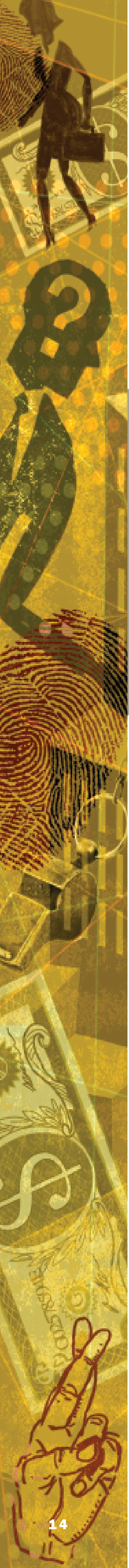
Curtis C. Verschoor, CMA, Editor



Empty Promises Aren't Enough to Prevent Unethical Behavior

While the efforts to identify and punish those who commit financial fraud have increased, many of the biggest violators are able to not only avoid severe punishment, but have also been allowed to walk without acknowledging any wrongdoing. If we are to stop unethical and illegal behaviors, harsher penalties will be needed.

The ramped up enforcement efforts of the Securities & Exchange Commission (SEC) and Department of Justice (DOJ) have taken an increased number of fraudsters and other securities-related wrongdoers into court (see "We Need to Stop Pay-to-Play Corruption," September 2009). Unfortunately, the punishments agreed to as part of court settlements are less than satisfactory. While neither admitting nor denying guilt, the defendants promise never to commit the same offense again. This is an easy promise to make and is one that most parents will tell you needs to be taken with a grain of salt.

One example is the Bank of America (BofA) acquisition of Merrill Lynch (ML) that was mandated and financially facilitated by former Secretary of the Treasury Hank Paulson and Ben Bernanke, chairman of the Federal Reserve Board, to help save the financial system from ruin. The SEC complaint graphically described the material lies that were contained in the BofA proxy statement sent to its shareholders to get their approval of the deal. BofA represented that no year-end bonuses would be paid to ML executives. In actuality, BofA had agreed that ML would pay its executives up to $5.8 billion in discretionary bonuses. These were the same ML individuals who had run the company into near bankruptcy and had triggered the government action in the first place. The proposed penalty for this major transgression was a mere $33 million fine plus injunctive relief promising no repetition. Interestingly, the $33 million is less than half of the retirement package for BofA CEO Ken Lewis, who recently announced his retirement at the end of the year.

The U.S. District Court of the Southern District of New York had a problem with forcing BofA shareholders, the victims of the shady dealings, to "pay an additional penalty for their own victimization." It concluded the proposed Consent Judgment was "neither fair, nor reasonable, nor adequate." The Court's 12-page decision provides interesting reading, but it also calls into question whether enough individuals in similar cases receive sufficient penalties for their fraudulent, illegal, and unethical activities—namely, time in a federal penitentiary.

While conceding that its normal policy is to go after company executives responsible for misdeeds, in this case the SEC said it couldn't do so in the BofA and ML case because lawyers for the companies drafted the proxy statement and decided that the bonus disclosure was lawful. If that's true, the Court said, "Why are the penalties not then sought from the lawyers?" Good question. A better question would be: "Why do we pay so much to rubber-stamping CEOs who hide behind their attorneys?"

Concerning the "Don't ever do it again" injunctive relief, the Court maintained that this was an empty promise since BofA had asserted that it had done nothing wrong. The SEC's contention that the settlement would punish BofA executives by diminishing their reputation was scorned by the Court, which said, "The notion that BofA shareholders, having been lied to blatantly in connection with the multibillion-dollar purchase of a huge, nearly bankrupt company, needed to lose another $33 million of their money to (quoting from the SEC's brief) 'better assess the quality and performance of management' is absurd."

The Court concluded that the proposed Consent Judgment was really only a "contrivance designed to provide the SEC with the facade of enforcement and the management of BofA with a quick resolution of an embarrassing inquiry—all at the expense of the real victims, the shareholders." The Court ordered the civil fraud case to be ready for trial in February 2010. Fortunately for those seeking justice, media reports indicate that federal and state authorities are investigating the possibility of criminal charges.

In another high-profile case, the SEC only gave a light slap on the wrist to General Electric (GE) in settling four charges of material fraudulent financial reporting and not charging any individuals with wrongdoing. GE is a long-time member of the Dow Jones Industrial Index and frequently lauded as an ethical company. The investigation resulted from a risk-based analysis of only one of GE's accounting practices. You wonder what the SEC would find if it undertook similar investigations of other companies.

From 1995 through December 31, 2004, GE met or exceeded final consensus analyst earnings per share (EPS) expectations each and every quarter. On four separate occasions in 2003 and 2004, however, high-level GE accounting executives or other finance personnel (and its external auditor, KPMG) approved accounting and reporting to the public that was materially out of compliance with Generally Accepted Accounting Principles (GAAP). Robert Khuzami, director of the SEC's Division of Enforcement, said, "GE bent the accounting rules beyond the breaking point." Without admitting or denying the SEC's allegations, GE agreed to a $50 million financial penalty. But the case involved many hundreds of millions of dollars of misstatements! GE also consented to permanently avoid future violations of the antifraud, reporting, record-keeping, and internal controls provisions of the federal securities laws, the basic "We won't do it ever again."

The 37-page SEC civil complaint describes in detail the four decisions that made the GE financial statements fraudulent and misleading. First, an improper application of the accounting standards to hedging the interest-rate risk in GE's outstanding commercial paper (CP) avoided unfavorable disclosures and an estimated $200 million pre-tax charge to earnings. The CP documentation that was prepared to make the scheme comply with GAAP was "revised" to be only "illustrative" rather than actual. GE's outside auditor, KPMG, declined to object to this decision without consulting its national office. The decision appeared to be made in haste as it occurred only nine days before the January public earnings release of the previous year's results.

In the second issue, GE failed to correct a misapplication of financial accounting standards relating to certain GE interest-rate swaps that shouldn't have been designated as hedges because they involved up-front fees. Although the cumulative difference in restated net earnings over four years totals only $381 million, the quarterly volatility resulted in changes of as much as 12.2%.

The third issue involved recognition of ostensible "sales" of locomotives to financial institutions that, through side agreements, never bore the risks of ownership. Side letters provided for reimbursement to the institutions for the related costs of holding the products until they were "resold" to the railroads in the following year. GE requested the institutions avoid any reference to the fact they were billing it for costs such as insurance and storage. GE called these transactions "bridge financings" because the financial institutions received interest and fees for their efforts. This scam accelerated recognition of more than $370 million in revenue and overstated the fourth quarter 2002 revenue and profit of the GE transportation business by 45.1% and 39.6%, respectively. The misstatement wasn't corrected until 2007.

In 2002, an improper change to GE's accounting for sales of commercial aircraft engines and spare parts improperly increased GE's

continued on page 61

For guidance in applying the *IMA Statement of Ethical Professional Practice* to your ethical dilemma, contact the IMA Ethics Helpline at (800) 245-1383 in the U.S. or Canada. In other countries, dial the AT&T USADirect Access Number from www.usa.att.com/traveler/index.jsp, then the above number.

Ethics

continued from page 16

2002 net earnings by $585 million. The original practice was to "levelize" margins within its commercial aircraft business by costing sales using an average expected margin from all products. This revenue accounting model (RAM) combined low actual margins from current aircraft engine sales with expected high margins from future sales of spare parts/spare engines.

To account for the acceleration of the margin recognized on as-yet-unsold spares/engines, GE maintained a deferred charge on its balance sheet equal to the amount of income it accelerated using RAM. Realizing that this accounting method was suspect, an offsetting accounting change was developed. A new method of costing spare parts sold to other GE divisions was applied on a prospective-only basis, rather than retroactively, as required by GAAP. The overstatement of 2002 GE pre-tax earnings was $943 million, or 5.7 %, while the overstatement of net earnings was by $585 million, or 4.8%. This misstatement was also corrected in 2007. The civil complaint pointedly notes that GE failed to document why a prospective-only change was GAAP-compliant.

The question is: Shouldn't those guilty of flagrant disregard of the basic principles and underlying values of accountancy be put in prison for their monumental crimes? Perhaps that would serve as a real deterrent that would help others in the future from starting that slide down the slippery slope of ethical misbehavior. **SF**

Curtis C. Verschoor, CMA, is the Emeritus Ledger & Quill Research Professor at the School of Accountancy and MIS and an honorary Senior Wicklander Research Fellow in the Institute for Business and Professional Ethics, both at DePaul University, Chicago. You can reach him at curtisverschoor@sbcglobal.net.