GOING TOO FAR IS WORSE THAN NOT GOING FAR ENOUGH: PRINCIPLE-BASED ACCOUNTING STANDARDS, INTERNATIONAL HARMONIZATION, AND THE EUROPEAN PARADOX

I. HOW DID WE GET HERE?—ACCOUNTING, FRAUD AND NATIONAL DEBTS OF AFRICAN COUNTRIES

When the smoke cleared in midsummer 2002, the Federal Government estimated that Andersen Accounting facilitated Enron to overstate its earnings by more than $1 billion.[1] Incidentally, this is greater than the national debts of Botswana, Djibouti, and The Gambia combined.[2] Later, in June 2002, WorldCom revealed that it had "improperly booked" some $3.8 billion in expenses through various accounting oversights.[3] This is greater than the national debts of Botswana, Chad, Djibouti, The Gambia, and Rwanda combined.[4] Deceptions of this

---

1. Gareth Vaughan, *In Enron's wake*, INDEP. BUS. WKLY., Mar. 2002.

2. CENTRAL INTELLIGENCE AGENCY, THE WORLD FACT BOOK 73, 154, 202 (estimating the national external debt of Botswana at $360 million, Djibouti at $366 million, and The Gambia at $476 million).

3. Luisa Beltran, *WorldCom Files Largest Bankruptcy Ever*, CNN MONEY, *at* http://money. cnn.com/2002/07/19/news/worldcom_bankruptcy/ (July 22, 2002).

4. CENTRAL INTELLIGENCE AGENCY, *supra* note 2, at 73, 110, 154, 202, 458

magnitude seldom go unchecked and when WorldCom filed for bankruptcy on July 21, 2002, legislation—including the Sarbanes-Oxley Act of 2002[5]—passed through Congress in an effort to change what many saw as a fatally flawed system of accounting and corporate oversight in the United States.[6]

Enron and WorldCom made the world community suspicious of American business practices. By pointing to numerous alleged loopholes and various off balance sheet activities that allowed companies to, in essence, legally defraud shareholders and creditors, many observers demanded change.[7] One of the premier proposals critics endorsed was the harmonization of American accounting practices, corporate governance and regulations with their international counterparts.[8]

The problem is not the movement toward international harmonization, though; the problem is that much of the world community demanded radical changes in American business and accounting practices but refused to adapt their systems in compromise.[9] Using Enron and WorldCom for leverage, European and Asian interests could demand greater change from the United States' regulation-based accounting system while refusing to compromise their principle-based accounting systems.[10]

(estimating the national external debt of Botswana at $360 million, Chad at $1,100 million, Djibouti at $366 million, The Gambia at $476 million, and Rwanda at $1,300 million).

5. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.).

6. *See* Beltran, *supra* note 3.

7. *See Are Current Financial Accounting Standards Protecting Investors: Hearing Before the House Subcomm. on Commerce, Trade, & Consumer Prot., House Comm. on Energy & Commerce*, 107th Cong. 11–16 (2002) (statement of Robert K. Herdman, Chief Accountant, U.S. Sec. & Exch. Comm'n).

8. Robert Bruce, *Now How Does It All Fit Together?*, FIN. TIMES, Sept. 15, 2003, at 1.

9. *Id*. at 1–2.

10. *See* Thomas Wardell, *The Current State of Play Under the Sarbanes Oxley Act of 2002*, 28 N.C. J. INT'L L. & COM. REG. 935, 937, 945–46 (2003); PROPOSAL FOR A DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the Harmonisation of Transparency Requirements with Regard to Information About the Issuers Whose Securities are Admitted to Trading on a Regular Market, COM(03) 138 final at 8–9, *available at* http://europa.eu.int/eur-lex/en/com/pdf/2003/ com2003_0138en01.pdf (Feb.

As this debate raged, on July 30, 2002, supporters of international principle-based accounting won a major victory when Sarbanes-Oxley passed into public law.[11] Section 108(d) of the act sought to alleviate the accounting loopholes that plagued the Enron and WorldCom scandals by directing the U.S. Securities and Exchange Commission (SEC) to commence a study on the practicality of revising the American Generally Accepted Accounting Standards (GAAP) from regulation- to principle-based.[12] Legitimated by this mandate, the sensationalism surrounding principle-based accounting standards and international harmonization began.[13] Principle-based accounting standards were touted as the savior of American investor confidence, the key to harmonizing international financial interest, and a chance to reincarnate the GAAP.[14]

In December 2003, the entire dynamic changed again when a European dairy conglomerate named Parmalat came crashing down. In the weeks ahead, investigators revealed that the company had misallocated, misappropriated or simply made up some €8–12 billion ($10–15 billion) in assets on their balance sheet.[15] As of January 2004, investigators estimated that the now defunct company's gross debt was nearly €15 billion ($18.8 billion).[16] The fraud ran so deep, in fact, that before the scandal broke, Parmalat recorded an annual gross profit for 2003 of €651 million ($794 million). In January of 2004, Price Waterhouse

16, 2003).

11. Sarbanes-Oxley Act of 2002, *supra* note 5.

12. *Id.* § 108(d) ("The Commission shall conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system . . . the study required by subparagraph paragraph (A) shall include an examination of (i) the extent to which principles-based accounting and financial reporting exists in the United States; (ii) the length of time required for change from a rules-based to a principles-based financial reporting system; (iii) the feasibility of and proposed methods by which a principles-based system may be implemented; and (iv) a thorough economic analysis of the implementation of a principles-based system.").

13. Bruce, *supra* note 8, at 1.

14. *See* Herdman, *supra* note 7, at 11.

15. *See Milking Lessons*, THE ECONOMIST, Jan. 3, 2004, at 45–46.

16. Fred Kapner & Mark Nicholson, *PwC Revels Grim Accounts at Parmalat*, FIN. TIMES, Jan. 27, 2004, at 20.

Cooper revised that number to a mere €121 million ($147 million) in annual gross income.[17] Mathematically speaking, Parmalat overstated its annual gross income by 80%. In other words, not only was Parmalat using fraudulent accounting to hide mountains of debt, but it was further using them to create fake profits.[18] With the debt now totaling over €15 billion ($18.8 billion), no one knows how expensive the tab might end up.[19]

As a result of the Parmalat scandal, European principle-based accounting was suddenly in a precarious situation. Its advocates faced the "European paradox": why should the United States struggle through the radical change toward principle-based accountancy and international harmonization when companies like Parmalat could achieve greater levels of fraud than Enron and WorldCom?[20] This paradox has thus far gone unanswered.

This Comment asserts that such a change would not be healthy for a recovering American economy and it is unlikely that a principle-based accounting system will effectively harmonize international accountancy. Further, with the advent of Parmalat, it is becoming clearer that the critics might have been asking the wrong questions all along. As John Oros, Financial Officer to Enodis plc (NYSE/FTSE) asserts, "We should be asking ourselves what good is a principle-based accounting system to an unprincipled person?"[21] Even more poignantly, should we not reconsider the wise words of Confucius: going too far is worse than not going far enough.[22]

First, this Comment will define the purpose of accounting standards and then highlight the fundamental differences

---

17. *Id*. (A rough estimate of income after taxes, depreciation and amortization will be subsequently lower than this amount.).

18. *See id.*

19. *Id*.; *see Milking Lessons*, *supra* note 15, at 45–46.

20. STEPHEN BAINBRIDGE, PARMALAT AS AN ACCOUNTING SCANDAL, *at* http://www.professorbainbridge.com/corporate_governance_scandals_and_crimes/index.html (Dec. 29, 2003).

21. Telephone Interview with John G. Oros, Finacial Officer, Enodis plc (Oct. 15, 2003) (copies on file with author).

22. Confucius actually said, "There is little to choose between overshooting the mark and falling short." CONFUCIUS, THE ANALECTS OF CONFUCIUS 108 (D.C. Lau translator, Penguin 1979).

between principle- and regulation-based systems. Then, within the context of the Enron, WorldCom, and Parmalat scandals, this Comment will analyze the concept of "financial engineering" to answer four important questions, namely:

1. Are the bright lines and specific mandates of the American GAAP to blame for the financial engineering that caused the downfall of Enron and WorldCom?
2. If so, is this justification enough to abolish our regulation-based accounting system (the GAAP) in favor of a more principle-based system (the IAS)?
3. What possible incentive does the United States have to move away from the regulation-based GAAP if synonymous frauds can occur in principle-based systems (such as Parmalat)?
4. Finally, do the incentives to move away from the regulation-based GAAP outweigh the negative impact to the current U.S. economy?

To answer these four questions, this Comment analyzes American domestic policy, the possibility of international harmonization, sensationalism, and finally, the European paradox. Weighing all these considerations makes it apparent that the American GAAP is the most comprehensive and unwavering accounting system in the world.[23] Further, the GAAP is only partially to blame for Enron and WorldCom, and these scandals do not justify overthrowing it for a system that is less tested and just as flawed. But first, what are the purposes of accounting standards and why are they important?

II. THE PURPOSE OF ACCOUNTING STANDARDS IS TO PRODUCE RELEVANT, RELIABLE AND CONSISTENTLY COMPARABLE INFORMATION

Financial reporting, or accounting as it is commonly

---

23. U.S. SEC. AND EXCH. COMM'N, STUDY PURSUANT TO SECTION 108(D) OF THE SARBANES-OXLEY ACT OF 2002 ON THE ADOPTION BY THE UNITED STATES FINANCIAL REPORTING SYSTEM OF A PRINCIPLES-BASED ACCOUNTING SYSTEM, *available at* http://www.sec.gov/news/studies/ principlesbasedstand.htm (last modified July 25, 2003) [hereinafter STUDY PURSUANT TO SECTION 108(D)].

referred, is the process of recording the financial elements of a business enterprise and reporting them to interested parties.[24] The most important purpose of accounting is to explain relevant financial information to interested parties, thereby allowing them to make informed economic decisions.[25] For example, a single company audit will (1) allow executives to better allocate resources between departments, (2) generate quarterly profit estimations to allow investors to decide how best to distribute their funds, and (3) create asset and liability lists for creditors to decide where to loan money.[26] These are all economic decisions that rely on precise financial information for accurate and beneficial choices; they are all decisions entirely dependant on accounting.[27]

To ensure the best possible decisionmaking, this accounting information must be "useful" to the financial decisionmaking process.[28] The GAAP defines "usefulness for decision making" as meaning that information is (1) relevant, (2) reliable and (3) consistently comparable.[29] Relevance is the ability of information to "make[] a difference to the decision maker in his/her ability to predict events or to confirm or correct expectations[]";[30] information that is irrelevant is worthless, no matter how accurate it is.[31] Reliability means that the information "portray[s] the important financial relationships of the firm itself," meaning that it can be verified and is dependably neutral.[32] Again, information that is unreliable is worthless, because it cannot be trusted no matter how relevant it is.[33] Finally, information must be consistently comparable with other information to be useful.[34] Specifically, this means that it "allows

---

24. PATRICK R. DELANEY, ET AL., GAAP 2004–INTERPRETATION AND APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES 24 (2003).

25. *Id*.

26. *See id.* at 24–25, 34–35.

27. *See id.* at 23–27.

28. *Id*. at 25.

29. *See id*. at 25–26.

30. *Id*. at 25.

31. *Id*. at 25–26.

32. *Id*. at 26.

33. *Id*. at 25–26.

34. *See id*. at 26.

the users of accounting information to assess the similarities and differences either among different entities for the same time period or for the same entity over different time periods."[35] Consistent comparability is more of a by-product of relevance and reliability: if the information is relevant and reliable, it will be useful to consistently compare with other relevant and reliable information, thereby allowing informed financial decisionmaking.[36] Throughout this Comment, it is important to remember that the purpose of accounting standards is to provide information that is "useful[] for decision making" and that this is achieved through relevance, reliability and consistent comparability.[37]

Armed with these objectives, every economically developed country creates accepted accounting standards that mandate how financial reporting is handled.[38] These standards are generally referred to as "accepted accounting standards" (in the United States this is the GAAP).[39] Accordingly, these standards are bifurcated into two basic camps: principle-based and regulation-based.[40] Understanding the basic objectives of accounting standards, what are the differences between these two camps?

III. THERE ARE FUNDAMENTAL DIFFERENCES BETWEEN PRINCIPLE- AND REGULATION-BASED ACCOUNTING STANDARDS

There are important fundamental differences between regulation- and principle-based accounting standards. The following subparts explain these differences by first defining the terms and then providing brief examples of each. As much as these terms are thrown about, they remain somewhat

35. *Id*.

36. *See id*.

37. *See id*. at 25–26.

38. DONALD E. KIESO & JERRY J. WEYGANDT, INTERMEDIATE ACCOUNTING 25 (1st ed. 2003).

39. *See* DELANEY, ET AL., *supra* note 24 at 1.

40. *See* Tim Reason, *On the Same Page: U.S. and International Standard Setters Are Coordinating Their Efforts to Craft a Common Language for Business*, CFO, May 2002, at 89.

amorphous.[41] As such, the following definitions come from current media, numerous Securities and Exchange Commission Reports, and various other accounting authorities.

A. *Principle-Based Accounting Systems*

Generally, a principle-based structure sets broad guidelines, with few specific rules, that accountants are required to follow when auditing a company's assets, liabilities, revenues and expenses.[42] It requires the auditors to decide whether the end product of the accounting is within the "spirit" of the rules, not necessarily whether it squares with any specific mandates within the rules themselves.[43] Principle-based systems are characterized by having neither bright line tests nor exact mandates, choosing instead to present broad guidelines for auditing practices in an effort to close loopholes.[44] Because of the general nature of this system, accountants and executives must decide exactly how to record financial information so that it is within the "spirit" of the rule as there are no specific mandates to fall back on.[45] Most economically developed countries utilize some form of principle-based accounting structure.[46]

The principle-based system is best illustrated by a simple example. Assume that Company X received a $1,000 return on a $600 investment in widgets it had made the prior fiscal year. This is simple company income that X will be required to report in its annual financial statements; the question is exactly how?

---

41. STUDY PURSUANT TO SECTION 108(D), *supra* note 23.

42. Phyllis Plitch, *SEC Economists Preview Agency's Accounting-Rules Study,* DOW JONES NEWS SERV., Apr. 11, 2003; *see* Judith Burns, *U.S. Regulator's Report Urges 'Principle Based' Accounting*, ASIAN WALL ST. J., July 29, 2003, *available at* 2003 WL-WSJA 55996615.

43. *See* Bruce, *supra* note 8, at 2; Cynthia A. Glassman, *Improving Corporate Disclosure,* HINDU BUS. LINE, at ¶ 10, *at* http://www.blonnet.com/iw/2003/04/27/stories/2003042700610700.htm (Apr. 27, 2003) (detailing excerpts from a speech given at the Northwestern School of Law); *see also* Cassell Bryan-Low & Carrick Mollenkamp, *Consistency Evades Accounting*, WALL ST. J. EUR., Jan. 13, 2003, *available at* 2003 WL-WSJE 3869004.

44. Plitch, *supra* note 42.

45. Bruce, *supra* note 8, at 2; Glassman, *supra* note 43, at ¶¶ 9–11.

46. Bruce, supra note 8, at 2; *see* Lawrence Richter Quinn, *The Rules Explosion: Is It Time to Move Toward Principles?*, STRATEGIC FIN., Jan. 2003, at 43.

In this situation, X did not actually gross $1,000. Some years prior, X outlaid the $600 investment for which it now receives a return, so what is the result? Company X is required to match this prior outlay, incurred when it made the initial investment, with the return that it later received. Thus, X would match the $600 outlay with the $1,000 return and report $400 of income in that fiscal year, instead of the full $1,000 as income in one year and the $600 as outlay in another. This illustrates the simple "matching principle."[47] Return revenues are always matched with the outlay expenses that earned those revenues; both are then reported in the same fiscal year.[48] Matching keeps companies from reporting the income from a transaction ($1,000) in one period, and then reporting the expenses related to that income ($600) in some other period, thus inflating or deflating the net income in the earlier, or later periods.

In a principle-based system, this matching principle is codified in a few simple sentences, with an explanation of its ultimate purpose and generally without any examples or exceptions to detract from the simplicity. A possible example of this is:

Principle: All entities must match revenues received with its matching expense outlay in the same fiscal reporting period.

Purpose: To ensure entities do not inflate income by reporting revenues from a transaction in one fiscal period and reporting the cost of that transaction in a later period.[49]

In this way, a principle-based system leaves the application of the matching principle up to the individual user. The accountants, lawyers, and businessmen that read and apply it are required to use their own prudence and judgment on how best to match the revenues received with the costs incurred during a fiscal year.

Company X is therefore left with some unanswered questions. Does an investment in widgets constitute an expense

47. *See* DELANEY, ET AL., *supra* note 24, at 30, 64 (discussing the "matching principle" and surrounding issues).

48. *See id*.

49. This example is simplified for convenience, but is based on various texts and articles. *See id*.; STUDY PURSUANT TO SECTION 108(D), *supra* note 23.

outlay? Does a return on this investment constitute income? Is this investment so small that it would not inflate Company X's income (the admitted purpose of the principle), and thereby X need not report it? One begins to see that principle-based standards would work if the world confined business to single owner lemonade stands, but, as we will discuss later, the advent of multinational super-conglomerate corporations, with numerous subsidiaries and various sources of income, this sort of idealism is rendered all but obsolete by practical legal necessity.[50]

B. *Regulation-Based Accounting Systems*

A regulatory-based accounting system is a specific set of rules that mandate exactly how to report transactions, record inflow and outflow of capital, document assets and liabilities, and generally record the financial makeup of a company for a given fiscal period.[51] In the United States, we utilize the Generally Accepted Accounting Principles (GAAP).[52] The GAAP is "concerned with the measurement of economic activity, the time when such measurements are made and recorded, the disclosures surrounding these activities, and the preparation and presentation of summarized economic information in the form of financial statements."[53]

Returning to the previous example of Company X and the matching principle this difference is clearer. Such a regulation is detailed with perspectives on the issue, definitions of terms, concepts, rules, examples, and exceptions.[54] A possible

---

50. *See* Cassell Bryan-Low & Carrick Mollenkamp, *'Off the Books' Clean-up Isn't a Snap*, WALL ST. J., Jan. 13, 2003, at C1; *Cf*. Quinn, supra note 46, at 41 (indicating that the United States moved from a principle-based accounting system to a regulation-based accounting system after a series of accounting scandals in the late 1960s); FULCRUM FIN. INQUIRY SERVS., INC., HOW PRINCIPLES-BASED ACCOUNTING AFFECTS LAWYERS, *available at* http://www.fulcruminquiry. com/article50.htm (Aug. 2005) (stating that the United States has moved toward a more regulation-based system over the years).

51. *See* Plitch, *supra* note 42; *see also* DELANEY, ET AL., *supra* note 24, at 23–33 (discussing general guides and goals of the GAAP).

52. Plitch, *supra* note 42; DELANEY, ET AL., *supra* note 24 at 1–2.

53. DELANEY, ET AL., *supra* note 24, at 1.

54. *See id*. at 59–94 (presenting a regulatory-based accounting example); Robert Bruce, *Global Harmony Hangs in Balance: Europe and US Face Critical Decisions*, FIN.

abbreviated version would look something like this:

Regulation:

1. Perspectives and Issues: "The primary focus of financial reporting is to provide information about an entity's performance that is useful to present and potential investors, creditors, and others when they are making financial decisions."[55] To best facilitate this, an entity must match revenues received with the matching expense outlay for that revenue in the same fiscal reporting period so as not to inflate or deflate income within any financial period.
2. Definitions:

   "Revenues. Increases in assets or decreases in liabilities during a period."[56]

   "Expenses. Decreases in assets or increases in liabilities during a period."[57]

   Fiscal reporting period. The component of time, from beginning to end, of any financial report.

   Entity. Any "sole proprietorship[], corporation[], general and limited partnership[] or limited liability compan[y]."[58]
3. Concepts and Rules: An entity will report revenues with all expense outlays incurred in the production of that revenue within the same fiscal reporting period.
4. Exceptions: This rule does not apply for expense outlays in real property, subsidiaries, structured investments that produce no revenue within a ten years period, and investments under $500.[59]

Immediately, the differences between the principle- and

TIMES, Feb. 23, 2004, at 2. (stating that "the American system is based in detailed rules and regulations.").

55. DELANEY, ET AL., *supra* note 24, at 59.

56. *Id*. at 61.

57. *Id*.

58. *See* MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS 1 (2000).

59. This, again, is a simplified version of a true regulation-based rule adapted from DELANEY, ET AL., *supra* note 24, at 59–94.

regulation-based accounting are evident. Here, Company X knows from a comprehensive reading that it must report the $1,000 revenue, minus the $600 expense outlay in the same financial period. Under the principle-based system, the questions were left unanswered.

C. Financial Engineering and Points of Inquiry

The GAAP is an even more comprehensive set of rules, specifically mandating auditing practices for accounting in the effort of providing clear financial information to all interested parties (such as investors, creditors, rating agencies, or the executives themselves).[60] As the above example shows, bright lines and specific numerical mandates are the hallmark of the regulatory system, and its greatest criticism.[61] Because of its specific nature, there are often loopholes and exceptions within the rules, causing some to proclaim that "it provides a roadmap for evasion through financial engineering."[62]

A closer reading of the exceptions in the above example reveals that Company X can avoid reporting the transaction altogether. By simply structuring two smaller investments of $300 each, instead of one individual $600 investment, Company X can fit under the $500 exception in 4 above. Company X could then avoid the matching principle and record its outlays and revenues for purchase in different fiscal periods. This is an admittedly simplified version of the sorts of loopholes often referred to as financial engineering—structuring company transactions, income, and debt in technically legitimate ways in order to falsify a company's financial report.[63]

It is the financial engineering aspect of regulatory accounting that is at the heart of this Comment. Now, armed with a proper definition of accounting standards and the basic differences between principle- and regulation-based systems, financial engineering must be inspected. This is done by asking the initial four questions in light of the Enron and WorldCom

---

60. *See id*. at 23–24.

61. Plitch, *supra* note 42.

62. *Id*. (quoting Rob Fisher, an economics fellow at the SEC)

63. *See id*.

scandals.[64] When all these considerations are weighed, it becomes readily apparent that the American GAAP is the most comprehensive and unwavering system in the world despite the possibility of financial engineering.[65] International accounting harmonization can be achieved through better means of compromise than current proposals. Additionally, this is possibly the worst financial climate to begin compromising our regulation-based system for global accounting uniformity. Perhaps most important of all, compromising our time tested system would be ignoring the European paradox and allowing the sensationalism of Enron and WorldCom to push us too far.

IV. FINANCIAL ENGINEERING AT ENRON AND WORLDCOM IS NOT THE MAIN REASON FOR CORPORATE SCANDAL

The first question to be asked is whether the bright lines and specific mandates of the American GAAP are to blame for the financial engineering that caused the downfall of Enron and WorldCom. In order to answer this, one must examine the financial engineering and fraud that occurred at Enron and WorldCom.

A. *Enron*

Enron was a child of the deregulated energy markets in the late 1980s. Before then, most utilities were publicly provided, and Enron realized it could turn a profit by selling and trading these utilities.[66] Sometime around 2000, Enron began trading

---

64. *See supra* Part I.

The four questions are:

1. Are the bright lines and specific mandates of the American GAAP to blame for the financial engineering that caused the downfall of Enron and WorldCom?
2. If so, is this justification enough to abolish our regulation-based accounting system (the GAAP) in favor of a more principle-based system?
3. What possible incentive does America have to move away from the regulation-based GAAP if synonymous frauds can occur in principle-based systems (such as Parmalat)?
4. Finally, do the incentives to move away from the regulation-based GAAP outweigh the negative impact to the current U.S. economy?

65. STUDY PURSUANT TO SECTION 108(D), *supra* note 23.

66. Anuj Thakur, et al., *What Happened to Enron?*, *DHAN,* Sept. 2002, *at* 2, *at* http://www.iimcal.ac.in/Community/Finclub/dhan/dhan2/art23-en.pdf (last visited Jan.

through the internet, a revolution in the industry.[67] The problem was that this strategy required a perpetually high share price. Thus, Enron's strategy shifted from energy trading to share price as the company's primary focus.[68] Most experts believe that it was around this time that Enron began using financial engineering to keep its share prices high and maintain a high profit on the books.[69]

To do this, Enron in essence "leveraged itself through debt, which it used to grow its non-core wholesale energy operations and service business"[70] by keeping most of this debt from appearing on the balance sheets with elaborate financial engineering.[71] When the stock price began to fall, though, these same off balance sheet entities ended up downgrading Enron's credit rating.[72] Suddenly, Enron was in over its head—it could not borrow money due to its low credit rating, nor could it use its own money to transact business, because it did not actually have any.[73] In fact, Enron had kept such a monumental amount of debt off the books—enough to encumber every asset Enron claimed and then some—that the company simply imploded under its own weight.[74]

B. WorldCom

WorldCom sings a similar tune, but the telecom giant's fraud is elementary compared to the massive workings of Enron.

19, 2005); *see* William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1288 (2002).

67. Thakur, et al., *supra* note 66, at 2.

68. *See id.*; John Lorinc, *After Enron*, 135 CA MAG., Dec. 2002, at 24.

69. Thakur, et al., *supra* note 66, at 2; *see* Daniel Kadlec, *Enron: Who's Accountable? – Inside the Growing Enron Scandal: How Evidence Was Shredded and Top Executives Fished for a Bailout as the Company Imploded*, TIME, Jan. 13, 2002, at 30 (stating that Enron bought out a partner's stake in a shell company called JEDI in Nov. 1997 thereby beginning "a complex series of transactions that enabled Enron to hide debts").

70. Thakur, et al., *supra* note 66, at 1.

71. *See id*.

72. *Id*.

73. *See id.*; *see also* Kadlec, *supra* note 69, at 30.

74. *See* Thakur, et al., *supra* note 66, at 1–3; *see also* Kadlec, *supra* note 69, at 30.

In fact, the ruse at WorldCom is relatively simple.[75] In 2001 and 2002 the company recorded $3.8 billion in normal operating expenses—in fact, routine maintenance expenses called "line-operating costs"—as investment assets.[76] That allowed the company to spread the cost over a number of years, instead of having to account for it all at once.[77] Unsurprisingly, this greatly inflated the profits WorldCom showed on its books, and kept the telecom giant projecting a virile financial face by inflating the company's presumed value to investors and creditors.[78]

In short, WorldCom was required to pay cash for the use of many phone networks. In the financial world these are called operating costs. Normally these operating costs are deducted from the company's net income, but in WorldCom's case, these expenses were added to the balance sheet as assets acquired.[79] As one reporter likened the situation, "it is as if a company pretended its outlay on paperclips and stationery–necessary, certainly, but by no means adding value–was in fact used to buy new equipment or build a new factory. So instead of making a $1.3bn profit in 2001, WorldCom was deeply in the red."[80]

C. *The Problems*

Admittedly both of these companies used fraudulent accounting practices and financial engineering to disguise debt and inflate assets, but that alone is not the point of this inquiry. Instead, we must ask whether the bright lines and regulatory nature of the GAAP are to blame for these malfeasances. This is done by recapitulating Enron's and WorldCom's actions through the lens of principle-based accounting and seeing first how much

---

75. *See* Interview by Geoff Colvin, Co-Anchor, with Richard Sloan, Director of the Financial Research and Trading Center and the Victor L. Bernard Price Waterhouse Coopers Collegiate Professor of Accounting and Finance, Univ. of Mich., *in* WALL ST. WK. WITH FORTUNE, Aug. 15, 2003, *available at* http://www.pbs.org/wsw/tvprogram/20030815.html [hereinafter Sloan].

76. *Id.*; *WorldCom: Why It Matters*, BBC NEWS, June 26, 2002, *available at* http://news.bbc.co.uk/1/hi/business/2066959.stm.

77. *See* Sloan, *supra* note 75.

78. *Id*.

79. *Id*.

80. *WorldCom: Why It Matters*, *supra* note 76.

blame lies in the regulatory-based GAAP, and second how much blame lies with the companies.

WorldCom's fraud is the easiest to dispose of because its actions were entirely illegal and not so much facilitated by any accounting system, but rather simply fraudulent.[81] As Mr. Oros (Financial Officer to Enodis plc) says, "all the principles in the world will not make a difference to an unprincipled person," and the WorldCom scandal is indicative of this notion.[82] "If individuals wish to hide debt, inflate income, or defraud investors, and they are further willing to" violate the law, then neither the most draconian regulatory system nor the loosest principle-based system will stop them.[83] In truth, the GAAP was not the cause of the WorldCom scandal, but instead the company auditors, executives and lawyers who flat out lied on the books were.[84] Armed with this knowledge, it is safe to conclude that the regulatory nature of the GAAP had little to do with the actual fraud at WorldCom.

Enron is a much more disturbing example, mainly because much of the financial engineering that caused its downfall was in fact legal under the GAAP and SEC rules of the time.[85] The most important vehicle of Enron's fraudulent practices was the off balance sheet "special purpose entity" or SPE.[86] Most scholars now believe that

> [a]t the heart of Enron's demise was the creation of partnerships with shell companies [special purpose entities], these shell companies, run by Enron's executives who profited richly from them, allowed Enron to keep hundreds of millions of dollars in debt off its books . . . it appears that initially Enron was using the SPE's appropriately by placing non energy-related

---

81. Larry Cata Backer, *The Sarbanes Oxley Act: Federalizing norms for officer, lawyer, and Accountant Behavior*, 76 ST. JOHN'S L. REV. 897, 900–01 (2002); *see* Sloan, *supra* note 75.

82. Telephone Interview with John G. Oros, *supra* note 21, at 1.

83. *Id*.

84. *See WorldCom: Why It Matters*, *supra* note 76; *see also* Sloan, *supra* note 75.

85. *See* Backer, *supra* note 81, at 900–01; *cf*. FULCRUM FIN. INQUIRY SERVS., *supra* note 50 (stating that with the exception of a limited number of minor examples, Enron did not deviate from "the precise and technical accounting rule").

86. Thakur, et al., *supra* note 66, at 3–4.

> business into separate legal entities. What they did wrong was that they apparently tried to manufacture earnings by manipulating the capital structure of the SPE's; hide their losses; did not have independent outside partners that prevented full disclosure and did not disclose the risks in their financial statements.[87]

Enron moved equity, stocks, and promissory notes out to various SPEs while simultaneously receiving cash, loans, and actual shares in return. In this way, Enron could hide debt and manipulate the books.

The answer to whether the GAAP was to blame for Enron's and WorldCom's financial engineering, therefore, is both yes and no. While it is true that much of the financial engineering Enron partook in was illegal under the GAAP because of failures to disclose, illegitimate transactions, and general malfeasance, it was not all so. The truth of the matter is that many of the transactions were perfectly legitimate under loopholes and bright line tests within the contemporaneous GAAP.[88]

But the same arguments can be made for Enron as were made for WorldCom: if an entity is so bent on deception that it is willing to break the rules, it does not matter what kind of rules they are. Most experts are in agreement that Enron was willing to violate the accounting laws to continue its financial farces, but this only answers for the cover-up half of the equation, the GAAP must answer for the half that got Enron into the SPE business in the first place.[89] By all accounts, the SPEs first utilized by Enron were legitimate under the relevant American accounting practices of that time.[90] Therefore, the bright lines and specific mandates of the GAAP at least partially contributed to Enron's, but not WorldCom's, downfall.

This leads into the second question of whether this partial

---

87. *Id*. at 3–4. Experts at the Financial Times constructed a helpful chart attempting to show how incredibly complex Enron's diffusion of debt and assets through Special Purpose Entities in fact was. *See Caught in Its Own Web*, FIN. TIMES, *at* http://specials.ft.com/enron/FT3LTT9G2XC.html (Jan. 30, 2002).

88. *See* FULCRUM FIN. INQUIRY SERVS., *supra* note 50; *see also* Herdman, *supra* note 7.

89. *See* Glassman, *supra* note 43; Andrew Hill & Andrew Parker, *FASB Chairman Tackles the Spider's Web*, FIN. TIMES, Apr. 21, 2003, at 22.

90. FULCRUM FIN. INQUIRY SERVS., *supra* note 50; Quinn, *supra* note 46, at 40.

blame is sufficient to justify changing the regulatory basis of our accounting structure. From the above analysis, only one concrete conclusion has been reached: SPEs must be disclosed, properly regulated, and kept independent from the companies that utilize them.[91] Concluding that all of the financial engineering in WorldCom, and most of Enron, is already illegal under the present regime in a sense vindicates the GAAP from much criticism. Thus, the legal financial engineering that Enron participated in, namely the off balance sheet SPEs, must be dealt with.[92]

In fact, this exact problem is currently being handled by the FASB, SEC and other legislative entities.[93] If proper guidelines are created to handle these off balance sheet transactions, what other justifications does the United States have to change to a principle-based system?

By clearing away the sensationalism concerning the Enron and WorldCom scandals, one uncovers that it is not the accounting system that is faulty, but the entities utilizing it.[94] The American system is the most time-tested, comprehensive, and insightful in the world,[95] it would be foolish to dispose of the very basis of the system in response to an easily reconciled issue of off balance sheet SPEs.

Concluding that the Enron and WorldCom sensationalism, and the problem of off balance sheet SPEs are not enough justification to abolish our regulation-based accounting system (GAAP) in favor of a principle-based regime, we proceed to our third question of what other incentives might the United States have to move away from GAAP. This brings the issue to the question of international harmonization of accounting standards.

---

91. *Cf*. Glassman, *supra* note 43 (indicating that information disclosed by companies should be "an honest assessment of the direction and risks that companies face"); Hill & Parker, *supra* note 89, at 22 (suggesting that under a principles-based system, disputes involving rule interpretation would require compromise).

92. Lorinc, *supra* note 68, at 23.

93. DELANEY, ET AL., *supra* note 24, at 9–10; Bratton, *supra* note 66, at 1351–52.

94. *See* Telephone Interview with John G. Oros, *supra* note 21, at 1–2.

95. *See* STUDY PURSUANT TO SECTION 108(D), *supra* note 23.

V. AMERICA: THE GAAP, GROSS DOMESTIC PRODUCTION, AND INTERNATIONAL HARMONIZATION OF ACCOUNTING STANDARDS

Possibly the greatest incentive that the United States has to move toward a principle-based accounting regime is the possibility of international harmonization.[96] The cornerstone argument for harmonizing U.S. regulatory standards to a more principle-based system is simple: the United States is basically the only economically developed country that utilizes a strict regulatory system.[97] But is this a bad thing?

While it is true that most countries use a principle-based accounting structure, it is also true that most countries did not generate $9.8374 trillion in Gross Domestic Product (GDP) in 2003.[98] In fact, the United States' closest competitor for pure scale of economy and raw production power is Japan at $4.8416 trillion in GDP, less than half that amount.[99] The simple fact that the United States' GDP is roughly equal to that of its five closest competitors combined[100] stirs images of the old joke about the 500 lbs. gorilla: he sits wherever he wants.

Yet even some stalwart isolationists can see benefit in harmonizing international accounting standards.[101] As previously mentioned, the prime objective of accounting is to record the financial composition of a business entity and report it to an interested party.[102] To do this effectively, the information must be reliable, relevant, and consistently comparable.[103] Consistent comparability for decisionmaking is difficult, if not impossible, if two companies use incompatible accounting systems.[104]

96. *See* Bruce, *supra* note 8, at 2.

97. Reason, *supra* note 40, at 89.

98. *See* THE ECONOMIST POCKET WORLD IN FIGURES 24 (Profile Books 2003).

99. *Id*.

100. *Id.* (estimating the GDP for Japan at $4,841.6 billion, Germany at $ 1,873 billion, the U.K. at $1,414.6 billion, France at $1,294 billion [this includes overseas holdings] and China at $1,079.9 billion for a sum of $10,503.1 billion in combined GDP).

101. *See* Bruce, *supra* note 8, at 1.

102. DELANEY, ET AL, *supra* note 24, at 24–25.

103. *See id.* at 25–26.

104. *See id*. at 26.

For example, assume informed investor X has received a windfall of $1,000, and decides to invest it in the stock market. With the proper training, X can discover the financial composition of potential investment opportunities, by looking up the quarterly financial reports of different companies. X can compare the profits, debts, assets, and liabilities of many different companies before making an informed decision as to where he will invest his $1,000. This type of informed decisionmaking only occurs if the information he receives is relevant, reliable, and consistently comparable.[105] Harmonizing the accounting standards on the international sphere will likely facilitate quicker and more reliable decisionmaking by investor X on an international scope, as opposed to limited opportunities that only utilize his domestic standards. If X knows that the same system is being used to produce the different data, then he is able to compare that international data quickly and efficiently with domestic opportunities and reach an informed decision.[106] In a harmonized world, all information would be easily comparable, no matter what its country of origin.[107] This sort of universality will likely produce a more cohesive world economy, facilitate a greater degree of confidence in foreign investment, reduce confusion in interpreting financial information, and allow businesses greater flexibility to enter competing markets.[108]

It is quite a sell, prompting many pundits into headlong support of international harmonization.[109] But, as with Enron and WorldCom, this is another example of sensationalism putting the cart before the horse. While it might be beneficial for the world to harmonize accounting standards, there are numerous ways to accomplish that goal.[110] The international community should take into consideration the vast raw economic

---

105. *Id*. at 25–26.

106. International Accounting Standards, SEC Concept Releases. Nos. 33–7801, 34–42430, 17 CFR Part 230, 240, § III.B (Feb. 16, 2000) [hereinafter International Accounting Standards].

107. *Id*.

108. *See id*.; Bruce, *supra* note 8, at 1.

109. *See* International Accounting Standards, *supra* note 106, at III.B.

110. *See* Bruce, *supra* note 8, at 1–2; John Plender, *They Fiddled, But the Economy Didn't Burn*, FIN. TIMES, June 16, 2003, at 24; Reason, *supra* note 40, at 89–90, 92.

superiority inherent in the American economy, the already comprehensive nature of the GAAP, and the preeminence of American financial markets and seek to compromise toward our regulatory system instead of using Enron and WorldCom as leverage to demand we move toward a principle-based system.[111] Perhaps convergence is a worthy goal, but it should be achieved in a manner that least disrupts the processes that have made the United States such an economic powerhouse.[112]

Bearing this in mind, the question is what methods the world should use to converge: principles or regulations? Concluding that international harmonization is an incentive to move away from the GAAP, in response to the third question, this Comment will answer the fourth and final question: do the incentives of international harmonization outweigh the negative impact of moving away from the regulation-based GAAP? In answering this question, it is important to first look at projects for international harmonization currently in the works.

VI. INTERNATIONAL ACCOUNTING STANDARDS PRESENT UNIQUE PROBLEMS: "TOMATOES AND TO-MAH-TOES"[113]

At present, the world is considering one main proposal to harmonize accounting standards.[114] This is the International Accounting Standards (IAS), as promulgated by the International Accounting Standards Board (or IASB). The IAS is a principle-based system that has been in the works for sometime now.[115] In its preamble, the IASB describes itself as:

> an independent, privately-funded accounting standard setter based in London, UK. Board Members come from nine countries and have a variety of functional backgrounds. The Board is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting

---

111. *See* BARRY J. EPSTEIN & ABBAS ALI MIRZA, WILEY IAS 2003: INTERPRETATION AND APPLICATION OF INTERNATIONAL ACCOUNTING STANDARDS 4–5 (2003).

112. *See* Bruce, *supra* note 8, at 2; Reason, *supra* note 40, at 89–90.

113. Reason, *supra* note 40, at 89 (comparing IAS and GAAP standards to old lyric regarding tomatoes and to-mah-toes).

114. *See* Bruce, *supra* note 8, at 2.

115. Reason, *supra* note 40, at 89.

> standards that require transparent and comparable information in general purpose financial statements. In addition, the Board cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.[116]

As of the date of this Comment, the IAS are the adopted national standards in Italy, Germany, the Netherlands, France, Turkey, Russia, Pakistan, Bangladesh, India, China, the West Indies and much of the Middle East, Eastern Europe, Africa and South America.[117]

The European Union set 2005 as the deadline for all listed companies to comply with the IAS, and many other nations, such as Australia, have decided that they will follow suit.[118] In the European Union alone, well over 7,000 corporations, currently following their nation's individually accepted accounting practices, that must conform to the IAS by December 31, 2005.[119] This is no small feat as these countries must retrain their accountants and executives with the IAS; but it is nothing compared to obstacles the United States would face if it attempted to implement these principles. The American GAAP is spectrums away from the loose principle-based wording of the IAS, and many think this is an insurmountable gap.[120]

Further, at the risk of sounding xenophobic, the IAS are standards created around British and other European principles of accounting.[121] This is perhaps the main reason that all adopting nations fail to see why the United States would make such a fuss: most of these countries already utilize a principle-based accounting system, quite similar to the current IAS.[122] The GAAP, on the other hand, is heavily regulation-based, more comprehensive, and more voluminous compared to its

---

116. Int'l Acct. Stands. Bd, *About Us – Mission Statement*, *at* http://www.iasb.org/about/ index.asp (last visited Oct. 27, 2004).

117. *See* EPSTEIN & MIRZA, *supra* note 111, at 17–18; James N. Bodurtha, Jr., *Use of IAS Around the World*, *at* http://bodurtha.georgetown.edu/IAS_39/FAS-IAS/use_of_ias_around_the_ world.htm (last modified June 28, 2002).

118. Bruce, *supra* note 8, at 2; Reason, *supra* note 40, at 89.

119. Reason, *supra* note 40, at 89.

120. *See id.*; Bruce, *supra* note 8, at 2.

121. *See* EPSTEIN & MIRZA, *supra* note 111, at 2.

122. *See id.*

international counterpart.[123]

These differences are far more than superficial; indeed it runs through the very fabric of both systems.[124] The problem is that most proponents to international harmonization do not see any problem; "Europeans will want to be satisfied that the Americans have got[ten] the proper training [to move to International Standards] by [2005]", quips Roger Davis, UK Head of Professional Affairs at PriceWaterhouse Cooper,[125] without apparently a thought to the procedure involved or any comprehension of exactly how deep the division between these two systems runs.[126] But it is the comprehensive GAAP that frightens Europeans the most "as it will be the only coherent system left [if the IAS is not adopted by the United States, and] Europe will end up with the solution it least wants, which is the dominance of US standards."[127] Convergence of accounting systems in Europe is not a problem, but the division runs too deep for the United States to effectively converge its system as

> International standards are based on principles and guidance. US standards are based on detailed rulebooks. American auditors have traditionally been uncomfortable with a principle-based system because it takes away much of the legal back-up which they can use to reinforce their position. Rules can be confirmed by lawyers. Principles and the resulting auditor judgment are harder for lawyers to certify comfortably.[128]

Ruling out the implausible assertion that the United States outright adopt IAS, dropping the GAAP in mid-step, the only remaining option to the world economic community is

---

123. *See* DELANEY, ET AL., *supra* note 24, at 11.

124. Reason, *supra* note 40, at 89.

125. Bruce, *supra* note 8, at 2.

126. *See id.*; Reason, *supra* note 40, at 89–90; Adrian Michaels, *SEC in Principled Stand on GAAP: Regulator Finds Rule-Based Approach of US Guidelines Imperfect, Preferring 'Objectives-Based' Approach, Says Adrian Michaels*, FIN. TIMES, July 26, 2003, at 8.

127. Robert Bruce, *Global Harmony Hangs in Balance: Europe and US Face Critical Decisions*, FIN. TIMES, Feb. 23, 2004, at 1.

128. Bruce, *supra* note 8, at 2.

compromise.[129]

Perhaps, as some observers have suggested, this is attempted payback for the Sarbanes-Oxley Act that so dynamically changed international finance (for all U.S. listed companies) that many Europeans felt was "decided very quickly and totally without thought of some remote countries across the ocean."[130] But, for whatever reason, the pundits of principle-based international accounting standards fail to recognize the insurmountable difficulties that switching systems would have on the American economy.[131] All American accountants and lawyers would have to relearn their trade as it pertained to the GAAP.[132] Aside from the sheer monetary cost this would entail, the monumental time commitment is something our recovering economy cannot sacrifice.

There are better options to achieve international harmonization than the IAS, and the United States should be given the autonomy that its vastly superior scale of economy mandates.[133] International harmonization is, by most accounts, a worthy endeavor, but full scale conversion of the American accounting system to an international principle-based system is, by all accounts, cutting off the face to spite the nose.

The differences that are hallmarks of each system make them incompatible at the core: specific mandates versus general judgments, bright lines versus soft generalities, precise affirmation of accordance versus best judgment accordance.[134] It is no wonder that even now, after years of diligent effort to reconcile the IAS and the GAAP, Tim Reason of CFO Magazine writes, that it reminds him of the old "tomatoe, to-mah-toe"

---

129. *See id.*

130. Alan Beattie, *Global Imbalances Undermining Transatlantic Stability Prospects*, FIN. TIMES, Jan. 24–25, 2004, at 4 (quoting Francis Mer, the French Finance Minister).

131. *See* Bruce, *supra* note 8, at 2.

132. *Cf.* Jim Kelly, *The Battle to Get All Accountants Speaking the Same Language*, FIN. TIMES, Sept. 15, 2003, at 2 (indicating that training programs have shifted to meet the growing demand for the international accounting standards).

133. *See* THE ECONOMIST POCKET WORLD IN FIGURES, *supra* note 98, at 24.

134. *See* STUDY PURSUANT TO SECTION 108(D), *supra* note 23.

song, begging the question "let's call the whole thing off."[135] Understanding this project proposal, and the fundamental flaws inherent in it, we can direct our attention to understanding the argument of principle verses regulation. The IAS as it is currently drafted has fundamental flaws, most importantly its failure to provide for American regulation-based accounting.[136] The fourth question is still on the table though, and its answer lies in the philosophical underpinnings of the principle- and regulation-based systems.

VII. PRINCIPLE-BASED ACCOUNTING SYSTEMS ARE CONSISTENTLY INCOMPARABLE, GENERATE WASTEFUL LITIGATION AND PROVE UNCERTAIN FOR FINANCIAL DECISIONMAKING

There are, no doubt, numerous arguments to be made from both the principle and regulation camps. As such an exhaustive discussion would be futile, this Part will limit discussion to three of the most important factors in any working financial system: comparability, the need to avoid litigation, and the elimination of uncertainty in decisionmaking.

A. Consistent Comparability

As previously discussed, consistent comparability is achieved with financial information that is both relevant and reliable.[137] Comparability is an essential element of any financial system of accounting,[138] especially if consistent comparability is the main incentive to adopt international accounting standards.[139] So, which system would produce the most consistently comparable results, principle or regulation?

The problem with principle-based accounting systems is its inherent relativity: it is entirely dependant on the individual

135. Reason, *supra* note 40, at 89.

136. *See* Bruce, *supra* note 8, at 2; Reason, *supra* note 40, at 89–90.

137. DELANEY, ET AL., *supra* note 24, at 25–26; s*ee supra* Part II.

138. *See* EPSTEIN & MIRZA, *supra* note 111, at 7; *see also* DELANEY, ET AL., *supra* note 24, at 26.

139. *See* International Accounting Standards, *supra* note 106, § III.B; *see also supra* Part V (discussing the possibility of improved comparability through the harmonization of accounting standards).

judgment of auditors and executives working on the financial records to make choices on how to characterize assets, liabilities, and record transactions, and how to estimate capital.[140] By definition, individuals are all different, "some people bend a little, some people bend a lot; some people see white, some people see black . . . individual discretion is a tough place to set an accounting system on top of."[141]

Take the above example of the accounting standards for the matching principle.[142] When reading the broad outlines of the principle-based version, one is presented with various questions of interpretation, all of which are left up to the individual to decide from his personal knowledge.[143] This leaves the individual to decide what the meaning of "revenue" is and whether his situation fits into that definition. It leaves to judgment the possibility of exceptions for various circumstances, and is silent to the issues of time, quantity and quality. Because these choices are based on individual judgment, and not set rules, they are all relative to the decisionmaker.[144] This means that individual discrepancy must be taken into account when comparing one company's audit to another.[145] Because of this, no two audits will ever be generated in the same fashion, with the same decisions and the same results.[146]

It is this inherent relativity and lack of specificity of definition that worries most American analysts and business people.[147] The simple fact is that no system can be absolutely dependant on total human discretion and still maintain consistent comparability.[148] The absence of bright lines, specific

---

140. *See* Bruce, *supra* note 8, at 2; *see also* Reason, *supra* note 40, at 89–90; Telephone Interview with John G. Oros, *supra* note 21, at 1–3; John Plender, *Share the Principles, Sharpen Up the Rules*, FIN. TIMES, July 21, 2003, at 20.

141. Telephone Interview with John G. Oros, *supra* note 21, at 3.

142. *See supra* Part III.A.

143. *See* Plender, *supra* note 140, at 20 (noting that under a principle-based approach, "managers and auditors make their own judmgnets on the specifics of how to apply board concepts").

144. *See id.*; *see also* Glassman, *supra* note 43.

145. *See* Plender, *supra* note 140, at 20; *see also* Plitch, *supra* note 42.

146. *See* Plender, *supra* note 140, at 20.

147. *See* Plitch, *supra* note 42; *see also* Reason, *supra* note 40, at 89–90.

148. For an excellent discussion on the relativity of human perceptions and

regulations, and numerical post marks will make a system of accounting less comparable as individual people will draw the line where they feel it should be—not where it actually is.[149]

Proponents of the principle-based IAS say this is precisely the point.[150] As previously mentioned, the financial engineering that led to the downfall of Enron and WorldCom was facilitated by regulations drawing a road map on how to evade the mandates of the law.[151] But as the vast majority of discrepancies in Enron and WorldCom's accounting were in fact illegal under the GAAP, only the off balance sheet SPEs are exemplary of this argument.[152] This unjustified attempt to leverage our system is further weakened by the European paradox of Parmalat, which will be discussed further in depth.[153]

B. *Avoidance of Litigation*

Another need for a stable accounting system is the avoidance, whenever possible, of litigation.[154] A well made system will not break down into costly and time consuming litigation, as the parties will know exactly how to act at any given time and will not require a judge or jury to instruct them. The evolution of the GAAP involved litigation over minutia and mandates, resulting in the time tested system that we now have. Indeed, this is one of the reasons that the GAAP is so

---

decisions, see Wilhelm Dilthey, *Book Four: Foundations of Knowledge*, *in* 1 INTRODUCTION TO THE HUMAN SCIENCES 243–391 (Rudolf A. Makkreel & Frithjof Rodi eds., 1989).

149. *See* Plender, *supra* note 140, at 20; *see also* Reason, *supra* note 40, at 89–90; Telephone Interview with John G. Oros, *supra* note 21, at 3; STUDY PURSUANT TO SECTION 108(D), *supra* note 23.

150. *See* Plender, *supra* note 140, at 20; *see also* Reason, *supra* note 40, at 89.

151. Plitch, *supra* note 42 (stating "[a]mong [GAAP's] pitfalls is that 'it provides a roadmap for evasion through financial engineering,' as financial-statement preparers 'move out to the boundaries' of the rules to find ways around them"); *see* Reason, *supra* note 40, at 89; Telephone Interview with John G. Oros, *supra* note 21, at 1.

152. *See supra* Part IV.

153. *See infra* Part VIII.

154. *See, e.g.*, William S. Lerach, *"The Private Securities Litigation Reform Act of 1995 – 27 Months Later": Securities Class Action Litigation Under the Private Securities Litigation Reform Act's Brave New World*, 76 WASH. U. L.Q. 597, 605, 610–12 (1998) (cites a study which claims that "allegations of accounting irregularities or trading by insiders now explain the lion's share of federal class action litigation").

voluminous and detailed: it has been amended to answer questions and disputes between parties.[155]

Like it or not, the United States is a litigious society. When people have a dispute, they do not hesitate to contact their lawyers *post haste*. If the United States was to implement a broad and ill defined system of accounting standards, companies would challenge every standard with which they were presented.[156] After all, if there is no case law, then there is no precedent on how the standard has been applied previously and every company would have a legitimate shot at interpreting the system in its favor. Then what would it have to lose but legal fees?[157] Parties would fight to the bitter end that they are abiding by the spirit of the laws, as this is such an amorphous concept. It would be a long, expensive, and detrimental process to figure out exactly what the spirit of these standards is. In the end, these resulting revisions and definitions would no doubt be added to the system, resulting in a rule book that looks exactly like the GAAP but billions of dollars more costly.[158]

This country is already burdened with the expense of litigation at every turn. In fact, citizens of the United States spend more per person in litigation costs than any other major industrialized nation.[159] Litigation has become so commonplace that most companies have even begun to allot budget money to pay for the inevitability of litigation as the simple costs of doing business.[160] If the business community is presented with such ill defined standards, American court dockets will overfill with litigation as companies look to challenge each mandate. In short, principles will inevitably spawn expensive and burdensome

155. *See generally* DELANEY, ET AL., *supra* note 24 (providing an interpretation and application of GAAP in a 1013 paged textbook).

156. *See* Plender, *supra* note 140, at 20; Telephone Interview with John G. Oros, *supra* note 21, at 2–3; Bruce, *supra* note 8, at 2.

157. *See* Reason, *supra* note 40, at 89–90.

158. *See* Telephone Interview with John G. Oros, *supra* note 21, at 3.

159. The White House, Office of the Press Sec., *Fact Sheet: Securing Our Economic Future*, Dec. 15, 2004, *at* http://www.whitehouse.gov/news/releases/2004/12/20041215-3.html.

160. *See* Lerach, *supra* note 154, at 599 (referencing Professor Janet Cooper Alexander's testimony in favor of the Private Securities Litigation Reform Act of 1995 before the House Subcommittee on Telecommunications and Finance).

litigation, something even lawyers can see as wasteful and unnecessary when we could maintain our time-tested and expressly defined regulation-based GAAP.[161]

C. Certainty in Decisionmaking

Our last point of analyzing principle versus regulation is certitude in informed decisionmaking. This is best observed contemporaneously with the environment American business is done in, as principle-based systems shift the burden of interpretation from the "rules as a system" to the "rule user as an individual."[162] This specifically means that in a principle-based system one is dealing with the inordinate amount of relativity discussed above in Part VII.A.[163] The system requires individual interpretation and discretion to divine the spirit of the rule, how to apply that spirit to their situation, and exactly to what degree.[164] As interpretation is always more relative when left to the interpreter, as opposed to an explanation contained and defined within the rule itself, it is said that the burden shifts from the rule to the interpreter.[165] Part VII.A concluded that relative systems are bad for consistent comparability, which is one of the end purposes of accounting, but it affects the certitude of decisionmaking as well, granting a dangerous amount of leeway to the individual.[166]

The difference is simple: it is dangerous that individual perceptions are relative (what is referred to as "consistent comparability"), but it is even more dangerous that individual morals are relative (what is referred to as "certitude in decision making").[167]

Perhaps the most ironic part about seeking to implement principle-based accounting systems to save the United States

---

161. *See* Telephone Interview with John G. Oros, *supra* note 21, at 2–3; *see also* Plender, *supra* note 140, at 20.

162. *See* Telephone Interview with John G. Oros, *supra* note 21, at 1–3; *see also* Bruce, *supra* note 8, at 2.

163. *See supra* Parts V & VII for a full discussion.

164. *See* Reason, *supra* note 40, at 89–91; *see also* Bruce, *supra* note 8, at 2.

165. *See* Telephone Interview with John G. Oros, *supra* note 21.

166. *See supra* Part VII.A. for a full discussion.

167. *See id*.

from corporate malfeasances is the possibility that it will have the exact opposite effect.[168] As Parmalat shows, principle-based systems provide extreme amounts of leeway to the interpreting party, mandating only that the spirit of the rule is followed, not any specific action. Harking back to the previous examples of WorldCom, Enron and Parmalat, remember that if a party is going to distort financial records, they will do so regardless of the system. The problem here, as John Oros puts it, is not only that ". . . they can twist the information regardless of the system. But, that with a principle[-based] system you only give them more rope to hang themselves."[169]

On a lesser and more theoretical note, the result of certitude in decisionmaking is enforcement and punishment for wrong decisionmaking. This begs the question of how would a system punish a person who truly believed his decisions were within the spirit of the standard, but nevertheless were not? The system instructed the individual to use his personal discretion to decide what was best, and though ignorance of the law is never an excuse, his failure in judgment does seem to lack the element of *mens rea* that the American judicial system holds dear. How can the system hold anyone responsible if no one knows exactly by what spirit he is required to make his decisions? Proponents of principle-based systems probably are looking in good faith to close the existing loopholes in our regulation-based GAAP, but they are simply opening new and more dangerous ones in the process.

Concluding that consistent comparability, avoidance of litigation, and certitude in decisionmaking all favor a regulation-based system of accounting, this Comment will shift attention to other pros and cons in the argument to move away from the regulation-based GAAP by analyzing the European paradox and the core of sensationalism in the media.

---

168. *See* Adrian Ladbury, *No Gain Without Pain on Accounting*, INS. DAY, Dec. 23, 2003, *available at* 2003 WL 61264510.

169. Telephone Interview with John G. Oros, *supra* note 21, at 2.

VIII. PARMALAT PRESENTS A PARADOX TO EUROPEAN DEMANDS FOR MOVEMENT TOWARD A PRINCIPLE-BASED ACCOUNTING SYSTEM: MILKING LESSONS AND THE GROSS DOMESTIC PRODUCTION OF THE WEST INDIAN ISLANDS[170]

When the scandal at Parmalat broke at the end of 2003, the strongest justification for the United States' movement toward a principle-based accounting system broke with it: the nearly pristine record of European companies in the last round of corporate scandals.[171]

Because of the foreign community's excessive usage of Enron and WorldCom as leverage, they now had some explaining to do. Leverage used to demand that the Eurocentric principle-based standard be the corner stone for any subsequent models of international harmonization was rendered moot.[172] Now they had to explain away that inherent paradox. What Parmalat showed the world is perhaps the most important point of accounting standards, be they principle- or regulation-based: if companies seek to subvert the law they will do so regardless of the system.[173]

Parmalat grew out of a local milk distributor in northern Italy.[174] Under the guide of the Tanzi family, Parmalat seemed to be the picture of ingenuity and endeavor as the small Italian company grew into a multi-billion dollar conglomerate over the years.[175] But all was not right at the dairy company, and when Parmalat failed to meet a bond payment in December 2003, Bank of America revealed that a document, purporting to show some €4 billion in cash assets held by the company in a Cayman Account, was in fact a forgery.[176] The Italian government

170. *Milking Lessons*, *supra* note 15.

171. *Cf*. Silvia Ascarelli & Paul Hofheinz, *Enron Gives New Urgency to Accounting Reforms*, WALL ST. J. EUR., Feb. 28, 2002 (quoting U.K. accounting experts, before the Parmalat scandal, stating that an Enron-like scandal could not happen under the U.K. accounting rules).

172. *Cf*. *id*.

173. Telephone Interview with John G. Oros, *supra* note 21, at 2.

174. *Parmalat: 40-year history at stake*, CNN.COM, Dec. 23, 2003, *at* http://www.cnn.com/ 2003/BUSINESS/12/22/italy.parmalat.sidebar/.

175. *Id*.

176. *Slow and Painful Death,* FIN. DIR., Feb. 1, 2004, *at* 2004 WL 67234901.

launched an investigation into this forgery without any idea just how far the rabbit hole went. Suddenly, a company that showed over €4 billion in cash assets on its yearly balance sheet was missing somewhere between €8–13 billion.[177] By the beginning of January 2004, Tanzi, Fausto Tonna—the long time CFO of Parmalat—and a few other senior executives were in jail,[178] and authorities noted that Parmalat management underreported the company's debt by €12.5 billion ($15.5. billion).[179] By the end of 2004, many observers had already certified that Parmalat is the largest corporate scandal the world has seen.[180]

Pundits of the principle-based system now had to explain to the United States why their system was somehow better than a regulation-based one. Indeed, they had to do this in the face of the revelation that Parmalat had kept some €10–13 billion off their balance sheet, and was somehow able to warp Italian accounting principles to pretend the company had over €4 billion in cash assets.[181] Most disturbing still is the revelation that no one knows where over €8 billion in assets went.[182] This is the rough equivalent of the Gross Domestic Production of Aruba, the Bahamas, Barbados and Bermuda combined.[183] In one fiscal year, Parmalat lost four island nations without a trace.

Remember, the Enron and WorldCom scandals together only totaled $4.8 billion in hidden debt; the fraudulent accounting was less than half the amount Parmalat is now facing, and the case is not even closed yet.[184] The facts speak for themselves:

---

177. *Id*.

178. *Slow and Painful Death*, *supra* note 176.

179. *See* Eric Sylvers, *Italy Seeks Solution to Corporate Scandals*, INT'L HERALD TRIB., Jan. 30, 2004, at 13.

180. *Id*.

181. *Slow and Painful Death*, *supra* note 176.

182. *See id*.

183. THE ECONOMIST POCKET WORLD IN FIGURES, *supra* note 98, at 232 (estimating the gross domestic production of Aruba at $2 billion, the Bahamas at $4.8 billion, Barbados at $2.6 billion and Bermuda at $2.7 billion for a total of $12.1 billion in gross domestic production). Gross Domestic Production refers to the entire value of services and goods produced by a country in one year. *Id*.

184. *See* supra, notes 1, 3 and 177 and accompanying text (noting that the Enron and WorldCom scandals totaled approximately $4.8 billion, while the Parmalat scandal totaled between $8–13 billion).

frauds of the same ilk, if not greater, can be perpetuated under principle-based regimes. Possibly the most striking fact about Parmalat is that much of the allegedly fraudulent business practices were legal under the relevant accounting system in Italy.

This is the European paradox: Why should the United States move toward a system of accounting that produce the same, if not greater, types of malfeasance? Thus far, this question has remained unanswered from both camps.

It will take time to sort out exactly what happened at Parmalat, and to see exactly what the price tag of the fraud will be. But there is no doubt that it must impact the decisionmaking on both sides of the Atlantic. There is no logic to the argument that the United States should improve its accounting system by moving toward a system that perpetuates fraud on the magnitude of Parmalat. In fact it strengthens the proposition of international harmonization toward a more regulation-based world regime, not a principle-based one. Our last point of inquiry is whether moving toward a principle-based accounting regime would minimize scandals like Enron and WorldCom.

IX. SENSATIONALISM: SELLING NEWSPAPERS

At best, Enron and WorldCom were sensationalistic motives that were great for selling newspapers, but poor for generating domestic accounting policy.[185] Besides the fact that they are dwarfed by the fraud at Parmalat, both were hyped by the American press, which clamored for governmental reform and action.[186]

This is not an attempt to justify the heinous actions of the executives of WorldCom and Enron, instead only to put them in perspective. Our American system of financial and business practices is far from perfect, but as Winston Churchill said of democracy, it "is the worst form of government except all those other forms that have been tried from time to time . . . ."[187]

---

185. *See* Herdman, *supra* note 7, at 13.

186. *See* Backer, *supra* note 81, at 904.

187. 7 WINSTON S. CHURCHILL: HIS COMPLETE SPEECHES 7566 (Robert Rhodes James ed., 1974).

There is a cost to doing business—what many scholars have termed the "residual loss" or "agency cost."[188] Modern business structure is set up in an agent-principal relationship: the principals are the shareholders, whose stock is a percentage claim to ownership in the company; the agents are the people who manage and work for the company.[189] The entire system rests on the agents keeping the principals' (and subsequently the companies') best interest in mind.[190] But, "[i]f both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interest of the principal."[191] To ensure the agents always keep the principals' best interests in mind, we must erect safeguards such as monitoring the agents' actions, compensatory incentives for the agent, and possibly bonding pecuniary systems.[192] All of these devices cost money, thus they are referred to as the "residual cost" of doing business.[193]

In many situations, this system breaks down for one reason or another. For WorldCom and Enron, there was simply not enough monitoring of the agents' actions. Had the actions of the agents in charge of the company been monitored to a greater degree, Enron could never have leveraged itself through monumental amounts of debt hiding, and WorldCom would never have been able to report operating line expenses as normal assets.

Perhaps, then, this is not a question of some fatal flaw in the accounting structure that is conducive to corporate malfeasance, but instead a question of the monitoring costs people are willing to include as a "residual cost" of doing business.

Automatically, one can see that the above story will not sell a single issue off the newsstand; it is scientific, unemotional and pragmatic—devices that any seasoned press member will tell

---

188. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and the Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (indicating that residual cost is a subset of agency cost).

189. *See id*. at 308–09.

190. *See id*. at 308.

191. *Id*.

192. *Id*.

193. *Id*.

you never to run on the first page. Consequently, the side of these corporate scandals that the American public saw was the flagrant and outlandish tale of while collar crooks that resulted in large lay-offs of employees and calls for government action.[194]

Sensationalism of this nature is never good to base domestic policy upon, especially long term fiscal policy. Already we are seeing a rise in confidence in the American financial system and the minimization of the Enron and WorldCom scandals.[195] The sensationalism is subsiding, cooler heads are prevailing, and allowing proper discourse and policymaking for American accounting practices.

After weighing the inherent flaws of a principle-based accounting system (Part VII), the European paradox of Parmalat (Part VIII), and the sensationalism of Enron and WorldCom (Part IX) we have to conclude that the incentives for the United States to move toward a principle-based international standard do not outweigh the negative impact such a move would entail.

X. CONCLUSION: PUTTING DESIRED CHANGE IN TUNE WITH DESIRED CONSEQUENCES

This Comment concludes that the bright lines and specific mandates of the American GAAP are at least partially to blame for the financial engineering that caused the downfall of Enron, but not WorldCom. But more importantly, this is not justification enough to abolish our regulation-based accounting system in favor of a more principle-based system. Another incentive to move toward principles is international harmonization, but when you look at the pros and cons of each system, the European paradox and plain media sensationalism, this incentive is not strong enough to outweigh the potential harm to the U.S. economy.

In closing, this Comment optimistically proposes that an international system based on a more regulatory structure is the

194. *See* Backer, *supra* note 81, at 904.

195. *See, e.g.*, *Bronwe DecisionQuest Polls Find Attitudes toward Corporate America Improving After Enron, MCI WorldCom Scandals; Corporate Executives Still Have Long Way to Go*, Bus. Wire, Nov. 19, 2003. Decisionquest can be accessed at http://www.decisionquest.com.

answer. It is the only way to create a cohesive world accounting structure that will simplify business, promote investment in all markets and provide the clear understanding of financial information that drives markets to new heights. In short, the world must put the desired change of international harmonization in tune with the desired consequence of economic prosperity.

James E. Rogers[*]

---

[*] J.D. Candidate, 2005, University of Houston Law Center. This Comment received the Baker Botts, L.L.P. Writing Award for Outstanding Comment in the field of International Financial Law. The author is greatly indebted to his parents Patrick and Maryanne Rogers for their continual love and support: DOMI SEDIT LANAM FECIT.