The Deal
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Full disclosure

By Victor Germack, RateFinancials

The recent bankruptcy by Circuit City Stores Inc. should hardly have come as a surprise. In July 2006, we at RateFinancials Inc. publicly questioned the electronics retailer's accounting practices and warned that the quality and integrity of its reported profits were extremely poor.

America's complex accounting rules almost encourage obfuscation and can easily be gamed to deceive even reasonably sophisticated investors about the true conditions of public companies they own. Despite reforms implemented post-Enron, WorldCom and Tyco, our firm continues to ferret out numerous examples of aggressive accounting, low earnings quality and poor corporate governance. Reforming the U.S. financial markets won't happen unless our nation's accounting rules and practices are overhauled.

A fundamental problem is the application of generally accepted accounting principles. In theory, GAAP accounting is a rules-based system designed to ensure that all companies adhere to the same reporting standards.

But rules are often made to be broken and basic accounting principles have become so marred with exceptions that corporate managers can easily "manage" their earnings on a quarterly basis rather than truly representing the economics of their companies.

Case in point: The accounting rule that once governed the "Consolidation of Special Interest Entities." Exemptions to this rule allowed Enron and others to avoid consolidating a substantial amount of their liabilities and remove them from their balance sheets.

The exemption was tightened somewhat after Enron's collapse, but not enough. Citigroup Inc. and numerous other major financial institutions still kept trillions of unconsolidated complex financial instruments off their balance sheets, thus improving their earnings This ledger sleight of hand has contributed mightily to our economic crisis.

Then there is the mark-to-market issue, which would require that financial institutions value the assets on their books based on current market conditions. Banks supported this rule in boom years when it made their earnings look better, but they oppose it now because the reverse is true.

Congress and the Securities and Exchange Commission should demand that fair-value accounting be applied to all financial instruments so investors are alerted to potential toxic problems well in advance and can gauge whether financial institutions have established sufficient reserves.

Another major issue is the accounting "Tower of Babel" ensuing because of efforts by the SEC and the Treasury to promote the wholesale adoption of the International Financial Reporting Standards — the accounting standards that are used by most countries except the U.S.

In late 2007, the SEC permitted some foreign private issuers to file their financial statements using IFRS accounting without having to reconcile them to GAAP accounting.

According to our analysis, reported earnings of foreign private issuers, whose securities are traded on the New York Stock Exchange, are nearly 20% higher using IFRS accounting than under GAAP.

The Big Board doesn't require even a modicum of disclosure regarding the discrepancy and few investors are even aware of this issue.

While there is merit to moving to the IFRS standard, the migration must be done with extreme caution and oversight. IFRS accounting must be done with extreme caution and oversight. IFRS accounting allows managements to make considerably more judgment calls; if many companies are already taking considerable liberties under GAAP rules, IFRS rules afford even more opportunities to deceive. Given that IFRS accounting isn't even taught yet in our schools, Congress should mandate that the standard not be wholly adopted for several years.

Finally, the Financial Accounting Standards Board, the designated private sector group for establishing the standards of financial accounting and reporting, must be held more accountable by the SEC and less influenced by political pressure and special interest groups. FASB's board representation was reduced in 2008 and the organization doesn't adequately serve the public's interests. FASB also must move considerably faster on implementing new procedures.

America's financial system has failed. Unless accounting standards are radically overhauled and streamlined, investors will forever be susceptible to continuous instances of corporate fraud and wrongdoing.

Victor Germack is founder and president of RateFinancials Inc.