulate accounting numbers.

In terms of solutions to the problem of improper financial reporting by company managers, the respondents see value in strengthening the role of the audit committee of a company's board of directors. While respondents are almost evenly divided on whether a member of a company's management should be a voting member of the board, there's strong support for the notion that company management should *not* be audit committee members and that the role of company audit committees needs to be strengthened. Although almost two-thirds of the respondents believe company audit committees should have the power to hire and fire external auditors, slightly more than 20% of the respondents wouldn't give them that authority.

Almost 90% believe external auditors should provide a high level of assurance that company financial statements are free of material fraudulent misstatements.

THE EXTERNAL AUDITORS

Responses to six statements dealing with the role of external auditors are summarized in Table 2. Over three-quarters of the respondents say a company's external auditors shouldn't bear the primary responsibility for ensuring the reliability of the company's financial statements. But almost 90% believe they should provide a high level of assurance that company financial statements are free of material fraudulent misstatements.

What about the impact on independence and objectivity of external auditors providing other-than-audit-services to clients? Unfortunately, the survey

TABLE 3: Role of Others

	PERCENT OF RESPONDENTS				
	STRONGLY AGREE	AGREE	NEUTRAL	DISAGREE	STRONGLY DISAGREE
1. Financial analysts should be required to disclose whether they own the stocks and other financial instruments they recommend to their clients.	52	39	3	3	0
2. The Financial Accounting Standards Board has failed to establish adequate accounting standards for new and emerging business transactions.	4	16	35	39	5
3. Intense external pressures have resulted in less-than-timely establishment of accounting standards by the FASB.	8	40	29	18	2
4. The Securities & Exchange Commission should take a more active role in the establishment of accounting standards.	3	27	26	35	8
5. The U.S. Congress should take a more active role in the establishment of accounting standards.	1	3	9	39	47
6. Auditing standards should be established via due process by an independent board similar in structure to the FASB.	9	49	23	12	3

Note: Percentages don't always add up to 100 because some individuals didn't respond to every statement.

respondents don't settle this decades-old controversy. They're about evenly divided on whether firms that provide external auditing services should be permitted to provide consulting services to the same client company. Few, however, advocate the more radical view that firms that provide external auditing services should not be permitted to provide consulting services to anyone. But almost two-thirds believe that providing external and internal auditing services to the same client company is incompatible.

Finally, although some industry watchers have argued that mandatory audit firm rotation would reduce the likelihood of another Enron or WorldCom, less than a quarter of the survey respondents give a thumbs-up to requiring publicly owned companies to obtain external auditing services from a different firm every five years.

OTHER LINKS IN THE FINANCIAL REPORTING CHAIN

Many individuals and groups participate in one way or another in the financial reporting process. Some are financial analysts, the Financial Accounting Standards Board, the Auditing Standards Board, the Securities & Exchange Commission, and the U.S. Congress. Six statements and a summary of the respondents' reactions appear in Table 3.

Analysts have been criticized for various reasons, such as their recommending investments to their clients they themselves hold. Over 90% of the respondents say financial analysts should be required to disclose whether they own the stocks and other financial instruments they recommend to their clients. One respondent adds: "Stock analysts should be prohibited from following any entity with which his or her employer maintains a significant business relationship (more than $1 million in fees)."

With respect to standards setting by the FASB, some

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commentators have given the Board a poor performance rating for one reason or another. Nearly half the respondents say intense external pressures have resulted in less-than-timely establishment of accounting standards by the FASB. Almost one-third say they are neutral.

Twenty percent believe the Board has failed to establish adequate accounting standards for new and emerging business transactions. On the other hand, more than 40% of the survey participants expressed an opposite view, and many participants—over a third—remain neutral.

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We also wanted to find out if the SEC or the U.S. Congress should play a more active role in accounting standards setting. The survey participants don’t send a clear message with regard to SEC involvement. Over 40% oppose the notion that the SEC should take a more active role in establishing accounting standards. Thirty percent support more SEC involvement, with approximately one quarter staying neutral. But almost 90% disagree (and almost 50% strongly) with the suggestion that the U.S. Congress should take a more active role in establishing accounting standards.

Finally, the respondents considered the process of establishing auditing standards. Auditing standards setting has been in the hands of the Auditing Standards Board, an arm of the AICPA, but critics have suggested a more open process, and many survey respondents agree. Almost 60% support the idea that auditing standards should be established via due process by an independent board similar in structure to the FASB. (The Public Company Accounting Oversight Board, established by the Sarbanes-Oxley Act, will get involved here.)

When considering auditing standards setting and the value of an audit, contrasting views surfaced. For example, one respondent says, “I believe you cannot get a 100% guarantee on any audit. I do not believe that having the SEC or any outside group make new rules will change that fact.” But another notes, “Accounting is all about checks and balances. If any company is able to defraud the public without its auditors catching on, then our profession is not doing its job to set high enough standards….”

UNASSAILABLE REPUTATIONS

The accounting profession, however it may be defined, has clearly lost stature because of Enron, WorldCom, HealthSouth, and other recent accounting disgraces. There’s enough blame to go around. But more important than pointing fingers is taking action that results in accountants and auditors (and their work products) being viewed favorably once again. As one respondent says, “Create an environment where less than ethical behavior is unacceptable…Our reputations should be unassailable!”

But how do we accomplish this? With respect to the future of financial reporting, one respondent suggests, “We need to make sure financial reports are clear and not misleading in providing the general investing public with the key financial information…Let’s strive to report the whole picture. Both corporate accountants and accounting [auditing] firms need to be more attentive to recommending changes to the financial reporting process….” Not everyone agrees though. As another survey participant puts it, “Existing…rules are fine! They were not properly followed…[in some cases]!”

In our view, disagreement and the resulting debate is healthy and necessary because it’s likely to assist us in determining how best to proceed in meeting the needs of society and reestablishing confidence in our profession and the financial reports we issue. Although the recently enacted Sarbanes-Oxley Act mandates many financial reporting changes, the door hasn’t been shut to proposals. We should welcome all ideas. After all, we can’t afford not to. ■

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