



The Worsening Crisis of Confidence On Wall Street

The Role of Auditing Firms

Submitted by
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to
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**Public Company Accounting and
Investor Protection Act (S. 2673),**
Introduced by
Sen. Paul Sarbanes (D-MD)

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Executive Summary

The crisis of confidence on Wall Street worsens with each passing day.

In an earlier paper, *Crisis of Confidence on Wall Street: Brokerage Firm Abuses and the Worst Offenders*, Weiss Ratings data showed that ratings from 94% of Wall Street firms continued to recommend that investors buy or hold shares in companies that went bankrupt in 2002, right up to the very day these companies filed for Chapter 11.

However, for shareholders seeking protection, Wall Street research analysts are merely the *second* line of defense. The first line of defense is manned by public auditors, the subject of this paper.

Herein, we examine auditing firms in two closely related areas: (a) in terms of their performance in warning the public of accounting irregularities; and (b) in terms of their performance in warning of bankruptcies.

Regarding accounting irregularities, we found that:

- Auditing firms almost universally failed to warn of accounting irregularities. In their auditor reports, the firms gave a clean bill of health to 93.9% of public companies that were subsequently involved in accounting problems.
- Over \$1.8 trillion of peak market value involved. The companies involved in accounting irregularities despite a clean bill of health from their auditors have had a total peak market value of nearly \$1.803 trillion. They are currently worth \$527 billion, implying an aggregate loss to shareholders of up to \$1.276 trillion, due to a variety of factors including accounting issues.
- Only one auditing firm issued warnings. Only PricewaterhouseCoopers issued warnings about companies involved in accounting irregularities. All others failed to issue any warnings in their auditor reports.

Regarding bankruptcies, we found that:

- Auditing firms failed to warn of nearly half of bankruptcies. The auditing firms gave a clean bill of health to 42.1% of the public companies that subsequently filed for bankruptcy between January 1, 2001 and June 30, 2002.
- Over \$225 billion of peak market value involved in bankruptcies. The companies that filed for bankruptcy despite a clean bill of health from their auditors had a peak market value of more than \$225 billion, nearly all of which has been lost by shareholders.

- Among the five largest auditing firms in the nation (the “Big Five”), KPMG had the worst track record of alerting shareholders to future financial difficulties, while Ernst & Young and PricewaterhouseCoopers had better track records.
- As a group, smaller auditing firms did a better job alerting the public than four of the Big Five auditing firms.
- Among companies that subsequently filed for bankruptcy, 88.9% displayed at least two negative financial indicators that were evident in their accounts at the time of the audit.

In sum, just as we found earlier among research analysts, the auditing process has suffered a broad breakdown with disastrous consequences.

Both among research analysts and auditors, the neglect and abuse are too widespread, too deeply ingrained, and too dangerous to be resolved strictly by recent regulatory proposals or new voluntary reforms. In order to help restore integrity to our accounting system and confidence to investors, we urge Congress to swiftly pass the Public Company Accounting Reform and Investor Protection Act of 2002, sponsored by Sen. Paul Sarbanes (D-MD).

In addition, we propose that corporate financial statements be reviewed quarterly and that the record of each auditing firm’s warnings of future difficulties be tracked and disclosed to the public.

The Worsening Crisis of Confidence on Wall Street The Role of Auditing Firms

Introduction

The crisis of confidence on Wall Street worsens with each passing day. Investors, already shell-shocked by Enron, Global Crossing and Kmart, have now been shaken by the new implosions of WorldCom, Tyco and Xerox. Domestic investors are on a buyer's strike. Foreign money, which greatly supported the US markets and economy throughout the 1990s, is fleeing the country. Despite sharp market rallies that raise fleeting hopes, commentators talk ever more frequently of "a massive betrayal of trust," "deep investor apathy," even "panic."

In an earlier paper, *Crisis of Confidence on Wall Street: Brokerage Firm Abuses and the Worst Offenders*, Weiss Ratings data showed that major brokerage and investment firms share a substantial part of the blame. Among the 50 firms studied, the ratings from 47 (or 94%) of the firms continued to recommend that investors buy or hold shares in companies that went bankrupt in 2002, right up to the very day they filed for Chapter 11. Worse, among 19 companies that went bankrupt and were covered by the Wall Street firms, 95% received unanimous or near-unanimous "buy" or "hold" ratings from Wall Street firms, also right up to the day of bankruptcy filing. However, research analysts are merely the second line of defense for investors.

The first and more important line of defense is manned by the nation's auditing firms. The auditing firms should play the primary role in protecting the public against accounting manipulations, financial failures and the devastating investment losses that almost invariably result.

In their report to shareholders, if auditors frequently fail to warn of obvious problems, it implies a neglect of their fundamental responsibility and a serious breach of trust. In this paper, we shall demonstrate that, unfortunately, this is the current state of affairs, especially among the five largest auditing firms in the country (the "Big Five").

Regarding the performance of auditors in warning of accounting problems, we followed these analytical steps:

Step 1 Which auditing firms conducted the audits of large public companies that were subsequently involved in significant accounting irregularities?

Step 2 In how many cases did the auditing firms issue a warning to shareholders regarding the company's viability over the next 12 months (a "going concern" warning)? In how many cases did they give the companies a clean bill of health?

Step 3 What is the relationship between accounting irregularities and corporate bankruptcies?

Regarding the performance of auditors in warning of bankruptcy, we followed these analytical steps:

Step 1 How many companies have failed since the beginning of 2001 and how many auditing firms were involved?

Step 2 What impact did the timing of the audit have on the ability or willingness of the accounting firms to detect or warn of future troubles?

Step 3 Which auditing firms had the best track record in terms of alerting shareholders of future bankruptcies? Which firms had the worst track record?

Step 4 Based on the evidence available to auditors at the time of the audit, would it have been possible to do a better job warning shareholders of future bankruptcies?

A. Performance of Auditors in Warning of Accounting Problems

With new types of revelations surfacing daily, a precise definition of “accounting problems” is elusive, and the inclusion or exclusion of companies to research would be subject to endless debate.

Therefore, we decided to review all companies cited through June 30, 2002 for accounting irregularities by major public sources of information.¹ We then proceeded to follow these analytical steps:

Step 1 Which auditing firms conducted the audits of public companies that have recently been involved in significant accounting irregularities?

There have been at least 33 public companies recently involved in, or cited for, significant accounting irregularities. With just one exception, each of these companies was audited by one of the Big Five auditing firms, as indicated in Table 1.

Table 1. Six Firms Audited 33 Companies With Accounting Irregularities

Auditing Firm	Companies with Accounting Irregularities		Peak Market Capitalization	
	(# of Cos.)	(%)	(mil. of \$)	(%)
Arthur Andersen	11	33.3	623,296	34.4
Deloitte & Touche	5	15.2	629,508	34.7
Ernst & Young	4	12.1	37,379	2.1
KPMG	5	15.2	85,114	4.7
PricewaterhouseCoopers	7	21.2	437,845	24.1
Tullis Taylor	1	3.0	52	0.0
Total:	33	100.0	1,813,193	100.0

Arthur Andersen performed the audits on 11, or one third, of the companies, while four other Big Five firms performed the audits on 21 of the companies.

Although the auditors are not responsible for the fluctuations of each company’s share prices, the peak market value (market capitalization) of the audited firms is provided as a measure of the size of the companies involved and the impact of the company’s fate on shareholders.

Just three firms — Arthur Andersen, Deloitte & Touche, and PricewaterhouseCoopers — performed the audits on companies representing 93.2% of the total peak market value of

¹ Major public sources of information include, among others, the *Wall Street Journal*, www.multixinvestor.com, Stamford Law at <http://securities.stanford.edu>, and *Bowman’s Accounting Report*.

the companies. The balance of the firms audited companies representing only 6.8% of the peak market value.

Step 2 In how many cases did the auditing firms issue a “going concern” warning to shareholders? In how many cases did they give the companies a clean bill of health?

As shown in Table 2, auditing firms gave a clean bill of health to 31, or 93.9%, of public companies that were subsequently involved in accounting irregularities, while “going concern” warnings were issued on only two, or 6.1%, of the companies.

Table 2. Very Few Auditors Issued "Going Concern" Warnings

Auditing Firm	Total Audits (# of Cos.)	Issued "Going Concern" Warning (# of Cos.)	Gave Company Clean Bill of Health (peak mkt. value, mil. of \$)	
			(# of Cos.)	(# of Cos.)
Arthur Andersen	11	0	11	623,296
Deloitte & Touche	5	0	5	629,508
Ernst & Young	4	0	4	37,329
KPMG	5	0	5	85,114
PricewaterhouseCoopers	7	2	5	427,195
Tullis Taylor	1	0	1	52
Total:	33	2	31	1,802,544

- Arthur Andersen gave a clean bill of health to 11 companies involved in accounting irregularities, while failing to issue a “going concern” warning on any of the companies reviewed in this study.
- Deloitte & Touche and KPMG each gave a clean bill of health to five companies involved in accounting problems, also while failing to issue a “going concern” warning on any of the companies reviewed here.
- Only one auditing firm —PricewaterhouseCoopers — issued “going concern” warnings on at least one of the companies with accounting irregularities.

All told, the 31 companies that were involved in accounting irregularities despite a clean bill of health from their auditors had a total peak market value of nearly \$1.803 trillion.

Currently, these 31 companies have a market value of \$527 billion, implying an aggregate loss to shareholders of up to \$1.276 trillion. Although it is impossible to determine which portion of the losses are directly attributed to accounting issues, these issues clearly played a very important role.

Step 3 What is the relationship between accounting irregularities and corporate bankruptcies?

Among the 33 companies with accounting irregularities reviewed in this analysis, six — Enron, Global Crossing, Kmart, Adelphia Communications, Metromedia Fiber Network and Nesco, Inc. — filed for bankruptcy after the accounting irregularities were revealed. This represents a failure rate of 18.2%, which is over four times higher than the average default rate on junk bonds.

Five of the six companies with accounting irregularities that failed received a clean bill of health in the last audits preceding the failures. Two of the audits were by Arthur Andersen, and one each by Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers, and Tullis Taylor.

By their very nature, accounting irregularities are difficult to track historically or quantify comparatively without additional investigations beyond publicly available data. However, we can shed light on the performance of auditors by analyzing their track record with respect to corporate bankruptcies, whether or not accounting issues have been revealed for the bankrupt firms. Corporate bankruptcies and accounting irregularities are closely related issues because:

- companies with known accounting irregularities are often likely to lose the confidence, support, and patronage of investors, lenders, suppliers and customers;
- companies with financial difficulties are among the most likely to resort to legal or illegal devices to hide those difficulties from public view;
- companies filing for bankruptcy may often harbor unknown accounting irregularities that may not become apparent until many months after the filing; and,
- companies with known accounting irregularities are often more likely than others to file for bankruptcy in the not-too-distant future, as documented by the high failure rate of companies with known accounting problems.

Table 3. Within 12 Months of Failure, 228 Failed Companies Were Audited by 23 Different Accounting Firms

Auditing Firm	# of Cos. Audited	Total
Arthur Andersen	48	
Deloitte & Touche	34	
Ernst & Young	46	
KPMG	28	
PricewaterhouseCoopers	38	
Subtotal: "Big Five"		194
Barfield, Murphy, Shank & Smith	1	
BDO Seidman	8	
Bella, Hermida, Gillman, Hancock & Mueller	1	
Cogen Sklar	1	
Don Harrison	1	
Ehrhardt, Keefe, Steiner & Hoffman	1	
Feldman Sherb & Co	2	
Friedman, Alpren & Green	1	
Radin, Glass & Co.	1	
Grant Thornton	7	
Hein & Associates	1	
Lazar Levine	1	
McGladrey & Pullen	2	
Pannell Kerr Forster	1	
Richard Eisner	1	
Singer Lewak	2	
Stonefiled Josephson	1	
Tullius Taylor	1	
Subtotal: Smaller Firms		34
Total		228

B. Performance of Auditors in Warning of Bankruptcies

In this section, we review auditing firms' performance in warning of future bankruptcies, whether or not these are directly related to accounting issues.

Step 1 How many companies have filed for Chapter 11 since the beginning of 2001, and how many auditing firms were involved?

Between January 1, 2001 and June 30, 2002, 307 publicly traded companies filed for Chapter 11. Among those, 228 companies received an auditor's report within 366 days of failure, and were reviewed in this study. The 228 companies were audited by 23 different accounting firms, as listed in Table 3 (previous page).

The 23 auditing firms and 228 bankrupt companies represent the scope of the analysis for steps 2 and 3.

Step 2 What impact did the timing of the audit have on the ability or willingness of the accounting firms to detect or warn of future troubles?

Naturally, it is easier to detect — and more difficult to neglect — a company's financial troubles when the audit is completed just days before the company files for bankruptcy, while problems are less evident in a company that may not file for bankruptcy until nearly a year later.

Thus, the timing of the auditor's report clearly has a significant impact on each accounting firm's track record, and this impact must be quantified before one can fairly compare each firm, as shown in Table 4.

Table 4. The Timing of Audits Has a Significant Impact on Results

Time Lapse Between Audit and Bankruptcy (Days)	Companies Audited (# of Cos.)	"Going Concern" Warning (# of Cos.)	Clean Bill of Health (# of Cos.)	Correctly Issued Warning (%)
0-91	45	41	4	91.1
92-183	44	32	12	72.7
184-273	60	29	31	48.3
274-365	79	30	49	38.0
Total	228	132	96	57.9

There were 79 auditor reports dated nine to 12 months prior to the date of bankruptcy. Among these, "going concern" warnings were included for only 30 (or 38%). The reports gave a clean bill of health to the companies in 49 (or 62%) of the cases.

In contrast, within three months of bankruptcy, there were 45 auditor reports. These reports included “going concern” warnings for 41 (or 91.1%) of the 45 companies, while giving a clean bill of health to only four or (8.9%) of the cases.

Thus, the data in Table 4 underscore the pattern we cited above: the longer the time between the date of the auditor reports and the date of Chapter 11 filing, the lower the percentage of correctly issued warnings. This pattern is the basis of an adjustment factor used in the next step of the analysis.²

Step 3 Which auditing firms did a better job alerting shareholders of future bankruptcies? Which firms had the worst track record?

The Big Five auditing firms audited 194 of the 228 companies that subsequently filed for bankruptcy, while smaller accounting firms audited the remaining 34. (Table 3.)

Overall, the auditing firms issued a clean bill of health to 96 (or 42.1%) of the 228 companies that subsequently failed, while issuing “going concern” warnings on 132 (or 57.9%) of the companies. The 96 companies had a peak market value of \$225.5 billion, nearly all of which has now been lost by shareholders. However, there was a significant difference in performance by each of the auditing firms, as illustrated in Table 5.

Table 5. Some Auditing Firms Did A Better Job Warning Shareholders

Auditing Firm	Companies Audited (# of Cos.)	"Going Concern" Warning (# of Cos.)	Clean Bill of Health (# of Cos.)	Score:		Adjusted Score (%)
				Correctly Issued Warning (%)	Avg. Time Before Ch. 11 (Days)	
KPMG	28	12	16	42.9	228	46.5
Deloitte & Touche	34	19	15	55.9	175	49.2
Arthur Andersen	48	27	21	56.3	206	55.6
Ernst & Young	46	30	16	65.2	181	59.8
Smaller auditing firms	34	20	14	58.8	231	63.1
PricewaterhouseCoopers	38	24	14	63.2	245	70.0
Total	228	132	96	57.9	209	

² Based on the data in Table 2, we compared the average score of auditor reports dated within 3 months before failure (38%) and the average score of reports dated 9 to 12 months before failure (91.1%), and we found that there is a differential of 53.1 percentage points. We also compared the median day in the first 3-month period to the median day in the last 3-month period and found that the difference corresponds to 275 days. Thus, on average, we determined that the scores decline by 0.1931 percentage points with the passage of each additional day between the audit report date and the bankruptcy date.

To evaluate the performance of each auditing firm, two questions are asked:

1. Among the companies reviewed by an auditing firm, how many were correctly identified as having financial difficulties, warranting a “going concern” warning in the auditor’s report?
2. On average, what was the time lapse (in days) between the date of the auditor’s report and the date of the subsequent Chapter 11 filing? As shown above in Step 2, the timing of each audit had a significant impact on the ability to detect or warn of problems. Thus, auditing firms that issued their reports further in advance of a bankruptcy filing were at a disadvantage, while auditors examining the books nearer to the time of the bankruptcy filing had an advantage. To account for the impact of the timing differences, each firm’s score is adjusted accordingly.

From this analysis, we found that:

- KPMG had the worst track record, issuing warnings on only 12 (or 42.9%) of the 28 firms it audited. (On average, KPMG’s reports are dated 228 days before failure, putting KPMG at a disadvantage in comparison to the global average of 209 days. However, even after adjusting for this disadvantage, KPMG’s score is still the lowest, at 46.5%.)
- PricewaterhouseCoopers has the best track record among the Big Five, with an adjusted score of 70.0%. This score reflects the fact that the firm correctly issued warnings on 24 (or 63.2%) of the 38 companies it audited. Plus it also reflects that the firm did so, on average, 245 days in advance of the bankruptcy filings. (This positive performance confirms our earlier finding shown in Table 2 — that PricewaterhouseCoopers was the only firm that issued “going concern” warnings on companies with accounting irregularities.)
- Ernst & Young had the best raw score, issuing warnings on 30 (or 65.2%) of the 46 companies it audited. However, on average, Ernst & Young’s reports are dated 181 days prior to the bankruptcy filings, giving the firm a modest advantage over the other firms, and resulting in an adjusted score of 59.8%.
- As a group, the smaller auditing firms generally did a better job issuing warnings than four of the Big Five auditing firms. Their reports correctly cited financial issues for 20 of the 34 firms examined. Plus, the smaller firms were at a disadvantage, issuing their reports, on average, 231 days prior to each company’s bankruptcy filing, as compared to a global average of 209 days. Adjusting for this disadvantage, the smaller accounting firms were able to achieve a final score of 63.1%, exceeding the adjusted score of four of the five large firms.

Step 4 Based on the evidence available to auditors at the time of the audit, would it have been possible to do a better job warning shareholders of future bankruptcies?

Among the public companies that have failed since the beginning of 2001, 96 were given a clean bill of health in the last auditor report performed prior to bankruptcy. This represents a significant failure to warn of future financial difficulties.

What information would have been available to the auditing firms that might have given them the opportunity to do a better job warning shareholders? To answer this question:

1. We focused on 45 of the companies, excluding those that failed more than 12 months following the date of the fiscal year end, the primary data available to the auditors.³
2. We reviewed the balance sheets and income statements of each company, using a series of seven financial indicators commonly used by auditors to help flag difficulties.⁴
3. Although different auditors may use different criteria for flagging difficulties, we used criteria that are widely recognized, and we applied them universally to all 45 companies reviewed. (See Appendix A.)
4. For each of the 45 companies, we counted how many indicators were flagging troubles, with the results of this count shown in Table 6.

**Table 6. There Were Many Yellow Flags
Warning of Possible Difficulties**

Number of Yellow Flags Found In A Company	# of Companies Displaying This Warning Level
None	1
One	4
Two	12
Three	9
Four	7
Five	8
Six	3
Seven	1
Total	45

³ Includes all companies (a) filing for bankruptcy in 2001 and 2002, with (b) fiscal year-end within 12 months of failure, and (c) a clean bill of health from auditors based on the fiscal year-end data.

⁴ The auditor reports are usually issued with a delay following the end of the previous fiscal year. Auditors should be aware of any significant deterioration in a company's financial status that might occur subsequent to the close of the fiscal year. However, for this step in the analysis, we have given the auditors the benefit of the doubt and have eliminated from consideration any companies that failed later than 12 months after the fiscal year end.

There were 45 companies that failed within 12 months of the date of the fiscal year end preceding the audits, despite a “clean bill of health” given by auditors. Among those 45 companies, we counted only one that displayed no yellow flags whatsoever based on the fiscal year-end statements, while most displayed from two to five yellow flags.

Table 7 shows the same data in a cumulative fashion. Among the 45 companies that failed despite a clean bill of health in the auditor’s report, 40 (or 88.9%) of the companies displayed at least two yellow flags, based on the fiscal year-end data available to the auditors, and 28 (62.2%) had at least three yellow flags.

Table 7. Almost 89% Displayed At Least 2 Yellow flags

Number of Yellow flags Found In Each Company	# of Companies Displaying This Warning Level	
	(#)	(%)
At least One Yellow flag	44	97.8
At Least Two Yellow flags	40	88.9
At Least Three Yellow flags	28	62.2
At least Four Yellow flags	19	42.2

It can be argued that it is easy to detect problems with 20-20 hindsight. However, in this analysis, we did not look at new data that may have been available to auditors beyond the fiscal year-end financial statements, and, as noted above, have used standard indicators, applied universally to all 45 companies.

It can also be argued that just one yellow flag may not be adequate to raise serious concerns or warrant a warning to shareholders. However, in nearly nine out of ten cases, the auditors should have been aware of at least two yellow flags. Whether or not they took further action is unknown. However, based on the numbers, it is clear that some further steps were certainly warranted — to investigate in greater depth and, in many cases, to issue a warning to shareholders.

Conclusions and Recommendations for Restoring Confidence in the Accounting System

The data demonstrate a broad and massive failure by auditors to adequately detect and warn of accounting irregularities and bankruptcies, despite their responsibility as the first line of defense against precisely such problems.

We realize that, in an imperfect world, it's not unusual for smaller, inexperienced companies to have severe problems. Nor would one be surprised to hear about relatively minor difficulties that might afflict larger, well-established corporations. However neither of these would come close to describing the recent experience in the U.S. — fatal, devastating, often deliberate mismanagement and neglect at giant corporations that are leaders in vital industries, including the largest energy trading company (Enron), the second largest telecommunications giant (WorldCom), Xerox, Tyco, and many more.

A Historical Perspective

Historically, a breakdown of this magnitude has only been possible in an environment of pervasive conflicts of interest and outside influences:

- In the 1980s, auditors, including KPMG and Deloitte & Touche, helped banking institutions inflate their net worth by failing to properly reserve for non-performing loans. Also in the 1980s, regulators assisted savings and loan associations in the creation of overstated goodwill accounts, which masked capital deficiencies. The companies, the auditors, regulators and Wall Street research analysts all played a role in the ensuing savings and loan debacle.
- In the early 1990s, several large insurance companies, including Executive Life of California, Executive Life of New York, Fidelity Bankers Life, First Capital Life and Mutual Benefit Life, went bankrupt, trapping 5,950,422 policyholders.⁵ Nevertheless, just as we have seen recently, there was a massive breakdown in the mechanism for protecting the public. Insurance regulators knowingly assisted many of the soon-to-fail companies in hiding large amounts of junk bonds.⁶ At the same time, the ratings from large, well-established Wall Street firms consistently gave “good” or even “excellent” ratings to the failing companies right up to the very day they failed,⁷ primarily because of serious conflicts of interest.⁸

⁵ Martin D. Weiss, “Toward a Full Disclosure Environment in the Insurance Industry,” testimony before the U.S. Senate Committee on Banking, Housing, & Urban Affairs, February 18, 1992. See especially Chart 1.

⁶ Martin D. Weiss, *The Ultimate Safe Money Guide*, John Wiley & Sons (2002), pp. 140 - 141, 322.

⁷ U.S. General Accounting Office, *Insurance Ratings: Comparison of Private Rating Agency Ratings for Life/Health Insurers*, (September 1994) GAO/GGD-94-204BR. Also available at www.WeissRatings.com, under Weiss' Track Record, U.S. GAO Ratings Study.

- In the late 1990s, we witnessed a very similar pattern with a similar result: giant, well-respected companies were promoted with distorted ratings and large sales forces, causing severe losses and shattered hopes for millions of investors. Only the actors and the scripts were different: brokerage firms instead of life insurers, public auditors instead of insurance commissioners, high-flying stocks instead of high-yielding insurance policies.⁹ As in the earlier episode with insurers, the ratings from large, well-established Wall Street firms continued to entice investors into failing companies right up to the day they failed.¹⁰

In each case, due to unbridled conflicts of interest, professional analysts, regulators, and auditors came under severe pressure to suppress negative information, cherry-pick positive data and sugar-coat their reports, thereby failing miserably in their responsibility to warn the public of real deficiencies. This must never be allowed to happen again.

Other Accounting Issues

A golden rule of accounting states that when books cannot be balanced due to a relatively minor discrepancy between assets and liabilities, the discrepancy cannot be swept under the rug. No matter how inconsequential it may appear, the discrepancy may be masking more serious errors in the books that require urgent attention. Therefore, the error must be found and corrected.

This should serve as a stark metaphor for the current dilemma, for two reasons: first, the accounting “errors” are by no means inconsequential, as we have demonstrated in this paper. Second, and more importantly, they may be a symptom of other, serious accounting issues that have, thus far, remained largely below the radar screens of both Washington and Wall Street. Specifically:

- Derivatives are largely an unresolved accounting and regulatory issue: Most observers seem to have overlooked a critical factor in the Enron failure: namely that many of the instruments Enron used to cook its books and to manipulate energy markets were derivatives. In the US today, derivatives are among the most voluminous,¹¹ most volatile and least accurately counted financial instruments. They have been associated with serious failures that threaten market stability,

⁸ Weiss Ratings, Inc., *Performance Review of Insurance Rating Agencies: Update and Expansion of United States General Accounting Office Report, “Insurance Ratings: Comparison of Private Agency Ratings for Life/Health Insurers”* (March 1995).

⁹ Martin D. Weiss, *The Ultimate Safe Money Guide*, John Wiley & Sons (2002), pp. 134 - 136.

¹⁰ Martin D. Weiss, *Crisis of Confidence on Wall Street: Brokerage Firm Abuses and the Worst Offenders*, presented at the National Press Club, Washington, D.C., June 11, 2002, revised June 19, 2002. See www.WeissRatings.com, under News Releases, Brokerage Firms, release dated 6/11/2002.

¹¹ As of year-end 2001, the total gross notional value of derivatives contracts reported by all banking institutions was \$46.3 trillion, exceeding the total value of all interest-bearing instruments outstanding in the U.S. Data: FDIC.

such as the demise of Long Term Capital Management and many others. However, modern accounting systems do not even have a clear place for derivatives on financial statements, while the footnotes to financial statements barely track the gross “notional” value of the instruments, with little or no information regarding the real value, real risk, or actual content of the derivatives contracts.¹²

- Accounting gimmicks are also used for tax avoidance. Most of the recent debate on accounting irregularities relates to manipulations that understate expenses and overstate revenues, thereby exaggerating profits. However, there are also many companies — both public and private — that use similar gimmicks to understate profits in order to avoid paying income taxes.¹³

Thus, the revelations of accounting manipulations that have surfaced to date may merely be a symptom of other, equally serious issues, which can have a negative impact on investors, the financial markets, and the economy.

Proposals

The issues raised in this paper are too widespread and too dangerous to be resolved by the Accounting Reform proposals recently offered by the Securities and Exchange Commission (SEC) or by the Corporate Auditing Accountability, Responsibility, and Transparency Act of 2002 (H.R. 3763).

Based on our findings, we propose the following measures:

1. Remove any conflicts of interest that may currently exist between auditing firms and the audited companies. We believe this can only be accomplished by ending consulting relationships.
2. Completely separate the business of auditing from the business of consulting by establishing separate corporations specialized in each field.
3. Completely separate the ownership and operations of auditing firms from those of consulting firms.
4. Create a legal firewall between the two businesses in order to prevent joint ventures, partnerships, or close cooperation between them.

¹² Although the total value of derivatives contracts is very large, publicly available data do not provide insights into the real risks assumed by each institution in the derivatives — let alone the risks associated with supposedly offsetting positions.

¹³ In addition, it is common for companies to avoid reporting taxable income of nonconsolidated subsidiaries by using a tax loophole: the parent company does not own greater than 50% of such subsidiaries, but still controls the subsidiary financially and/or through management.

5. More clearly charge auditing firms with the responsibility to warn shareholders and prospective investors of suspected accounting manipulations and of financial difficulties. Currently, this is often difficult because auditors have essentially only two choices when issuing their reports. Although they may make comments regarding various qualifications, in their final opinion, they can only (a) give a company a clean bill of health or (b) raise “going concern” issues. Instead, we recommend that one additional, intermediate, level of warning be made available for public companies. In effect, the auditing firm would have three options:

Green light The company has a clean bill of health, with adequate resources to withstand deterioration in business conditions within the next 12 months.

Yellow flag The company is currently stable but may suffer financial pressures if the business environment deteriorates within the next 12 months. This level of warning alerts shareholders and regulators but does not invoke SEC actions.

Red flag The company is currently unstable and may not have the resources to withstand deterioration in the business environment. This level of warning should invoke further investigation by securities regulators.

6. Review quarterly statements (10-Qs). There are three levels of service provided by auditing firms: Compilation, Review, and Audit. Currently, although auditors are involved with the production of quarterly 10-Q statements with their clients, they do not issue an opinion on these statements. We recommend that the auditors review 10-Q statements, with involvement of the Audit Committee, issuing a “Review Report” each quarter.
7. An agency of the government, such as the SEC, should track each auditing firm’s track record in warning of accounting or financial difficulties, making that information available to the public.

The Public Company Accounting Reform and Investor Protection Act of 2002 (S. 2673), introduced by Sen. Paul Sarbanes (D-MD), is a critical step in the right direction because:

- It prohibits accounting firms from performing audits and providing lucrative consulting services to the same company, helping to remove the conflicts of interest that we believe were responsible for the widespread failures cited in this paper. Neither the SEC proposal nor the Oxley bill ensures auditor independence in this way.
- It creates a strong, independent board to oversee the auditing of public companies, with no member of the board allowed to receive any compensation from an accounting firm. In contrast, the Oxley bill and SEC proposal create oversight

boards with members who may be partners and employees of accounting firms, perpetuating the current practice of allowing the industry to police itself.

- It gives boards full investigatory and enforcement powers. In contrast, the boards under the Oxley and SEC proposals provide limited investigatory and enforcement powers.

The Sarbanes bill is a long-overdue, much-welcomed first step toward fixing the nation's accounting deficiencies and averting disasters that could be even more damaging than those revealed to date. However, it can be further strengthened by adding measures to ensure better disclosure to the public as outlined above.

Appendix A. Selection of Ratios Used and Criteria for Determining “Yellow flags”

We selected ratios that are commonly believed to be useful as predictors of failure based on empirical studies and an article from the *Journal of Accountancy*.¹⁴ Based on these sources, we analyzed two years (i.e., eight quarters), reviewing the ratios in absolute terms and the apparent trend in the timeframe. The criteria for flagging the resultant ratio as being a negative indicator were as follows:

- Cash flow from operations to total debt:
 - Ratio negative in both years
 - Decrease $\geq 50\%$ if positive (or increase of negative $\geq 100\%$) or from positive to negative 3 out of 4 times when comparing quarter on quarter.
- Net working capital to total assets:
 - Negative working capital in both years
 - Decrease $\geq 50\%$ if positive (or increase of negative $\geq 100\%$) or from positive to negative 3 out of 4 times when comparing quarter on quarter.
- Debt to equity:
 - Ratio ≥ 3.0 at end of 2000.
 - Increase $\geq 100\%$ year on year and > 1.0 at end of 2000
- Return on equity:
 - Negative equity at end of 2000.
 - Decrease $\geq 50\%$ if positive (or increase of negative $\geq 100\%$) or from positive to negative 3 out of 4 times when comparing quarter on quarter.
 - Ratio < -1.0 or ratio > 1.0 .
- Current ratio:
 - Ratio ≤ 1.0 at end of 2000
- Net income to sales:
 - Negative both years
 - Decrease $\geq 50\%$ if positive (or increase of negative $\geq 100\%$) or from positive to negative 3 out of 4 times when comparing quarter on quarter.
- Cash flow to current liabilities:
 - Negative both years.
 - < 0.5 and 2000 less than 1999 (year on year).

¹⁴ Discussion of the ratios used in this study can be found in: William H. Beaver, “Financial Ratios as Predictors of Failure,” *Empirical Research in Accounting, Selected Studies, 1966*, Supplement to Vol. 4 (*Journal of Accounting Research*, pp. 71-127; Leopold A. Bernstein), “Financial Statement Analysis: Theory, Application, and Interpretation,” 1974, p. 463; and John R. Mills and Jeanne H. Yamamura, “The Power of Cash Flow Ratios,” (*Journal of Accountancy*, October 1998, pp 53-61).

Appendix B.
Companies Involved with Allegations or News of Accounting Irregularities
Reviewed

Company Name	Auditing Firm	Has the Company Filed for Chapter 11?	Did Auditor Issue a "Going Concern" Warning
Adelphia Communications	DT	Yes	No
Applied Digital Solutions Inc	PWC	No	Yes
CMS Energy	AA	No	No
Computer Associates	KPMG	No	No
Dollar General	EY	No	No
Dynegy Corporation	AA	No	No
Enron	AA	Yes	No
Gerber Scientific	KPMG	No	No
Global Crossing	AA	Yes	No
Great Atlantic & Pacific Tea Company	DT	No	No
Halliburton	AA	No	No
Hub Group	AA	No	No
Kmart	PWC	Yes	Yes
Lucent Technologies	PWC	No	No
Merck	AA	No	No
Metromedia Fiber Network	EY	Yes	No
Microsoft	DT	No	No
MicroStrategy	PWC	No	No
Nesco Inc	Tullis Taylor	Yes	No
Network Associates	PWC	No	No
Peregrine Systems	AA	No	No
PNC Financial	EY	No	No
Qualcomm Inc	PWC	No	No
Qwest Communications	AA	No	No
Rayovac Corp	KPMG	No	No
Reliant Resources	DT	No	No
Rite Aid	DT	No	No
Supervalu	KPMG	No	No
Trump Hotels & Casinos	AA	No	No
Tyco International	PWC	No	No
Williams Companies	EY	No	No
WorldCom	AA	No	No
Xerox	KPMG	No	No

AA - Arthur Anderson, DT = Deloitte & Touche, EY - Ernst & Young, PWC - PricewaterhouseCoopers