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Calling all parties: Now is the time to come to the aid of the balance sheet

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Abstract Recently, accountants were instructed by President Bush to get their acts together. Indeed, the Enron, WorldCom, Tyco, and other recent corporate financial reporting failures have prompted a loss of faith in accountants and accounting. To a large extent, this loss of faith involves corporate balance sheets and it is warranted. Corporate managers and shareholders have a vested interest in addressing balance sheet shortcomings. This article highlights the pervasive shortcomings of contemporary corporate balance sheets, identifies the underlying foundational tensions creating those shortcomings, offers proposals to address those tensions, and discusses the potential implications of our proposals.

"*I distrust the incommunicable, it is the source of all violence.*"
—Jean-Paul Sartre (20th century French, Nobel Laureate)

1. Condition critical: The health of the balance sheet

In the wake of the startling revelations regarding the financial reporting fiascos at Enron, Tyco, WorldCom, Adelphia, Qwest, Xerox, HealthSouth, and others, consider the violence (we use Sartre's word) done to the faith of the investing public regarding contemporary financial reporting. In part, that faith-shattering violence is due to the overnight collapse of these seemingly healthy, promising companies. Investors large and small saw their rainy-day, college, and/or retirement savings devastated. Dreams of financial security quickly turned into nightmares of information voids and investment helplessness. Main Street wondered how such failures could come to pass when the financial statements did not indicate anything was amiss. Indeed, Wall Street had to admit that, "the financial reporting system is completely broken" (Henry, 2004, p. 80).

In response to these headline-grabbing financial statement failures, the U.S. Congress passed the Sarbanes—Oxley Act of 2002 (SOX), which is, in the minds of many, the most significant change in

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corporate financial reporting laws since the Securities Acts of 1933 and 1934. Among other things, SOX created a new regulatory body (the Public Company Accounting Oversight Board), established new reporting responsibilities for corporate chief executive officers (CEOs) and chief financial officers (CFOs), delineated new responsibilities for corporate audit committees and boards of directors, and increased the criminal penalties for those who participate in financial statement misrepresentations. Public outrage and congressional attention to the scandals have galvanized intensive reflection at the Financial Accounting Standards Board (FASB) and have heightened concerns at the Securities and Exchange Commission (SEC). Few would disagree that the efficacy of financial reporting is at stake.

Much of the news coverage pertaining to the recent financial reporting failures has focused on income statements and their misstatements of revenues and earnings. For example, WorldCom's eventual correction of its infamous earnings misstatements essentially reversed all the earnings it had reported during its fraud years. Due, in part, to such publicity, regulators have enacted some income statement-related reforms. It would be a great shame, however, if the drive for financial reporting reform stopped with the income statement. The creditability and usefulness of balance sheets is also at stake.

It has been known for some time that "analysts often perceive balance sheets as irrelevant" (Epstein & Palepu, 1999, p. 50). The *Wall Street Journal* has even reported that "investors [are] on edge about corporate balance sheets" (Zuckerman & Benson, 2002, p. C1) and, yet, balance sheets matter a great deal. In another *Wall Street Journal* article, it was reported that "debt levels [a key measure to be reported in balance sheets] are among the most important measures of a company's financial health" (Weil, 2004, p. A1). Consider also that just before its demise, Enron and its accountants disclosed a US$1 billion balance sheet overstatement of assets and equity. Earlier, however, Enron management had chosen not to mention that fact in a meeting with analysts because "the matter was [just] 'a balance sheet issue' and did not need to be included in the...discussion" (Emshwiller & Smith, 2001, p. A10). It was the eventual disclosure of that reduction in assets and equity, however, that caused rating agencies to downgrade Enron's credit, a key spark igniting the company's subsequent, rapid demise. The 'it-was-just-a-balance-sheet-issue' mentality was a major miscalculation.

In general, contemporary balance sheets suffer from the dual sins of omission and commission; i.e., not all important items are presented, and the amounts for those items that are reported are not all that helpful. If balance sheet shortcomings were due only to what Sartre calls the "*incommunicables*" (i.e., the information for which we have no ability to measure or describe), balance sheet preparers and the companies they represent might be able to dismiss the current crisis of faith with the justification that they did their best, despite any flawed outcomes. However, we believe the root cause of balance sheet shortcomings has more to do with "*uncommunicateds*" (i.e., the information which could be reported but is not) than "*incommunicables*."

This is not a problem that should be left for accountants to address; specifically, corporate managers need to be concerned. As noted earlier, SOX requires CEOs and CFOs to sign explicit representations that they have read their company's SEC financial statement filing (which covers the company's balance sheet) and that they believe their company's financial results are fairly presented. No CEO or CFO will sign such a representation until he or she has received an equivalent representation from their company's operating people. In some companies, this has resulted in a cascaded set of signed representations from a couple hundred other managers. Thus, every manager with significant responsibilities within his or her company must be mindful of the shortcomings, and the possibilities for improvement, in balance sheets.

"*You may fool all the people some of the time. You can even fool some of the people all of the time. But you can't fool all of the people all the time.*"
—Abraham Lincoln (16th President of the United States)

There is no reason why balance sheets should confuse some of the people all of the time and all of the people some of the time. By its own proclamation, the financial reporting profession has said that the litmus test for the efficacy of financial statements is that they be understandable to the reasonably prudent reader and helpful in making decisions regarding the company to which they pertain. Even a casual reading of the business press during the past several years would suggest that, in regard to these twin tests (decision usefulness and understandability), balance sheets and their related explanatory footnotes have failed (e.g., Stock, 2003). Over the past several years, a few positive changes have been made to balance sheets (e.g., the elimination of the pooling method for reporting the consolidation of subsidiaries), and certain accom-