The Shift toward a Global Economy: Changes in Accounting Regulations to Repair a Broken Past and Lay a Solid Foundation for the Future

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Abstract

With the growth and development of a much more dynamic business market, many companies have seen opportunities to expand and profit. However, this has also led to much confusion over which specific regulations and entities should dictate how businesses should report and act. The Financial Accounting Standards Board and the International Accounting Standards Board have been working concurrently to provide a consistent standard that can be applied universally. Though there are many differences between the frameworks of the two organizations, compromises are being made to suit the general business realm.

The recent recession has also caused problems for the business world, and has put an even greater urgency on the need for reform and revisions. With the collapse of Enron in 2001 and the passage of the Sarbanes-Oxley Act, accounting regulations have taken a step in the right direction, but these changes will not automatically solve all problems within the industry. Ethical education and universal enforcement also need to be emphasized to cut down on corporate greed and dishonesty to ensure that another economic meltdown will not occur in the near future.

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The History of Expansion and Accounting Within the United States

Over the past few centuries, the world has been shrinking. Perhaps not in a literal sense, but through advances in communication and transportation, it is easier to navigate. As a result, new opportunities have developed that would never have seemed feasible in the past. Trade between nations has increased exponentially and businesses have been forced to adapt. Multinational corporations like Coca-Cola and McDonald's have flourished by stretching themselves to reach markets that have not yet been exposed to similar industries (Kristensen & Morgan, 2007).

In an attempt to gain a portion of these emerging markets, some small businesses look to investors as a way of quickly raising capital and expanding. However, if investors want to feel secure in a particular venture, they should pay special attention to the financial statements and earnings records of the company in which they plan to invest. The problem that this presents is that regulations between nations can sometimes vary greatly. This not only poses a dilemma for investors, but also for the business world in general. Gaps within the standards can lead to earnings manipulation and dishonest reporting, which leads to even greater distrust toward the industry.

The Securities and Exchange Commission (SEC) was created in 1934, with the authority to oversee accounting practices of publically traded companies in the United States and regulate the securities and trading markets (Spiceland, Sepe, Nelson & Tomassini, 2009). Throughout the history of the US, numerous regulating bodies have been established to take the place of the previous bodies to meet the needs of the

increasingly complicated business world. The American Institute of Certified Public Accountants (AICPA) was the first organization to deal specifically with accounting matters and did so from approximately 1936-1959 (Facts, 2009). Currently, the Financial Accounting Standards Board (FASB) oversees accounting regulations within the United States while the International Accounting Standards Board (IASB) deals with international affairs. To provide added guidance, the FASB has established a conceptual framework and Generally Accepted Accounting Principles (GAAP) to assist in decision making. The IASB also has a conceptual framework for companies to follow, but has no formal organization to enforce these regulations (Spiceland, et al., 2009). This presents a problem for some multinational corporations as well as for investors that are interested in financing foreign companies. A universal standard helps to ease some of these issues by ensuring consistency of practice throughout the industry and improved, centralized enforcement. The Joint Conceptual Framework Project is a collaboration of members from the FASB, the IASB, and various other countries' representatives (Lian, 2009). With so many differing ideas and opinions about how standards should be set, some compromises must be made.

Another reason for the call for a set of uniform standards is the mistrust of the public in regards to the financial stability of the economy and certain financial institutions. Over the past few decades, certain businesses have been at the forefront of conversation when discussing financial misfortunes, including Enron, Adelphia, and WorldCom. Even the present financial situation has roots in the need for universality and continuity of accounting standards. Dishonest sub-prime lending and gross misstatements of income have caused the housing market to deteriorate at a rapid rate and the general

stock market declined substantially as a result (Kiviat, 2007). The government sponsored enterprises Freddie Mac and Fannie Mae received governmental subsidies to assist the lower income borrowers and thus began giving out loans with higher than average interest rates to account for the increased risk. These loans were then pooled and sold to investors as mortgage backed securities. Though this temporarily helped to increase home ownership and the value of the housing market, it was unsustainable and collapsed when the individuals could not afford to pay the high interest costs and began to default on the loans. This over-valuation in the mortgage backed securities led to a severe collapse that many people blamed on the accounting treatment of Freddie Mac and Fannie Mae and the loans they were providing (Jaffee & Quigley, 2008). If the public cannot trust lenders and banks or the value of their own homes, then how can they trust big businesses that only seem to care about their bottom lines? The passage of the Sarbanes-Oxley Act has helped to address many of the issues within the United States, and through the work of the Financial Accounting Standards Board and the International Accounting Standards Board on the Convergence Project, the accounting profession will undergo some serious changes from a global perspective and not only emerge stronger, but also better equipped to prevent and deal with dishonest reporting and inadequate internal controls.

Enron and the Sarbanes-Oxley Act

One of the prime examples of suspect accounting occurred during the late 1990s and early into the 21st century at Enron. However, the fault does not lie solely with the management and internal reporting; financial auditors and regulators have also taken a fair share of the blame and were a catalyst for the passage of the Sarbanes-Oxley Act (SOX) in 2002 (Reinstein & Weirich, 2002).

The name Enron was not always associated with scandal; in fact, prior to its collapse, Enron was a respected and seemingly prosperous company. Initially an energy supplier and distribution company, Enron found success as a pioneer in the emerging market of deregulated energy and eventually expanded to include various other industries including energy brokerage and derivative trading (Reinstein & Weirich, 2002). In early 2001, *Fortune* magazine acknowledged Enron as the "Most Innovative Large Company" for the sixth straight year in its annual survey of "Most Admired Companies" (Healy & Palepu, 2003, p. 3). The problems began when the inflated expectations of stockholders could not be met and the company began to utilize Special Purpose Entities (SPEs) as a way to diversify risk and appear to investors as financially viable (Schwarcz, 2002). Though in principle SPEs are legally permissible, many of the SPEs connected with Enron were controlled by managing executives and served as a source to hedge funds and risk. With a personal interest in the success of these SPEs, a significant amount of management within Enron began to face conflicts of interest. The transactions between the parent company, Enron, and the SPEs essentially amounted to internal transfers that helped to inflate their profit to an embellished and unsustainable level (Healy & Palepu, 2003). The corruption was so widespread throughout the company that even when the company's vice president, Sherron Watkins, approached the CEO Kenneth Lay and the Board of Directors and said she was "incredibly nervous that we will implode in a wave of accounting scandals" (Reinstein & Weirich, 2002, p. 22), her concerns were ignored. This lack of internal control and indifference to wrongdoing eventually led to Enron's downfall.

While it is easy to condemn the actions of Enron's management, their auditing firm Arthur Anderson and the governing bodies that regulate these events are just as much at fault for their failure to deal with the illegal behavior. The purpose of having these checks and balances in place was to assure the investors that the financial statements are reliable and that they have been prepared accurately.

> Characteristically, the professional gatekeeper essentially assesses or vouches for the corporate client's own statements about itself or a specific transaction. This duplication is necessary because the market recognizes that the gatekeeper has a lesser incentive to lie than does its client and thus regards the gatekeeper's assurance or evaluation as more credible. To be sure, the gatekeeper as watchdog is typically paid by the party that it is to watch, but its relative credibility stems from the fact that it is in effect pledging a reputational capital that it has built up over many years of performing similar services for numerous clients. (Coffee, 2002, pp. 5-6)

Yet with corruption and dishonest accounting practices so prevalent within the industry, profits and preference with clients took priority over credibility. The auditing firm, Arthur Anderson, had become so lenient with the management at Enron that they let the accounting misstatements and errors continue, which eventually resulted in Enron's bankruptcy (Healy & Palepu, 2003).

It was this culmination of problems that led Congress to pass the Sarbanes-Oxley Act of 2002, a set of reforms to enhance compliance by auditing firms and establish stricter internal controls within companies. One key element of the act was the creation of the Public Company Accounting Oversight Board (PCAOB). Prior to the formation of

the PCAOB, the accounting profession was largely self regulatory and had limited enforcement. This new Oversight Board, which consists of members appointed by the SEC, closes the gap in regulation and ensures accountability for the audits of public companies (Spiceland et al., 2009). Two other provisions of the Sarbanes-Oxley Act include the necessity for executives to develop a code of ethics with enforcement mechanisms that strengthen internal control and a requirement to rotate the firm that audits their financial statements (Orin, 2008). The alternation of outside auditors is especially important because it prevents firms from becoming complacent and too familiar with their clients. This not only protects investors from the danger of longstanding collusion within the two companies, but also protects the auditing firm from the potential bullying by their larger clients with the threat to leave the auditor and deprive them of the lucrative auditing fees in exchange for looser regulation (Coffee, 2002).

With the passage of the Sarbanes-Oxley Act, oversight of public accounting has increased greatly. In 2005 alone, just three years after the passage of the act, the Public Company Accounting Oversight Board inspected 281 registered accounting firms to determine their compliance with the new regulations (Wegman, 2008). However, the PCAOB only has authority within the United States and has no power over other international corporations. The inclusion of ethical principles and guidelines within the Sarbanes-Oxley Act has helped to set a precedent for the future of accounting regulations. The financial downturn of 2008 has helped to bring this issue back to the forefront of accounting discussions and encouraged the inclusion of enhanced enforcement mechanisms as a global standard within the Convergence Project.

Response to Current Economic Crisis

Although work on the Joint Conceptual Framework Project had already begun before the financial crisis really started to affect the economy, the crisis only helped to spur the response made by the Financial Accounting Standards Board and the International Accounting Standards Board. As a way to quickly mediate some of the problems that were perceived to have directly contributed to the current problems, the Financial Crisis Advisory Group (FCAG) was established in December 2008. According to the official news release by the FASB, "the primary function of the advisory group is to advise the boards about standard-setting implications of (1) the global financial crisis and (2) potential changes to the global regulatory environment" ("News release 12/30/08," 2008, p. 1).

The main goals of the Convergence Project and the Financial Crisis Advisory Group are largely the same, but they differ in their focus. While the Convergence Project is in the process of settting a uniform global standard in the accounting field (Williams, 2007), the FCAG is utilizing the current organizations and individuals within those groups to come together and immediately try to resolve the most important issues that are present today (Wendell, 2009). At the first meeting of the FCAG on January 20, 2009, it was made clear that the Financial Accounting Standards Board and International Accounting Standards Board have been researching and attempting to revise the proper issues, but there is still one fundamental issue that could potentially cause some discrepancies when they attempt to converge the two sets of standards: a difference in technical language over some of the same issues ("January 20, 2009: Meeting Summary," 2009). For example, when recognizing inventory, the FASB allows companies to utilize

the last in, first out method (LIFO), while the IASB does not (Hoyle, Schaefer, & Doupnik, 2009). One study conducted in 2009 took a sample of 305 companies, 218 of which utilized LIFO as the method for valuing inventory, while the other 87 did not. The purpose was to determine what effect LIFO may have earnings representation and a possible distortion of balance sheet information. One result of the study showed that the mean size of the LIFO reserve, or the material difference in inventory when comparing the first in, first out method to the last in, first out method, was $269 million and the maximum reserve was as high as $25.4 billion (Coffee, Roia, Lirelv, & Little, 2009). This wide variance that occurs due to a change in inventory recognition shows the potential for the distortion of financial statements. Though much emphasis has been placed on the differences between the conceptual frameworks of the two organizations, but to fully understand the need for one global standard, it is important to see how and where these standards differ.

A Comparison of Conceptual Frameworks

The frameworks for both the FASB and IASB are relatively similar in the methods that they use to recognize financial statements, but there are also a few key differences. One similarity is the overall objective for both organizations. They both agree that the main purpose of financial statements is to provide information, whether that is in regard to the current financial position or for future planning.

One of the fundamental keys to accounting is the basis for which the financial statements are prepared. The Financial Accounting Standards Board and the International Accounting Standards Board agree that the proper method for recording revenue is the accrual basis (“Framework,” 2008; Spiceland, et al., 2009), as opposed to the cash basis,

which is more relevant to financial planning done by executives and is used for internal purposes. The going concern principle is also a basic assumption that underlines both frameworks. This assumes that the business will continue to operate unless there is significant information that indicates otherwise (Spiceland, et al., 2009). One characteristic that is missing from the IASB's framework that is included in FASB's framework is the monetary unit assumption. This would make sense that an international organization would not include this principle because most countries have independent monetary systems and thus would not use the US dollar, or some other unanimously accepted currency.

When recording information on the financial statements, the qualitative characteristics provide much needed assistance to help determine which information is most important to include. While the Financial Accounting Standards Board sets its characteristics in a hierarchy to emphasize the importance of certain elements ("FASB issues proposal on GAAP hierarchy," 2005), the International Accounting Standards Board lists the characteristics, not necessarily putting preference on any. Understandability is crucial to both organizations because if the statements are not easily understood, then they will not satisfy the overall purpose of the statements, which is to provide the user with information. The second tier, or primary qualities, for the FASB include relevance and reliability, while the secondary qualities include comparability and consistency (Spiceland, et al., 2009). One clear difference with the IASB in this case is that they do not incorporate consistency as one of their qualitative characteristics. The Financial Crisis Advisory Group highlighted this omission as one of the most important principles to include in the Convergence Project. Understanding of financial statements is

the main concern of reporting and consistency in reporting helps investors to be able to transition between financial statements of similar industries ("January 20, 2009: Meeting Summary," 2009). This can be seen most clearly in the US stock exchange, where several companies with similar business practices may have very different accounting procedures.

> It is very difficult, if not impossible, for a potential investor to directly compare the financial position and performance of chemical companies in Germany (BASF), China (Sinopec), and the U.S. (DuPont) because these three countries have different financial accounting and reporting standards. (Hoyle et al., 2009, p. 502)

The financial statements for the International Accounting Standards Board and the Financial Accounting Standards Board contain many similarities with the only significant differences in technicalities. The income statement and balance sheet both contain many fundamentals including revenue, expenses, net income, assets and liabilities, but the FASB breaks down equity to specify the investments by owners and the distributions to owners, while the IASB leaves it as just equity (PriceWaterhouseCoopers, 2009). This difference is important because when it is applied properly, it can often reveal any potential conflicts of interest that management may have with their investments, or can uncover atypical compensation for certain executives. The FASB also divides the balance sheet into revenue, expenses, gains, losses, and comprehensive income; where the IASB has just income and expenses. The IASB also divides the balance sheet into just income and expenses, where the FASB includes revenue and expenses, along with gains, loses and comprehensive income. This also gives investors and regulators a better idea of what

specific projects may be causing the gains or loss. Historically, the issue of determining profit and revenue has caused great controversy and complications for investors. For example, in 1989 when the Berlin Wall was taken down, Western companies were encouraged to purchase businesses in Hungry, Poland and various other former communist nations. However, the objective and principle of profit and accounting of assets was so different under the communist governance, that public accounting firms were called upon to convert the financial statements of these companies to a basis similar to the companies in the West so that investors could better understand the financial standing (Hoyle et al., 2009).

Even though the differences between the conceptual frameworks of the IASB and FASB are emphasized while developing a Joint Framework, there are actually many similarities that provide a base for comparison and compromise. This is especially helpful in the Convergence Project, because it gives them a basis for what must be done to accomplish convergence, but shows that their ambitions are comparable and that they will not need to develop an entirely new framework. The main objectives as well as many of the characteristics, elements and financial statements are essentially identical, while the only significant difference lies within the monetary policy, valuation of assets and liabilities and visual presentation of financial statements. Every minute difference and conflicting idea must be carefully debated and considered so that the new standard will address any discrepancies and ensure that all valuation issues are resolved. This contributes to the overall goals of understandability and consistency by confirming that the definition of any asset or liability is the same in the United States as it may be in France or any other country.

> Brokers and stock dealers favor IFRS [international financial reporting standards] because it is a consistent reporting method when comparing the financial reports of a British company against one in the U.S. Also, IFRS makes it easier for foreign companies to report in the U.S. (Beets, 2008, p. 28)

Accounting for Business Combinations

According to the IASB, the Convergence Project was divided into two phases: the first was a short-term look at the standards to deal with the pooling of interest method and various aspects of goodwill, while the second would work with the FASB to take a general perspective of business combinations and bring the two standard setting bodies as close to agreement as possible (International Accounting Standards Board, 2009). With the release of the Statement of Financial Accounting Standard (SFAS) 141R, the FASB has geared many of the new standards for mergers and acquisitions toward a fair value accounting system and away from the more traditional historical cost based valuation system. This is not only an attempt to value the assets, liabilities, and equity of the two companies involved in the merger or acquisition more properly, but it also helps investors who may reference the financial statements in an attempt to predict future earnings potential. It also brings the US closer to the standard set by the IASB, as the revised International Financial Reporting Standard (IFRS) 3 also has moved toward a fair value approach.

Suzanne Bieldstein, the director of the FASB for major projects and technical activities, noted that, “while some might criticize the boards for not achieving ‘true’ convergence in this instance, she prefers to focus instead on the many differences between IFRS and U.S. G.A.A.P. eliminated by this project. ‘We can’t let perfection get

in the way of progress' " (de Mesa Graziano & Heffes, 2008, p. 35). Though the current plans for business combinations have been completed, there is yet to be seen one standard that has been agreed on by both the standard setting boards. Both organizations are still producing their own regulations within their respective jurisdictions, but as the need for a formal set of unified standards nears, there will certainly be a move made to join the standards officially; however, the narrowing of the gap has already improved both the consistency and comparability of reporting worldwide.

Another significant area that needed to be addressed was how to deal with the actual consolidation of financial statements and how that could all differ with the presence of controlling and non-controlling interests. Prior to SFAS 160, companies under governance by the FASB would not recognize the proper fair value equity valuation of non-controlling interest, but instead would base the non-controlling interest (NCI) on the historic book value of the acquisition. This change made by the FASB has again updated the standards to serve both the corporate sector as well as the needs of the public, yet there still exist a few minor differences between the IFRS standard. Using the international reporting standards, IFRS 3 established a process where companies have two options to most accurately represent the fair value of the NCI. Each acquisition is taken independently and the non-controlling interest can either be represented as their proportion of the fair value of the identifiable assets or at their full fair value (PriceWaterhouseCoopers, 2009). Though this difference may appear to be insignificant, it can have a rather large effect on the carrying value of the non-controlling interests.

One of the preliminary steps taken by the FASB to determine the global differences between treatments of business combinations was to examine the

reconciliations to U.S. GAAP that were prepared by foreign companies. This process was required by the SEC for these foreign companies to be listed on the stock exchanges within the U.S. For example, they evaluated the earnings difference of China Southern Airlines Company Limited, which prepared its financial statements according to international standards, but reconciled its earnings to U.S. GAAP in one of its notes to the financial statements. In 2004, it reported a $48 million loss according to the international standard, but after reconciling to GAAP, it resulted in a $239 million gain (Hoyle et al., 2009). The majority of this difference was due to differing tax regulations as well as categorization of sales, leases, and capitalization of interest. Though this extreme discrepancy in earnings is not common, it shows the potential for earnings disparities when comparing international companies. It also laid out, in a detailed list, all the potential differences between accounting standards that would manifest themselves in the financial statements and thus what the FASB and IASB would need to change to achieve universal financial reporting.

With the FASB making so many changes to their reporting standards, not only to update to a fair value approach, but also to conform to a more internationally centered approach, the gap between financial statements in the US and the rest of the world has drastically narrowed. Though the two-part project established by the IASB has seen completion, there is still much work to be done before a single set of standards is universally applied. In the coming years the public can expect to see updates on various other projects by the two standard setting boards as we near a more global economy.

Necessity for Immediate Change

With the proper base for accounting standards being set by the Convergence Project, the Financial Crisis Advisory Group hopes to solve some issues that are immediately affecting both the Financial Accounting Standards Board and the International Accounting Standards Board. The FCAG is composed of elite fifteen to twenty individuals who possess a wealth of experience with international markets and accounting standards. Overseeing the meetings are two joint chairs, one representing North America and the other Europe ("Financial Crisis Advisory Group," 2009). While the hope is that when the Convergence Project is completed that many of these problem issues will be resolved, the process is too slow to deal with some of the specific issues that the FCAG has been asked to resolve. For this reason, the select group meets concurrently in a forum type discussion to provide valuable information to the FASB and IASB. To foster conversation and optimal input, no final conclusions are required, but instead it is seen as an opportunity to voice all opinions and concerns that will later act as guides for the standard setting organizations. This is beneficial not only for the Financial Accounting Standards Board and the International Accounting Standards Board but also for the industries that these changes will affect and the general public. It gives them a chance to see preliminarily what the suggestions are for accounting standards and possibly voice any concerns that they may have with the current proposals before the standards are voted on and approved by the FASB and the IASB.

Many people placed the blame on accountants and the role that fair value had played in the recession, but in December, 2008, the Securities and Exchange Commission published a report to Congress based on research conducted on mark-to-market

accounting as required by the Emergency Economic Stabilization Act of 2008. The results of their study was that, "fair value accounting under SFAS No. 157 is not the root cause of the current global economic crisis and that a suspension or repeal of fair value accounting would not strengthen investor confidence in the current environment" ("SEC report," 2008, p. 150). The study also found "no 'convincing empirical evidence' that fair value accounting contributed to the current global economic crisis and that the crisis is primarily the result of bad operating, investing, and financing decisions, poor risk management, and in some instances fraud" ("SEC report," 2008, p. A-3). The only effect that fair value accounting played in the financial collapse was that it put a physical amount on the losses that many investors and banks had already known were coming and becoming more frequent. One *BusinessWeek* article concluded that the problems really began back in 2007 when the precarious investments started to manifest themselves in losses:

> The value of mortgage-backed securities, which are bonds backed by home loans, and other risky investment products fell sharply beginning in 2007 as the housing market deteriorated and the economy faltered. Banks were required, because of the accounting rules, to record hundreds of billions of dollars in noncash charges to reflect the waning value of those investments sitting on their balance sheets. (Bernard, 2009, p. 11)

Fair value accounting made it much more apparent to governing boards how dangerous these loans were and that with loses already beginning to pile up, changes needed to be made before the situation became any worse.

The Financial Crisis Advisory Group was thus created to discuss and propose certain accounting regulations that could help repair the broken economy. During the first meeting, they agreed that accounting had played a minor role in the financial collapse, but should not be held responsible. The cumbersome issue of fair value was not completely blameless. The FCAG concluded that "the true causes of the crisis are excess greed, excess liquidity, poor risk management and irresponsible organisations, not accounting. However, fair value accounting does have pro-cyclical effects" ("January 20, 2009: Meeting Summary," 2009, p. 9). When an event is described as pro-cyclical, it implies that whenever the economy moves in an upward trend, the fair value will increase as well, or in the case of the economic recession, when the financial markets began to move downward, so will the fair values of many key goods. However, the pro-cyclical nature of fair value practices is not a reason to discredit fair value as a proper way to assess assets and liabilities. Gross domestic product (GDP) as well as sales for luxury items are pro-cyclical but yet are still reliable indicators. Fair value is defined as "the price that would be received to sell assets or paid to transfer a liability in an orderly transaction between market participants at the measurement date" (Spiceland, et al., 2009, p. 33). One member of the FCAG referenced the Chicago Board Options Exchange Volatility index (VIX) when discussing the increase in recent market volatility, but proposed that it could be potentially due to a misunderstanding of fair value estimates by investors ("February 13, 2009: Meeting summary", 2009). Conversely, in the next meeting, another member challenged the assumption that fair value was pro-cyclical at all. In fact, he believed it was the other way around; "anecdotal evidence actually proves the opposite because mark-to-market accounting is less procyclical. Mark-to-market

accounting fosters quicker responses by the investing public, but does not, by its nature, lead to procyclical results" ("March 5, 2009: Meeting summary," 2009, p. 4). With the value of an object being continually updated and revised, it gives investors a better perspective of the current financial position of the company and therefore, if the value is higher or lower than expected, the result is increased volatility which, in-turn, affects the general market based on that valuation. Fair value is misunderstood, and helps to provide more relevant information to users. Instead of being forced to refer to outdated information, investors are presented with valuation updates which are more useful when assessing not only the current, but the future value of a company as well.

Although there was still some debate over how proper fair value accounting should be defined, the Financial Crisis Advisory Group thought the issues of consolidation and securitization were considered to be more important, and thus should be more of a focus for their efforts ("January 20, 2009: Meeting Summary," 2009). With consolidation of standards as the overarching goal, the FCAG targeted specific issues to be kept in mind by the Financial Accounting Standards Board and International Accounting Standards Board while working toward a joint conceptual framework.

Purpose of Financial Statements

One significant issue considered was the role of accountants and who should be considered when setting accounting standards. It was stressed that with the wide range of people who are affected by the changes, many significant individuals should be consulted and taken into account during the process of preparing and voting on accepting new standards. Preparers, auditors and regulators are also essential to the process since they are the ones who actually must cooperate and work with the standards ("March 5, 2009:

Meeting summary," 2009). Yet since investors are generally the primary users and beneficiaries of financial statements, their needs and expectations are usually considered first when setting the rules. Though preparers, auditors and regulators all play very significant roles in the reporting process, their primary purpose is to convey the financial position of the company to the investors to the best of their abilities. The investors then use that information to choose either to invest more money into the operations or to withdraw their support and let someone else carry that burden. Investors can also pose the greatest threat to the stability of a company, as their opinions essentially control what decisions are made by the company and how they implement certain long term goals.

The Problem with Speculation

The most prevalent problem with finance and investing is that there is a human element involved in each. Predictions that are made based on emotions instead of facts can significantly affect the movement of the market with no performance indicator to explain the change. This is abundantly seen on the New York Stock Exchange, especially in times of increased volatility (Schwert, 1989). The Financial Crisis Advisory Group noted that,

> The role of accounting is to reconcile the short-term focus versus the long-term focus of investors. It should be considered whether accounting should be neutral with respect to management, investors and speculators. There is also a huge difference between stock owners, who invest for the long term, and stock renters, who are speculators. ("January 20, 2009: Meeting summary," 2009, pp. 9-10)

Hersh Shefrin (2000) referred to this phenomenon as heuristic-driven bias. One example that Shefrin used was the gambler's fallacy. Though this practice may not result in any

material loss when considered by the casual observer, this fallacy can result in significant financial loses when they are applied to investments. Shefrin used a series of coin flips to illustrate his point. He noted,

> After a run of five heads, people tend to predict tails on the sixth toss, because of the representativeness heuristic. From their perspective, "a tail is due." But this reasoning is wrong, just as below-average returns are no more likely after "the longest period we've ever had with such high returns." (Shefrin, 2000, p. 18)

This fallacy in logic can result in some investors becoming too confident, or adversely, not confident enough in their initial investments. This unfounded speculation can result in severe variance of stock prices which can lead to a ripple effect that has nothing to do with the actual performance of a company:

> There are nearly 10 billion shares traded daily in the United States, and this is primarily done by speculators who are trying to take advantage of prices moving up and down as opposed to investors worried about sound governance of the company they invest in. ("February 13, 2009: Meeting summary," 2009, p. 2)

Though speculation may be impossible to eliminate in its entirety, "one role of accounting is to interrupt the chain letter, to challenge speculative beliefs, and so anchor investors on fundamentals" (Penman, 2003, p. 77). With regulating authorities promoting transparency and reliability in financial reporting, investors are encouraged to base their interpretations on real, tangible information and thus hedge out the speculators.

Speculation also can affect the general mindset of the public due to the fear of the unknown. This can be seen today through the governmental bailouts of financial institutions and the auto industry due to concern over the stability of the economy. What

many people do not realize is that the stimulus packages and bail-outs given to banks and financial institutions are not unique when considering historical examples of speculation resulting in financial support. Shefrin referenced an instance in September 1998 with the hedge fund Long-Term Capital Management and quoted Herbert Allison, who was president of Merrill Lynch at that time,

> They were left to ponder whether all this was necessary, and whether a collapse would really have jolted the global financial system. “It was a very large unknown,” Merrill’s Mr. Allison says. “It wasn’t worth a jump into the abyss to find out how deep it was.” (Shefrin, 2000, p. 21)

This seems to be the popular governmental opinion when discussing the current bail-outs of both financial institutions and the auto industry. The phrase *too big to fail* has been used increasingly more and more since the economic recession and was the basis of thought behind many of the bail-outs that benefitted companies like “Fannie Mae and Freddie Mac, Bear Stearns, AIG, Bank of America, Citibank, Merrill Lynch, major insurance companies, a legion of auto parts suppliers, and Chrysler and General Motors” (Smith & Yandle, 2009, p. 3). With these companies qualified as too big to fail, management is essentially assured that no matter what risk is taken, that they are guaranteed to be saved:

> Once a firm is designated TBTF [too big to fail], it can then increase its risk-taking. This is the problem economists call moral hazard. In the words of an old country song, we are reminded that ‘Uncle Jack insured his shack and now he plays with matches.’ In this case, the American taxpayers provide the no-fault insurance. (Smith & Yandle, 2009, p. 3)

In a few years, individuals can all look back with the benefit of a perfect hindsight, but as it stands, many people are not willing to risk the possibility of a complete economic collapse. This fear of the unknown can also present itself in the form of a bear market. With the uncertainty of the market and the subsequent rise in speculators who only add to the volatility of the stock market, sound investors are afraid to lose their money on a sound company that could become the next victim of speculation.

Restoring Investor Confidence

One of the biggest concerns the country now faces is restoring investor confidence. The best way to fight speculation is to ensure that users become informed of what is actually occurring and encourage them to make educated decisions based on tangible evidence of performance instead of mere speculation. However, many investors feel as if there is an information overload and that financial statements and rules should be simplified and more transparent ("January 20, 2009: Meeting summary," 2009). The Financial Crisis Advisory Group agreed that simplifying the accounting for investors was important, and that the best way to achieve this goal would be to improve consistency and work toward convergence. Some companies or organizations may take certain liberties when preparing financial statements that can make them overly complicated or confusing to an investor. The FCAG has put a large focus on consistency and proper implementation of standards, which stands to reason that viewers of the financial statements will find them easier to navigate and distinguish differences between businesses when there is uniformity and accuracy in the presentation of the statements. The Financial Crisis Advisory Group also suggested that too many changes in accounting standards could be dangerous due to the current instability of the economy. One principle

that continued to echo in their opinions was that the reporting standards dictate how the economic situation should be dealt with and that the standards should not be catered to fit the economic situation ("March 5, 2009: Meeting summary," 2009). Using this approach, there should not be a need to update standards to meet the needs of a situation; instead these standards should endure the test of time and help to maintain consistency no matter what may arise. Bringing the Financial Accounting Standards Board and the International Accounting Standards Board together to discuss convergence preemptively helps to prevent further issues from arising due to difference in opinions or options. The single set of accounting standards will stand as the uniform set of regulations that everyone must follow and will not allow for the leeway or misunderstanding that two governing bodies allow.

Nevertheless, the Financial Crisis Advisory Group did have a few suggestions and points of emphasis for investors. When looking over financial statements, it is "fundamental to transparency to understand the thinking of management and not just focus on the numbers" ("January 20, 2009: Meeting summary," 2009, p. 9). One important concept that can never be stressed enough is that accounting is based on concepts and the thoughts behind them, not simply about the numbers. There is only so much information that can be directly gathered from the data on a balance sheet or income statement; it is much more beneficial to use that information and attempt to evaluate from a management perspective. This allows the investor to gain much more insight into the inner workings of the company and to get a better picture of what the future may hold.

Ethical Education

To ensure that a complete financial collapse does not occur, there also needs to be an emphasis on ethical education and enforcement. Many of the scandals over the past 10 years were not merely accidents or entirely due to lack of regulations. It was the deliberate deceit and greed by executives that has plagued the business profession. Though the passage of the Sarbanes-Oxley Act has helped to strengthen internal controls, the underlying problem is not as easy to prevent. It is a fundamental overhaul in ethical education that must be implemented by all institutions of learning and universally supported by the public.

The movement for ethical education and guidance has gained momentum through the American Institute of Certified Public Accountants and the Code of Professional Conduct that they developed. There are several provisions within the code which aim to direct accountants toward professional, ethical decisions and behaviors, including the following:

Responsibilities. In carrying out their professional responsibilities, accountants should exercise sensitive professional and moral judgment in all of their activities.

Public interest. Professional accountants should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

Integrity. To maintain and broaden public confidence, professional accountants should perform all professional responsibilities with the highest sense of integrity.

Objectivity and independence. A professional accountant should maintain objectivity and be free of conflicts of interest in discharging professional

> responsibilities. A professional accountant in public practice should be independent in fact and appearance when providing auditing and other attestation services.
>
> *Due care.* A professional accountant should: (1) observe the profession's technical and ethical standards; (2) strive continually to improve competence and the quality of services; and (3) discharge professional responsibility to the best of his or her ability.
>
> *Scope and nature of services.* A professional accountant in public practice should observe the principles of the Code of Conduct in determining the scope and nature of services to be provided. ("AICPA code of professional conduct," 2009, Section 50; Loyd & Crawford, 2009, p. 1)

However, with no real authoritative power, the AICPA's code of professional conduct is considered a suggestion for how accountants should professionally handle themselves to ensure that there is no question of their integrity. The Public Company Accounting Oversight Board has aided in the enforcement of these principles within the US, but without a global agency to do the same for international countries, the problem is only partially solved. The reforms that were put in place by the Sarbanes-Oxley Act must be expanded to include all global businesses through the Convergence Project to bring supervision to an area that has gone unregulated for too long.

Another proposal that has been discussed is the idea of including ethical education in the accounting curriculum. One study took a survey of deans of schools that were members of the Association to Advance Collegiate Schools of Business International (AACSB). When asked if business ethics should be an important part of the educational

mission of AACSB-accredited business programs, 89% of the respondents either somewhat or strongly agreed (Evans & Marcal, 2005). That same survey also asked to respond whether they strongly agree, somewhat agree, were neutral, somewhat disagree, or strongly agree to the prompts, “In light of recent high-profile business scandals, I personally believe business schools should place more emphasis on ethics education” and “It is likely that undergraduate students who take a business ethics course will experience a change in attitude and behavior” (Evans & Marcal, 2005, p. 237). The responses for these questions were 80% and 61%, respectively, that they either strongly or somewhat agreed. These results show that academia clearly supports the emphasis on ethics in education and that through this training, students can better prepare themselves for instances when they may face moral dilemmas in the work place.

However, even with the outcry for more regulations and ethical training, there is still change that needs to occur. One study done in 2008 which updated the progress of the Sarbanes-Oxley Act of 2002 showed that “the coverage of ethics on the three most common U. S. professional exams is minor ranging from 1.4% on the CIA examination to 4.3% on the CPA examination to 5.8% on the CMA examination,” “that only four of the fifty U. S. states require CPA candidates to study ethics prior to sitting for the examination” and that “one of the major findings of this study is the relative lack of ethics training required by CPAs as part of their regular CPE requirements. The maximum training is four hours per year and thirteen states require no ethics CPE” (Bates, Waldrup, & Calhoun, 2008, p. 11). The confidence and trust of the people cannot be gained through the mere appearance of change. By starting from the bottom and training employees to follow their ethical and legal obligations, the impact should be seen

in every aspect of their performance. Though the change may not materialize instantly, but a gradual improvement may help to encourage stronger ethical practices in the future.

Plan for the Future

With the focus on globalization causing a shift in the perception of the business world, the best step that can now be taken is to plan for the future and attempt to be prepared for every situation that may arise. The Institute of Internal Auditors Research Foundation concluded that with the passage of the Sarbanes-Oxley Act, there have been significant control improvements in areas such as: control environment, high-risk accounting areas, routine accounting controls and anti-fraud processes (Rittenberg & Miller, 2005). The work of the Financial Crisis Advisory Group has also helped to identify where some grey areas may exist between the Financial Accounting Standards Board and the International Accounting Standards Board to ensure a consistent global standard. With many of the economic indicators beginning to improve and many signs pointing toward a recovery, it is imperative that the suggestions by the Financial Crisis Advisory Group are heeded and placed with preference to avoid similar situations from occurring in the future and to clear up any potential miscommunications or grey areas that may have arisen in the past.

Continued success and stability cannot fully succeed without the cooperation and long term vision of the business industry. These regulations should not stand as mere obstacles to be avoided and exploited through technicalities. Instead the focus of these standards should be guidance and ensured consistency within each organization. Education on ethics should be at the forefront of many business plans to protect them from a fate of a company like Enron, but also to set a precedent for how business should

be conducted. A sustainable future should not merely rely on the standards and standard setters for technical guidance, but also must be supported by the ethics of those who choose to enter the industry.

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