The SEC needs reporting processes for the Information Age.

New Technology Can Help Avoid A Second Enron

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To suggest that Enron was just about a Houston company's accounting fraud is like suggesting the Cold War was just about the shooting down of Francis Gary Powers; it misses the big picture. Enron was about accounting and securities fraud, and bad corporate management, but it was about much more than that. It involved a systematic failure of America's institutions of capitalism.

Enron's management failed. Enron's board of directors failed. Enron's internal audit function failed. Enron's external auditors failed. Enron's attorneys failed. Enron's commercial and investment bankers failed. The credit rating agencies failed. Wall Street's securities analysts failed. The business press reporting on Enron failed. In other words, the institutions of American capitalism that many had touted, indeed even preached about to the rest of the world, simply all failed.

In Enron, the greatest failure of American free market capitalism was the failure of the Securities and Exchange Commission. As the government's watchdog over public companies to ensure adequate and timely disclosure of relevant corporate information, the SEC simply failed in all aspects. It was not a watchdog, or a lapdog, or even involved in Enron, except in several negative ways. The watchdog did not bark. To quote Gertrude Stein, "There was no 'there' there."

If there is a major positive to come out of Enron's failure and its damage to American capitalism, it is the opportunity for the SEC to alter dramatically how it monitors periodic corporate filings and screens them for irregularities that may deserve an investigation. If the SEC seizes this opportunity, it would take an important step in ensuring that another Enron is not taking place.

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BACKGROUND

Enron was a true bipartisan failure on the part of the SEC. A Democrat, Arthur Levitt, chaired the Commission from 1993 to 2001 when the seeds of Enron's collapse were planted and sprouted. A Republican, Harvey Pitt, chaired the Commission from 2001 until 2002, when the collapse finally occurred. Democrats controlled Congress until 1995, when both houses swung to the Republicans, and then the Democrats briefly regained the Senate in 2001.

Many supporters of the SEC contend that congressional failure to provide adequate appropriations for the SEC is the root problem of its failure. In fact, my research suggests that there was a policy management failure on the part of the SEC leadership and an oversight failure on the part of Congress. Lawmakers and their staff did not ask the right questions of the Commission for a decade.

Every four years The Enron 10(k) for 1997, which was filed in April 1998, was the last Enron periodic filing to be examined by an SEC staff member until the Commission reacted to comments in the press about the firm's problems and opened an enforcement investigation during the third quarter of 2001. Enron went bankrupt in the following quarter. In short, the SEC's failure to examine the Enron filings represents a stunning failure of public policy oversight.

Worse, that failure was in compliance with the SEC's stated

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and congressionally approved policy of only reading a public company's periodic filings once every four years, or reviewing 25 percent of all of the corporate filings each year. That was considered adequate. Enron shows that it was not.

Mark-to-market accounting In a no-objection letter dated January 30, 1992, Walter P. Schuetze, chief accountant of the SEC, granted Enron permission to use mark-to-market accounting for its gas trading operations, Enron Gas Services, beginning the first quarter 1992. Enron responded that after "further review," it was going to begin using mark-to-market accounting for the first period of 1991 and that the "impact on earnings was not material." In fact, it was material. The year 1992 marked the beginning of the end at Enron, and the SEC never challenged the companywide use of mark-to-market accounting over the next nine years.

Mark-to-market accounting is a valid accounting technique. Banks and insurance companies mark to market their bonds and equity portfolios quarterly for their public reports, and do it daily for internal management reports. They indicate the increases and decreases in the current market value of the portfolio. The underlying accounting theory is that the current market value is a better measure of the liquid asset's value than its historical acquisition cost. It is most often used for assets for which a third-party valuation is readily available from the newspapers, Internet, Bloomberg, etc.

Gas contracts are relatively uniform contracts for the future delivery of natural gas at stated volumes, prices, purity, and geographic location for delivery. Hence, the gas contracts are relatively easy to price and compare, similar to U.S. Treasury bonds. Mark-to-market accounting is not used for unique assets, project finance projects, and ongoing sales operations that do not have relatively uniform marketable assets that can be easily priced in the open market by looking at the Internet, newspaper, or trade journal publications for current market prices.

Based on the SEC no-objection letter on mark-to-market accounting for its gas trading business only, Enron used mark-to-market accounting for all aspects of its business for SEC reporting and its public disclosures to securities analysts. Enron's SEC filings were not straightforward and obfuscated the fact that Enron was using mark-to-market accounting for all of its businesses.

There is no indication that the SEC ever responded to Enron's February 11, 1992 letter or objected to Enron adopting mark-to-market accounting a year earlier. Indeed, it does not appear that the SEC ever understood the materiality to Enron's earnings. The shift in accounting techniques permitted Enron to show earnings in 1991 that were similar to earnings it reported in 1990. In fact, the 1991 earnings would have been down if Enron had not booked two very large gas supply contracts late that year and marked them to market.

In retrospect, even though it was apparent that Enron was trying to hide what it was doing, the SEC never challenged the firm's companywide use of mark-to-market accounting. That is a nine-year period of failure by the SEC, seven of which were while Arthur Levitt was chairman and two while Harvey Pitt was chairman.

PUHCA The Public Utility Holding Company Act of 1935 was passed to protect consumers from the complex holding company structures and cross-share ownerships of many of the electric and gas utilities in the 1920s. Essentially, if a company is classified as a utility, it must file a number of additional forms for review by the SEC before issuing public securities. (The forms require the company to detail the ownership structures and percentages of ownership and inter-company debt between the parent holding company and its subsidiaries.) In October 1993, Enron petitioned the SEC to declare that power marketers were not utilities under the Act. In response, the SEC issued a no-action letter on January 5, 1994.

When Enron acquired Portland General Electric in 1995, it argued that it was not operating in interstate commerce, but only in the state of Oregon. In fact, Enron reincorporated in Oregon from Delaware, where it had previously been incorporated. Consistent with its past precedents, the SEC found that Enron was not a public utility in interstate commerce. This was a classic case of the lawyers running the SEC based on what had been done before and ignoring the reality of what Enron and PGE were doing. This is another example of SEC failure in regulating Enron.

As later noted by the Senate Government Oversight Committee staff report on Enron, if the SEC would not have exempted Enron from PUHCA, the firm would have been required to prepare much more detailed reports explaining the ownership connections between the parent and its many subsidiaries. The reports would have been filed and (presumably) read by the SEC utilities group. Many questions would have been raised about the nature of the ownership relations and Enron's off-balance-sheet use of the Special Purpose Entities.

XBRL AND THE SEC

Shortly after the accounting scandals at Enron and WorldCom, Congress passed the Sarbanes-Oxley Act. One of the purposes of the Act was to address the deficiencies of the existing SEC corporate filing and review process. It did so in two ways:

- Under Section 408, the Act mandates "Enhanced Review of Periodic Disclosures by Issuers," and requires the SEC to review the filings "on a regular and systematic" basis. It then enumerates six review criteria that the Commission must consider.
- Under Section 409, the Act authorizes (but does not mandate) that the Commission initiate real-time issuer disclosures from issuers of securities.

Those changes may appear to be subtle, but they are notable alterations to how the SEC had been operating.

XBRL By chance, there is a new classification system that, if the SEC adopts it, will permit the Commission to alter its filing and analysis of periodic corporate reports in a transforming way. eXtensible Business Language Reporting (XBRL) is a new private sector scheme developed to improve the consistency, accuracy, and quality of financial reporting in the business sector. XBRL is owned by a non-profit company, which in turn is owned by over

200 member companies around the world. About 50 of the member companies are U.S.-based. Any company can join the consortium and all of them pay their own expenses to work on the project. XBRL is freely licensed to anyone who wants to use it.

In essence, XBRL is a uniform standard for the electronic distribution and comparison of business reports. It enables users to compare the financial performance of a company against a group of companies and know that the data are comparable. It has been described as an Excel spreadsheet that is preloaded on a web server with all of the other companies in its industry. For example, in the retail sector in XBRL, "sales per square foot" will now be uniform in their comparison, whereas previously, companies could and did have different definitions of such matters as what space (restrooms? stockrooms?) should be included in the square footage.

In terms of its effect on financial reporting, XBRL has been analogized to bar coding for financial statements or the introduction of containerization in world trade and shipping. Another description is that XBRL will do for financial reporting what the Dewey Decimal System did for libraries. Those analogies all seem to be apt. Mike Willis of PricewaterhouseCoopers, who also is the head of the International Steering Committee of XBRL, has claimed, "The effect that XBRL will have on the business community will be more significant than the transition from paper and pencil analysis of financial information to the use of electronic spreadsheets."

The standards or taxonomies underlying XBRL are expected to be available for testing and use in the fall of 2003. The standards for the banking sector are already virtually completed, and commercial and industrial standards covering 97 percent of the economy are scheduled to be completed in the fall of 2003.

Five of the six major accounting firms that audit virtually all of the public companies in the United States have led the development of XBRL, its taxonomies, and the accompanying industry standards developed by the private sector industry working groups. The accounting firms are KPMG, Ernst & Young, PricewaterhouseCoopers, Grant Thornton, and BBDO Sideman.

XBRL has been entirely developed in the private sector, and there is no government money or even government sponsorship involved. Indeed, XBRL is being adopted by the government from the private sector. The Federal Examinations Council (comprised of officials from the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision) announced last June that the government would convert the basic bank report to the government agencies, known as the Call Report, to XBRL. Assuming the schedule is met, a major test will occur the first quarter of 2004, and all banks will begin filing in XBRL during the third quarter of 2004. In other words, the private sector is addressing the failures of the SEC for a decade, and improving transparency in corporate reporting so that the capital markets can function more efficiently. The government has failed to do that.

"TRUST" REPORTING

I developed for the SEC a new XBRL web-based corporate filing and screening system. This proposal was then reviewed with senior SEC staff, and was refined and improved with their cooperation. The Commission is likely to consider it this fall.

My recommendation is called "Transparent Reporting Using Standardized Terminology," or "TRUST" for short. It is essentially an XBRL-based reporting system for the SEC to use in reviewing periodic corporate reports filed by public companies. The flow charts in Figures 1 and 2 demonstrate the current SEC filing and screening system and the TRUST system.

TRUST provides the SEC with an opportunity to revise its filing and screening process for all periodic public company filings like the 10(k) and the 10(q). It enables the Commission to screen electronically all of the filings and determine which ones are consistent with industry standards and which individual companies' filings require additional explanation before the SEC can sign off on them. It is like posting to the company's website, except that XBRL makes the data available for computer analysis and manipulation once it is posted. It does not have to be entered into a spreadsheet by hand.

If Enron had filed in XBRL, its reported revenues, cash flows from operations, and profits would have been compared against industry standards. Its growth rate and the growth rate of its purported cash flows from operations would have been so far above the industry norms that it would have been flagged for an SEC staff review. It looked too good to be true, and an examination by the SEC's Corporate Finance Department would have showed that it was too good to be true. In other words, using XBRL, the comparison to industry standards would have prioritized the Enron work for the SEC staff.

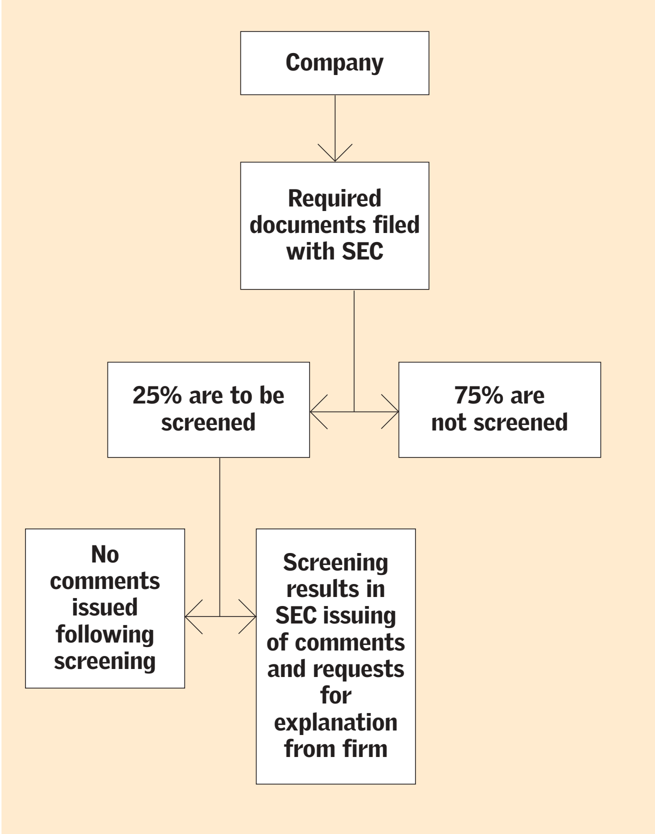
If the XBRL-based TRUST system had been in place prior to Enron's collapse, the firm's corporate filings would have been flagged for SEC review.

Second review Using XBRL, the SEC would be able to identify deviations from industry norms or standards. The SEC could then "comment" on the deviations and request an explanation electronically. Those deviations that the SEC determines are material and not adequately explained by the companies through an electronic e-mail would then be reviewed by the

FIGURE 1

The Present

The current SEC filing and screening system



Corporate Finance Staff, which would attempt to resolve the questions through a conference call with the firm's financial officers. That process would resolve most filing issues.

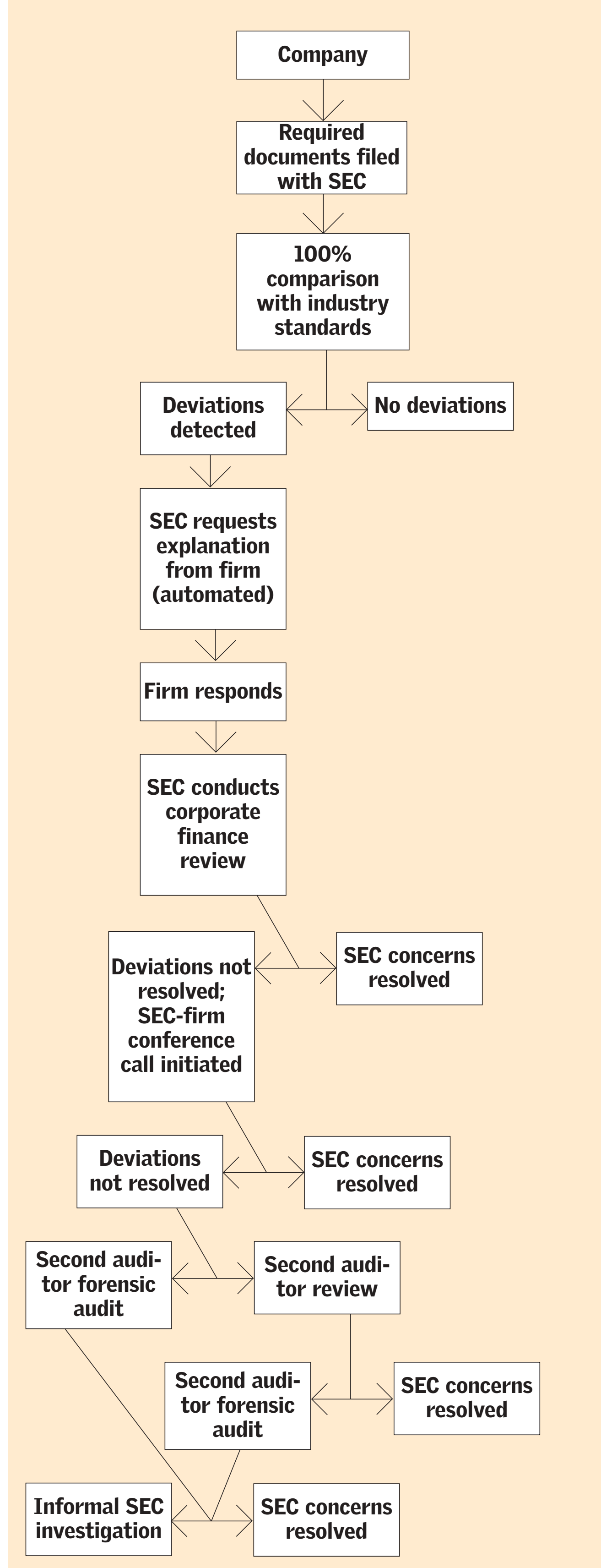
For questions that would not be resolved in the conference call, the SEC could request a second audit firm to audit the filings in dispute. This would not be a complete second audit, which would be too expensive. But, by focusing on the disputed issue, the second audit firm would recommend a resolution to the SEC and the company. Hopefully, that would lead to resolution of the matter. If resolution does not occur, the SEC would have the option of ordering a forensic audit of the company by the second auditor on the disputed matter. That should resolve the matter in virtually all cases that do not become SEC enforcement investigations.

In the case of Enron, even a cursory review of its 10(k) or 10(q) disclosures by a second auditing firm would have raised serious questions as to their adequacy in describing Enron's business and the off-balance-sheet transactions Enron employed. If a second firm had been asked to review any one of Enron's 10(k) filings from 1992 to 2001, the auditors would have produced a critique of the disclosures that would have caused the SEC Corporate Finance Department to initiate a serious investigation into what was going on. That would have almost undoubtedly led to enforcement actions that would have halted Enron's questionable practices several years before 2001.

FIGURE 2

The Future?

TRUST Reporting



The Second Auditor Review policy has been praised by all who have examined it, including senior SEC staff and non-government experts on corporate reporting. In fact, Bill McDonough, the new chairman and CEO of the Public Company Auditing Oversight Board that was created under Sarbanes-Oxley, said about the Second Auditor Review, "That puts all of the incentives in the right places for everyone."

At this time, it appears that the SEC is preparing to announce that it will convene an SEC Round Table Discussion on "tagged reporting" with private sector participants. That is the normal SEC process and is similar to its recent SEC Round Table Discussion on Hedge Funds. The discussion is expected to occur before the end of 2003. After the SEC Round Table, the Commission will make a formal decision on TRUST. Discussions with SEC officials indicate that it is highly likely that TRUST will be the basis for a complete overhaul of the SEC's filing and screening process. Implementation could begin in 2004.

Benefits of TRUST The TRUST recommendation is fully consistent with (and in some places surpasses) the requirements of the Sarbanes-Oxley Act. Indeed, Section 408 of the Act requires that the latest available technology be used to make filings meaningful and useful to the SEC. The TRUST proposal permits the SEC to screen 100 percent of its filings; the Sarbanes-Oxley Act requires only that 33 percent be reviewed annually. What is more, TRUST can work in "real time," thus satisfying the important requirement contained in Section 409.

The TRUST system would provide the SEC with the screening tools that it needs to monitor corporate filings and comply with the congressionally mandated criteria for screening under Sarbanes-Oxley. The use of industry standards developed by the private sector increases the probability that they will be more accurate and effective than those that would be developed by the government. The system's greatest contribution is that the incentives for the SEC, the primary audit firm, and the chief financial officers of publicly traded firms are all aligned to avoid the use of the Second Auditor Review, which would trigger adverse consequences, discipline, or even dismissal of the CFO and the auditor involved.

Last, at the macro level, the contribution of the TRUST system is that it would begin to close the "expectations gap" between the auditing firms and the needs of capital market participants for improved transparency. It moves away from earnings per share as the exclusive measure used by the investment community to gauge corporate performance. Enron's earnings, which supposedly followed Generally Accepted Accounting Principles, were manufactured through an elaborate Ponzi scheme and accounting fraud that the SEC did not even attempt to detect. Neither the SEC nor GAAP reporting worked to ferret out Enron to provide private sector market discipline. I recommend that the SEC should study the addition of non-GAAP performance metrics to the SEC GAAP reporting requirements, a recommendation also endorsed by the American Enterprise Institute and the Brookings Institute.

Need for transparency According to a July 2002 CNN/*USA Today* poll, 77 percent of the public believes that CEO greed and corruption caused the recent U.S. financial meltdown. A survey of Main Street Investors conducted that same month found that 71 percent of investors say accounting fraud is rampant. That is the real cost of the SEC's failure in Enron, and it is in no small part influenced by the constant coverage by the business new programs on cable television 24 hours a day, seven days a week.

Free capital markets cannot operate properly without transparency and confidence in the information they have. The current GAAP accounting and SEC reporting systems do not serve America's twenty-first century needs for transparent capital markets with trustworthy information. Fortunately, the private sector has been working to correct that problem. The SEC's adoption of TRUST will go a long way toward making GAAP reporting consistent and useful.

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