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By Kathryn M. Welling _
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Cockamamie Accounting

*Surprised By AIG's Woes? There Were Signs...
& Now H&R Block Can't Count!*

There was no mistaking the frail voice on the other end of the phone line, nor the genuine sorrow—and very real ire—in its tone. It was Prof. Abraham Briloff, for decades the scourge (in Baruch College classes, in Congress, in his books and in the pages of Barron's) of companies that played fast and loose with auditing conventions and the accountants (and investment types) who let them. An accident several months ago landed him, at age 87, in rehab and the therapists were demanding repetitions, as is their wont. Abe obliged (and is now mending at home). But the repetitions that leapt to his still-agile mind had nothing to do with muscular stretching and lifting—and everything to do with the sort of stretching and abuse of accounting rules in pursuit of preternaturally smooth earnings progressions (among other Wall Street hang-ups) that now have a bumper crop of disgraced CEO in the dock.

“Why it is that for years they lent themselves to these kinds of maneuvers? Why did **AIG** have auditors? Do you realize, despite all stories that have been written, we've heard very little about the auditors, **PriceWaterhouseCoopers**? They are supposed to look at these things. And AIG was said to have a ‘Tiffany’ audit committee and board of directors!” Abe's questions, of course, were purely rhetorical. Hank Greenberg's fatal flaw is “hubris,” he opined. What really grieves the good professor is that so much of the skullduggery apparently was plotted on the watch of a fellow accountant, fired AIG CFO Howard Smith (a PWC alum)—and that, at least in accounting circles, it was no secret that AIG, among other insurers, had long been pushing the envelope, but good, to burnish profits while (among other tricks) time-shifting liabilities in accounting for “retrospectively rated” reinsurance products.

The accounting profession was queasy enough about it, way back in 1993, to throw the question to FASB's Emerging Issues Task Force. The SEC also made threatening noises, but, hey, it was the 1990s, and both sets of regulators punted. This wasn't hushed up. Abe pointed it out to me 12 years ago in the interview excerpted over yonder.

“They were sloshing money around,” Abe recalls, “making it appear that reinsurers were covering losses, when in fact they were just passing money around like in a street corner game of three card monte. But why investigate? Investors cared only that earnings beat by pennies.”

Plus c'est change...So what did **H&R Block**—the tax-prep company—announce Thursday? Profits sank in its latest fiscal year and it has to restate earnings for the last several due to a laundry list of bookkeeping snafus. But not to worry,

special

the quarter edged higher, a split was announced, and the stock soared about 10%. When investors don't learn from history...

A Profession's Conscience **Abe Briloff Ponders Accounting's Current State**

Barron's, 10/11/93, page 10

Abraham J. Briloff. How do you introduce a legend? As the Emanuel Sachs distinguished professor of accounting emeritus at Baruch College, part of the City University of New York? As, at 76, the senior partner of a small New York City-based accounting firm, AJ & LA Briloff, CPAs, which is now largely run by his daughter, Leonore. As an esteemed and prolific contributor to Barron's for the past quarter-century – and, it's fervently hoped, for years to come? They are all accurate, but don't really speak to the essence of the courtly gentleman many would describe as the scourge of the accounting profession. That image derives from Abe's adamant and tireless insistence on reminding his colleagues that they should pay more than lip service to what he sees as the profession's ultimate responsibility – providing full, fair and independent accountings of the enterprises they audit. Yet scourge isn't really right, either. Sure, in four books and in innumerable articles in learned journals, as well as in this magazine and before countless congressional committees, Abe has fashioned a career out of chastising his accounting brethren when they've failed to live up to the high ethical standards he sets for himself and others. And he has also been known to heap considerable scorn upon corporate managements for playing fast and loose with the accountants' book of rules. But no animus or element of vengeance inspires Abe's always meticulously researched and reasoned critiques. Rather, it's an abiding love of what he calls this "beautiful profession of accountancy."

We turned on the tape recorder when Abe dropped in at our offices recently; capturing his musings, not only on his career and on some of the knottier issues facing his beloved accounting profession, but also on some pending corporate transactions.

-- Kathryn M. Welling

BARRON'S: You have been the conscience of your profession – forever, it seems, Abe. Could you have taken on a more thankless task?

Briloff: It really hasn't been thankless. I have been privileged to have ideas, concepts, feelings with respect to a professional pursuit to which I have been dedicated for 60-odd years. I want to emphasize the word "privileged." I feel the profession of accountancy is an integral part of our universe of learning. And I am privileged to be able to see the interrelationships between that pursuit and other aspects of our society. Then, where I believe that the objectives of this profession are not being fulfilled consistent with the requirements of our society, I speak out. And I have been very

privileged to be able to do so – I've said this often in many contexts – in Barron's. This would never have been, if it weren't for the fact that Barron's, back in 1968, picked up something that I had written in the Financial Analysts Journal with respect to pooling-of-interest accounting, and gave me a much broader forum to express my views. You took the ruminations of someone who otherwise merely would have been an academician, albeit a competent one, and afforded me tremendous leverage.

Oh, come on -- you can't really blame, much less credit, us for creating you!

No, but I have a very special sense of appreciation for what it is that Alan Abelson and Bob Bleiberg made possible. Back then, I started writing for you on a different company every three months or so. At that time, my eyesight was very good, almost perfect. My vision now is better, because I can see things far more clearly with many more years of understanding and presumptive wisdom. But then I was able to cope more easily with a great many more annual reports and SEC documents. And my writings in Barron's had a ripple effect—not that they necessarily turned the profession around. But changes did evolve. They have been numerous. As have the congressional hearings at which I have been invited to testify. The profession has been made to respond to some of the issues that we saw. And some accounting precepts have been improved, especially those concerning business combinations involving poolings of interest, and some of the disclosure matters which we had complained about. Frustrating? No. Have I accomplished the nirvana or the ultimate objective that we had in mind? Scarcely. Nevertheless, I've demonstrated that ideas can have consequences. And I am still here making some contribution to the accounting profession.

But is it still a "profession" or has accounting really become big business industry?

It is a profession. Intellectually, a great number of my colleagues in practice share that sense and, certainly, greater numbers of my colleagues in academia share it. But regrettably, things are happening in the accounting environment, which run counter to that. Just as corporate enterprise has become lean and mean, so have the major accounting firms correspondingly moved toward becoming lean and mean. Therefore, instead of encouraging an intensity of commitment by the partners and staff towards the advancement of the profession as a profession to meet society's needs. . .

Isn't that a luxury the firms can ill afford in the competitive environment of the 'Nineties?

The phrases I hear all too often now all add up to, "Look, you are in a jungle now and you are going to be able to eat only that which you kill." It is not only true of the accounting profession. It is also true of the legal profession. As law firms and accounting firms grow larger, instead of being organized as professional partnerships, they become some kind of an organizational enterprise with a hierarchy and pecking order. And as that happens, those who move upwards in the hierarchy are the rainmakers, so-called, who Balkanize the firm, developing all kinds of political enclaves. We've seen that any number of times.

If not the rainmakers, then whom should the firms reward?

Ideally, we'd see movements upwards of persons within the firm because of the way in which they have contributed to the advancement of the profession's body of knowledge, and because of their ethical precepts, as well as their commitment to the totality of its social obligations – instead of the extent to which they've contributed to the firm's bottom line.

Today's reality could scarcely be at greater variance from your ideal.

Indeed, today there are terminations of partners galore in the accounting world. I just heard last night, for example, that Arthur Young, which had one of the very best accounting research groups in the profession, had disbanded it – I think, perhaps, even before the merger that created Ernst & Young. The persons who were in it were turned out to relate to clients on the assumption that research did not contribute to the bottom line.

But isn't the ivory-tower stuff better left to you academics – and to bodies like the Financial Accounting Standards Board?

Here, let me refer to some recent correspondence I've had with Steve Zeff, a distinguished accounting professor at Rice University. As he wrote to me, instead of trying to advance the body of knowledge and to come to grips with the major theoretical challenges that confront us as new technology and new financial and economic concepts come along, the research arms of the firms are essentially reduced to taking the output of the FASB and writing analyses and memoranda describing what it is that they are doing, and how it may be applied. So instead of the firms contributing to the upward development of the body of knowledge and the theory of accountancy, they move pragmatically to merely implement what the FASB puts forth. And when you look at what FASB comes up with . . .

You don't like what you see?

I see mere bodies of rules – generally lacking that important theoretical probe, the quantum leaps that might be required. The FASB is constantly playing catch-up with respect to problems that may be festering. And, eventually, possibly clarifying the problems of yesteryear. While it's oblivious, largely, to new ones coming along the pike.

You're saying, then, that FASB is merely a political organization – and about as counterproductive as Congress?

To be fair, it is beset by various pressures. But yes, just like Congress with all the lobbyists and vested interests impacting on it. Importantly, you have the corporate interests. Also, the accounting profession, which in turn reflects its clients' interests, impacts on the FASB. As a consequence, they don't really come forward with what would be required to produce the "full and fair" accountability, which in essence, has been my "*cri d' coeur*" – going back to 1968.

What does "full and fair" accountability mean in what you called the modern business jungle? What should the accountant's role be?

What the accountant should do—Corporate managements, however importantly committed they might be, are themselves all too tied, generally, to what they can eat, namely that which they can kill, and therefore concerned with the bottom line. Recognizing that there is this kind of polarization between the interests of management and the outside world – including not only shareholders, but consumers, government and society, generally – the accountant *ought* to be committing himself (herself, itself) to being an historian, with all the full force and vigor the term implies. Namely, to go in there and probe the circumstances that prevail. Then, with the historian's view of the truth – with humility, I am not saying he is getting the ultimate, absolute truth – but with a historian's dispassionate view of the truth, the accountant must set forth his views regarding the company's financial condition and results of operations. What I am saying contrasts invidiously quite generally with the prevailing circumstance, where it is *not* the view of the truth *as the accountant sees it* that is presented.

Then what is?

It is the view of the truth as the client's chief financial officer might see it, to the extent that the client's CFO is able to rationalize the client's objectives as being within the framework of Generally Accepted Accounting Principles. Federal District Court Judge Stanley Sporkin recently referred to that as "shoehorn accounting." Trying to fit the circumstances within GAAP, sometimes stretching the shoe, sometimes tightening the foot, somehow or other making it fit. And then, to make matters worse, instead of being the independent historian who is presumed to say, "You (corporate management and those in the corporate enterprise) create the circumstances, create the history; I will then come in and determine just how the history ought to be written," the CPA works cheek by jowl with corporate managements. So the CPA now works to try to determine how transactions might be structured – sometimes contrived – to meet some aspect of GAAP. Sometimes it is an exotic aspect of GAAP. Sometimes it is a GAAP precept which doesn't really, and shouldn't really, apply. Or shouldn't be made to apply. But somehow or other it can be tortured to fit. We see this in business combinations. We see this in leasing. And in a myriad of other circumstances.

Aren't you essentially asking the impossible? While shareholders ultimately foot the bills for auditors' services, it's corporate managements who control who gets the assignments. Even lawyers – members of a much-maligned profession, if ever there were one – at least know their duty is to serve their clients.

I'll turn to the law in a moment. First, I want very much to disagree with your premise. Not about that which is. But I would disagree about what has to be if our civilization is going to be worthy of the designation "civilization." For example, right now the major debate is health care. The critical question is, can those enterprises – corporate or otherwise – can those professions identified with health care – hospitals, doctors and the like – be permitted to retain the "dog-eat-dog" way of life? In short, if we are going to succeed in keeping even a modicum of civilization in a very complex society where none of us can take full responsibility for our own well-being, we have to delegate enormous pools of responsibility to many different groups, hence to many different corporate enterprises. We must look to them for a full commitment to accountability to all of us. And this is what it is that corporate managements, and therefore the corporate boards of directors, and therefore the corporate audit committees, and therefore the corporate auditors, have to be made to understand. When you turn to the legal profession, you are right. Where the attorney acts as an advocate, by all means he knows who his client is.

We sense that there's a "but" coming here.

Absolutely. But when the attorney acts as corporate counsel, documenting what it is that is happening, then, as Justice Louis Brandeis put it, he is counsel to the situation. And to be counsel to the situation, the justice said a century ago, is to be counsel to the total society. I frequently draw an analogy between the CPA's role as the independent auditor and the role of the judiciary. The two have a common responsibility, namely, to the total situation.

But judges aren't paid by the plaintiffs or defendants.

I understand, but the very notion of public accounting is rooted in independence. The only reason we are there is that we are presumed to be independent. If we fail to fulfill our duty on that score, then we are perpetrating a hoax on society.

A hoax?

I know it sounds naive. I know it sounds idealistic. But it has to be if we are going to retain our status as the profession

responsible for independent audits. We have got to disassociate our mindset from who it is that is paying our fee. I agree, the situation is grievous now. It is made even more so as a result of the relaxation of our rules of professional conduct which now permit competitive bidding.

You find it unseemly for accountants to openly jockey for business?

It's not so much that it offends my sensibilities – though it does. It's that it reduces the audit function to a commodity to be bid down. For example, as I understand it, when one of the major firms had the contract to audit the Javits Center, the auditors' fee was \$90,000 a year. Then they opened it up to competitive bidding, and in one year dropped the fee to \$70,000. After successive competitive biddings, a firm from Albany is now doing it for \$30,000. Now, that payout can't cover an effective audit. So why did they take it on? Possibly to utilize whatever spare time their staff might have. Or to somehow or another, they audit that much more superficially. Or they are possibly hoping to get a foot in the door, to use the audit contract as a "loss leader" to snare more lucrative contracts -- namely management advisory services contracts. This should not be. Traditionally, we were not permitted to engage in this kind of competitive hustling.

Isn't it possible, though, that the Javits Center was paying way too much, previously, for its auditors' services?

That is true. The other side of the ledger is that there has to be self-restraint on the part of the professional firm in the way in which they do their billing. And what it is that they expect. You are right. I believe that those of us who want the togas and kudos of being a member of a learned profession traditionally expected a nice way of life. We expected to accumulate something for retirement and to leave to our family. That, essentially, was what we aspired toward economically. But we have moved to the point where the professions – medical, legal, accounting – have become oriented toward wanting to be very much like those captains of industry to whom they relate. Therefore, we have doctors pulling down \$300,000 or half a million a year, with their jet planes and condominiums all over the map. Accountants wanting \$1 million a year. The legal profession, the same way. As they move up the hierarchy, that's what they want. And all the others have to contribute. Now, on top of the enormous fees that professionals want, or the earnings they want, they also want pension plans which will give us 25%, 40%, 50% into our years of retirement. And the government's tax laws permit, even encourage, benefit plans that turn a doctor earning \$200,000 a year into a pension expert.

Are you saying there's something wrong, in a capitalist society, with charging what the market will bear for professional services?

No, but all of this impacts the pricing structure – the burden – that is put on society. I know there is a naiveté in what I say. But we have got to, somehow or other, turn things around somewhere, somehow. Otherwise, there are going to be increasing tensions within our society.

Let's go back to GAAP. Is the problem the gaps in GAAP, the loopholes, or is there something intrinsically wrong with the way the profession's rule-book is being written today?

Some of each. GAAP, conceptually, can be seen as being a language which has numbers and words in it. I start out with the premise that, within that language, the words and numbers can be utilized to most appropriately reflect the economic reality of that which is being accounted for, even if sometimes additional verbiage is necessary. But what happens is that, within GAAP, there are various rules, for example, with respect to leases. In order to have a so-called finance lease,

for which profits can be booked in bulk rather than attenuated over time, certain standards have to be met. So various contrivances are created to "meet" those standards. There were some articles in *The Wall Street Journal* not long ago describing the convoluted process IBM had gone through, with the help of Merrill Lynch, to make believe some of those standards were met. That's the difference today. These are the same kind of contrivances that we thought we had put to rest back in the 1970s, with respect to business combinations.

Back then, you wrote about how some of the conglomerate builders abused the accounting rules. What is it that you're saying is different today?

Sometimes the more things change... Just coincidentally, some of what I wrote in 1968 on the topic of dirty pooling related to Paramount Pictures, which is again so much in the news in the context of yet another takeover proposal. Back then, Gulf & Western acquired Paramount Pictures for about \$180 million. And I made a great to-do about the fact that, in the process, G&W submerged about \$80 million of costs via pooling-of-interests accounting. And then it turned some of Paramount's films over to NBC for \$10 million. And so it is that Gulf & Western was able to report "profits." But the difference, you see, is that back in the 'Sixties, pooling-of-interests accounting was somewhat outside the penumbra of respectability. Not only were the numbers small by today's standards, but it was only the gunslingers, like Saul Steinberg with Reliance Insurance, or Jimmy Ling, at LTV, who would engage in it to massage their bottom lines. But today, pooling of interest has become a matter of respectability among the high priests in the temples. So it is that in 1991, AT&T literally shoehorned, to use Judge Sporkin's metaphor, the transaction into pooling format, when it acquired NCR Corp.

How so?

If you recall, NCR had introduced a poison pill to prevent AT&T from taking them over, by entering into a transaction that would prevent a pooling takeover. But AT&T wanted pooling and wanted NCR. So despite the hue and cry that came from the accounting profession, somehow AT&T was able to turn this thing upside down, move it around and get it through the SEC. That agency's accountants undoubtedly had to hold their noses, and shut their eyes, to permit the pooling, but the result was that about \$7.25 billion of costs were booked at only about \$1.8 billion. So \$5.4 billion of costs were submerged – and will never flow through AT&T's books.

Perhaps you'd better explain, briefly, why you sometimes object to pooling-of-interests accounting.

Very briefly, when companies are acquired, the acquiring company can either pay cash or notes to buy the other entity, like in the RJR Nabisco deal, or it can issue stock for the company being taken over. If they pay with cash or other property, there is no question but that purchase accounting has to be used. So if the acquirer pays \$10 billion for the company, \$10 billion has to enter into the costs on the books, some of it booked for the acquired company's cash, its inventories, its property. And if anything is left over, it goes into goodwill. And that which enters into the books as cost has to be written off over time. Goodwill has to be amortized. The property has to be depreciated. Inventory has to go into cost of goods sold. So if one company pays \$10 billion to acquire another enterprise, \$10 billion of costs are entered on the books, even if the company that was taken over had a book value on its own books of only \$2 billion.

So the upshot is that the stepped-up depreciation and amortization charges are a drag on the combined companies' earnings going forward.

Exactly. If, however, the target company is acquired for \$10 billion in stock, and the transaction is accounted for as a pooling of interests, it is the target company's \$2 billion stated book value that is entered into the combined companies' books as its "cost," not the \$10 billion economic value of what was given up to complete the transaction – namely, the stock of the acquirer. So the future depreciation will be limited to the \$2 billion. The only impact on the earnings would be derivative from the \$2 billion and not from the \$10 billion. Therefore, \$8 billion of costs are submerged in perpetuity.

Isn't AT&T doing the same thing again in the McCaw Cellular deal?

Yes. AT&T is now in the process of acquiring McCaw by issuing about \$12 billion of its shares. When I look at McCaw's balance sheet, I see a mere \$129 million in equity. So instead of the \$12 billion cost of acquiring McCaw becoming – to use your phrase – a "drag on earnings," only a very minimal amount will be entered on AT&T's books as the cost of McCaw. Therefore, no drag on earnings. Not only that, but notice that return on equity will be expanded. Because if you toss in virtually nothing as the equity, then whatever return you produce is proportionately so much greater than if you had put in \$12 billion as the equity.

So what's changed in the last 25 years is that the numbers involved in these accounting games have gotten orders of magnitude larger – and that engaging in them has become "socially acceptable."

Right. The most respectable companies are doing it. I mentioned IBM. Back in January '86, I wrote something for you [*Barron's*] called "What Is Good for General Motors." The opening phrase was something like, "There was a time when I looked at General Motors' accountings as being the Tiffany..." but then what happened when they acquired EDS, when they acquired Hughes—

You tell us.

They squirreled away the goodwill in the parent company, where it would have minimal impact on the company's earnings. In that way, they insulated Hughes and EDS from absorbing that cost amortization factor, thereby sweetening the earnings of these new acquisitions.

So now General Motors, IBM and AT&T – entities that would not have lent themselves, I submit, to this kind of practice back then – are engaging in shoehorn accounting. I suppose this is an indication of the intensity of competition in the marketplace. Maybe it reflects the expectations of the so-called professional investors, who somehow feel themselves compelled to demonstrate – on a quarterly basis – their astuteness in selecting investments, and who are insisting that corporate managements produce the kinds of numbers conducive to increased respect in Wall Street.

But from the perspective of an investor, does it really matter if the quality of AT&T's or IBM's earnings are degraded—as long as virtually everyone else is likewise employing similarly aggressive accounting?

It doesn't appear to make much difference at the moment, any more than we might have said in 1983 that junk bonds don't make that much difference. They were accepted in the marketplace. They were yielding 15%. And we had all kinds of academic studies saying they really weren't very risky. But that was before we learned that Michael Milken was determining the market prices for the junk bonds.

Let's go back to the issue of "fair" vs. "GAAP fair." You've argued in any number of stories that if the auditors

had presented a full and fair picture of the companies' economic realities, their reports would have stood at considerable variance to their GAAP results.

That is central to the dilemma that confronts us. If you recall my 1989 Lomas Financial Corp. article, for instance, that company had a responsibility, under their various loan indentures, to demonstrate that they had shareholders' equity of \$500 million. Well, along comes an end of a quarter and they don't have \$500 million – not quite. So just before the end of the quarter, they enter into a contrived transaction with Merrill Lynch, issuing preferred shares to sweeten the shareholders' equity. Now, normally, preferred stock *does* sweeten the shareholders' equity – unless it is preferred stock that is mandatorily redeemable at a fixed redemption date.

Because, in that case, it is really more debt than equity?

Precisely. It is the equivalent of debt. So to make Lomas's preferred appear to be equity, they said there is no redemption requirement. However, the deal was structured so that if the preferred issue weren't redeemed, at the option of Lomas, by a certain date, there would be draconian consequences. Clearly, they had to redeem it or else. But by not making the deal "mandatorily redeemable," Lomas could count the money so raised as equity, and squeak by for that quarter. And that was only one of the accounting contrivances the company employed. But of course, in the end, all of its accounting alchemy didn't help Lomas very much. What its auditors did was to very meticulously apply GAAP. But doing so produced unfair consequences, under the circumstances. In another instance that I wrote about extensively, that of Guaranty Security Life, the company actually engaged in sham transactions for several years on Dec. 31, which were reversed on Jan. 2. As documents produced at subsequent Senate hearings made clear, even the documentation ostensibly supporting those transactions were forgeries. As I made abundantly clear at the time, the auditors, if they had applied even a modicum of the healthy skepticism that is appropriate for their occupation, should have said "this is nothing but nonsense," and tossed it out.

So the auditors were asleep at the switch, in that instance.

At least. It has parallels for the accountants in the Lincoln Savings & Loan-Charles Keating mess. I recommend reading Judge Sporkin's extraordinarily incisive opinion in the case in 1990, describing the multitude of real-estate transactions that were carried out in order to give Lincoln S&L the appearance of substantial profits. Contrived transactions with straw men and straw corporations. Those deals permitted Lincoln to show big pre-tax profits, on which taxes were calculated, and those taxes on those fake profits were then moved upwards to American Continental Corp., Keating's parent holding company. Judge Sporkin's lament was that these transactions lacked economic reality. I quote him regularly now on that score: "One of the things that the auditors must learn, or should learn, from this case is that the mere pursuit of GAAP is not sufficient if it does not reflect economic reality."

Let's turn to Consec, Abe. Of your recent writings, anyway, it stirred up the most controversy in the Street.

I don't know that it ignited so much controversy in Wall Street. All I know is that Consec attracts a great deal of favor in Wall Street. And I want to make clear that I own 10 shares of Consec, a holding that permits me to easily get its SEC filings and corporate reports. I find the company a source of extraordinary fascination. I want to say that right up front. I am watching it with such intrigue, I am mesmerized by the extraordinary competence of their financial officers – especially, undoubtedly, their chief financial officer, Rolland Dick. He is worth every million dollars he is getting in compensation or through stock. I am watching him the way a chess fiend watches an extraordinary master play the game.

And I am saying, "But it can't be, it can't go on. That kind of situation must not be." Yet it is, and it does go on.

How do you explain it?

Some might say in retrospect that their timing was right, and that their luck was right. I would say, as a preliminary observation, that things would have been a lot less felicitous for Conseco if the bond market hadn't responded in the past couple of years in the way it has, producing very substantial appreciation in their bond portfolios – appreciation they have utilized remarkably well, the way, to switch metaphors, that a virtuoso is able to get the most sweet notes out of violin.

Could you summarize, briefly, what it is that disturbs you about Conseco's accountings?

As my 1992 article spelled out, part of it had to do with Conseco's application of what's called present value of purchased business accounting. Under it, when they acquire an insurance company, they put on their books the discounted value of the profits that they expect in the future from the acquired company's existing book of business. They put that on their books instead of goodwill, which they would have to write off. This present value of purchased business, or PVPB, is different because it serves as the basis for *accretion*. So if, for example, they established a \$200 million present value of their future profits, discounted at 18%, that would mean that in the first year they are able to pick up a \$36 million addition to their income, namely, 18% of that \$200 million, as though they were booking a receivable, offset by some amortization. They used this PVPB accounting in connection with Conseco Capital Partners' acquisitions in 1990-91. And it gave them a very substantial bottom line for those years. Then, however, the SEC asked the FASB, through its Emerging Issues Task Force, to take a look at this particular issue. That's where Conseco also got lucky. The mentor that was assigned to develop the brief on that problem for the Emerging Issues Task Force was a person from Coopers & Lybrand, the firm which coincidentally happened to be the auditors for Conseco. This matter got to the Emerging Issues Task Force in July of 1992. And they fussed back and forth. FASB would not accept what was happening. Or, more precisely, not happening. Nor was the SEC particularly happy. So finally, in mid-November of 1992, the Emerging Issues Task Force came to a consensus on PVPB accounting which is very much more limited and restrictive than what Conseco had been doing. They had been discounting at 18%; they now have to use about 9%. But Conseco closed its Bankers Life & Casualty acquisition 10 days or so before that consensus was reached, so that transaction was grandfathered. You see, luck shines on them.

Yet the impression in the Street is that FASB has blessed Conseco's accounting.

In September '92, Conseco issued a press release telling how FASB had blessed them. What they did was to write a lead paragraph and then excerpt a few phrases from the FASB's 50-page report. But they did, very appropriately, also send a copy of their press release to the FASB. And in response, Conseco got a blistering letter from the chairman of the FASB, telling them that their release was entirely unfair and improper. That these sound-bites won't fly.

Essentially, doesn't your complaint about Conseco boil down to there almost never being any comparability in its accounts from period to period?

That's part of it. Bear in mind that if you pump in "earnings" through PVPB accounting, eventually that has to come back to haunt you. Because eventually you have to realize that amount. If you start out with a \$200 million receivable and keep pumping in 18%, against a \$1 billion anticipation, eventually you have to get that \$1 billion. And if it falls apart, it

falls apart. So recognizing that this build-up could become dicey, Conseco has utilized the appreciation in its bond portfolio to help bring down the carrying value of that factor.

Most intriguingly, and I know of no other insurance industry circumstance where this is being implemented, as of Sept. 30, 1992, Conseco took its bond portfolio out of so-called held-to-maturity status, which is the way insurance companies normally hold their bond investments, to back up their long-term obligations to policyholders. And they said, "We are now going to call this 'actively managed.'" In other words, available for day-to-day trading. So now, instead of carrying those bonds at amortized cost, Conseco carries them at prevailing market, which at this point, because of the tremendous bull market we've had in bonds, is higher than amortized cost.

Granted, they're probably top-notch bond investors, but why expose their balance sheet to all that market risk?

They now take pieces of the unrealized appreciation in their bond portfolio and use it to bring down the carrying value on their balance sheet of the present value of their purchased and produced business. Their rationale is that, had they actually realized those gains, the yield on their remaining portfolio, going forward, would have been less because of the lower interest rates currently available. What this does is permit Conseco to easily meet the so-called premium-deficiency test that the FASB implemented after the Emerging Issue Task Force looked into the PVPB issue in '92. Under it, if the present value of the contemplated premiums are less than the present carrying value of the asset on the books, you have to chop that carrying value down and charge it to operations to meet this premium-deficiency test. But by using the unrealized appreciation in its bond portfolio to reduce that carrying value, Conseco is able to easily avoid that charge to earnings.

Go on.

Beyond that, it is not only the comparability of Conseco's accountings that I question, but also their consistency. It is a Humpty Dumpty phenomenon. Again, in 1990-91 and through June '92, Conseco consolidated its own insurance and other operations with those of Conseco Capital Partners, which was owned by a partnership.

Beginning in September '92, after Conseco Capital Partners' IPO, Conseco deconsolidated, so it only picked up its proportionate share of CCP's earnings. But it did not restate its first six months' results to provide any comparability, any consistency. Comes now November of 1992, and they acquired Bankers Life & Casualty and consolidated its results. So Conseco's 1992 reports showed Conseco consolidated with Bankers Life compared with the 1991 results of Conseco consolidated with CCP. There was neither comparability nor consistency.

Dare we ask, so what? Isn't consistency the hobgoblin of small minds?

What is wrong with that is that it is virtually impossible to see what the numbers represent, what Conseco – as Conseco – was doing, what Conseco has wrought from one period to another. Comparability and consistency are the key qualities of understandability in accounting. It is as though you somehow switched from English to Latin to Esperanto as you moved along. Then somehow, somewhere in the management discussion and analysis, if you look carefully enough, you might find something that might pass as a partial Rosetta stone, so that you might be able to link one with the other. Is that the test that ought to be put? Again, I'm in awe of what the master chess player is doing. But it hurts, because it does violence. As of Dec. 31, 1992, remember, Conseco consolidated with Bankers. But then Bankers did an IPO early this year. So at March 31, it was deconsolidated. The SEC should never have permitted that consolidation and neither should have Conseco's auditors.

Why not?

Because the book of rules says that, even if there is 100% ownership, if that is merely a temporary situation, it shall not be consolidated. Here, the control situation, to the extent it prevailed, existed for only two months. And now, because Conseco recently increased its stake in Bankers, it will be consolidating its results again. But even more intriguing, at yearend '93, Conseco's results undoubtedly will be deconsolidated from those of their own insurance operations – those of Western National. Because at the same time that they announced the acquisition of Bankers, Conseco said that they are going to sell at least 51%, possibly 60%, of their own insurance operations.

It's challenging, to say the least, to follow Conseco's bouncing ball, but what's the harm in all this, from a shareholder's perspective? As its fans will tell you, the company is growing rapidly in an environment where any kind of growth is to be prized.

Conseco has certainly been producing extraordinary stockmarket gains for shareholders.

Let's pause and see just what Conseco's income trend is. Put aside just for the moment the profits created from Conseco's own insurance operations, Western National. What you're left with is that a substantial part of the profits Conseco has been reporting resulted from the IPO of CCP, from the IPO of Bankers. And, I would argue, should fairly be entitled to a price/earnings factor of just one. They shouldn't be given a multiple because they are not the kind of earnings that are recurring.

What about the profits of Conseco's own insurance operations, though? You can't just ignore them.

If I look at Western National's numbers – its top-line insurance-policy income has been on a downward slope at least from the first quarter of 1992. And when I compare 1992 against 1991, the gain was only minimal. Part of the reason, of course, is that Western National was acquired years ago, and Conseco's PVPB calculus front end loads income in the early years. Meanwhile, the FASB has already severely restricted Conseco's game plan with respect to PVPB accounting, so the question arises whether they will be able to generate reported earnings in the future the way they have in the past. A second question arises from the fact that in order to continue their aggressive forward momentum, they have to keep acquiring. What's questionable is whether they'll be able to continue paying prices for these acquisitions that will appear to be bargains, at least retrospectively.

If, as you say, Conseco has to keep acquiring to grow, why is it now planning to issue shares in its Western National Insurance subsidiaries to the public? Clearly, part of the answer is that – as they did in the Bankers and CCP IPOs – Conseco can then scoop the unrealized appreciation in its holdings of Western National's shares into income. It may also be that they are offering Western National as an IPO because it's not that attractive as an operating company. It may, in fact, represent a very substantial resource strain on Conseco.

Why do you say that?

I haven't been able to obtain Western National's registration statement yet, but I have looked at the so-called convention blank that Western National filed with the state insurance authorities for 1992, which shows that Western National had some \$250 million of so-called surplus debentures outstanding, owing to Conseco.

Which means that Conseco had pumped \$250 million or so into Western National...

As an incident to its acquisition of underlying enterprises. That essentially was a receivable from Western National on Conseco's books, and Conseco could expect to get that back as the operations of Western National permitted. But surplus debentures carry a special meaning in the insurance world, whereby the regulators can say, "To the extent that this company needs portions of that debenture for its capital and surplus to protect the policyholders, that amount will be deemed to be part of the insurance company's capital and surplus." Only the rest of it will be deemed to be a liability of the insurance company to its parent.

In other words, the regulators can basically permit insurance subsidiaries to confiscate capital, in the form of surplus debentures, from the parent?

That's right. In Western National's case, as I recall, at year-end 1991, about half of the surplus debentures outstanding were required for capital and the other half were listed as part of its liabilities. And Western National was paying interest to Conseco. But as of the end of 1992, presumably at the direction of the Texas insurance regulators, the entire amount had to be tossed into capital to meet Western National's policyholder requirements. This, to me, raises serious questions.

Can you be more specific?

Well, once the interest is not there and once the capital repayments are not there, then clearly a source of liquidity for the parent company disappears, indicating possible pressure on the parent. It cannot keep feeding the subsidiary. Therefore, perhaps, the IPO. All of this, of course, will be disclosed in the prospectus. And the IPO might well fly beautifully because of the Conseco cachet.

Yet you remain deeply skeptical.

Clearly, I'm fascinated by Conseco – by its overly astute implementation of what I deem to be highly questionable accounting practices. What I see does not comport with my notion of full accountability nor with the auditors' responsibility. And I am particularly aghast at the fact that this is going on in an area where – traditionally, at least – one would expect that the industry's executives would be – not holy-holy – but committed to recognizing the long-term transcendent responsibilities that they have to future generations, instead of obsessing on the next quarter's profits.

You don't really care if you're seen as tilting at windmills, do you?

A: I don't fancy myself as quixotic. But maybe I'm a Jeremiah and maybe I'm an Amos in the temple, saying the high priests are not living up to the standard to which they ought to be. To the extent that I feel intensely about the presumed standards, I might be described as being foolish, but I'm prepared to justify what I am saying.

Have any other accounting issues captured your attention lately?

Yes. Emerging Issues Task Force Issue No. 93-6, which relates to retrospectively rated contracts.

What, we almost hate to ask, are those?

Assume that in 1991, insurance company A, called the ceding insurer, entered into a reinsurance agreement with company X, a reinsurer, whereby the ceding company paid a premium of \$200 million to X. And X agreed to

compensate A for all, repeat all, hurricane losses, but with the understanding that on the next renewal, any excess of losses over and above \$200 million will be added to the ensuing year's premium. And any deficiency in losses against that \$200 million will be subtracted. And if it were cancelled, then any excess loss would have to be paid at cancellation and so on. Comes Hurricane Andrew in 1992 and the losses are \$350 million and the renewal hasn't come up yet. Now insurance company A knows that it is going to have to ante up \$150 million more next year. But they say, "We are reinsured this particular year, the premium was \$200 million and the reinsurer is going to take all losses." So it does not pick up that \$150 million of costs. Now, any accountant with an iota of sensitivity, looking at FASB Opinion 5, relating to contingencies, would say, "Here is a contingency that ripened in 1992 and therefore the additional liability of \$150 million has to be picked up at the end of 1992."

So, what's the emerging issue?

Some auditors went along with not recognizing the liability, as I understand it.

At least not all of them, or it wouldn't be before the Emerging Issues Task Force.

Well, what often happens when auditors feel just a little bit sensitive – when they've done something they know is a bit naughty—they turn to the Emerging Issues Task Force and they say, "This issue has emerged."

And that soothes their consciences?

Yes, because they then can have all the philosophers come and sit around the table and opine, "Yes, you have a major issue and we have to got to resolve this." And in the meantime, you see, there is a sense of absolution with respect to the past. After all, the philosophers can't reach a consensus. Now, I wasn't there, but I must say, based on what someone at the FASB told me, at one of the Emerging Issues Task Force's early meetings on this, the chief accountant of the SEC said he'd never permit this thing to pass; in fact, he reportedly said such statements would be false and misleading. That these contracts are an absolute liability. That it was absolutely wrong and this has to be corrected. You are going to have to restate 1992 to show it. I understand that those gathered around the table turned white.

How come?

Because if they have to restate, that means that it is a correction of an accounting error. So the issue was put off to another meeting.

And has another been held?

Yes, in July, when a compromise was reached that doesn't mandate restatement. The SEC's chief accountant went along, but then indicated that there would have to be additional pro forma disclosures as to how earlier years would have been impacted. This is symptomatic. It is, mind you, normal these days for the chief accountant to go along. But to go along on something that he recognized as wrong...So all right, if someone has to be quixotic and tilt at windmills, I guess I'm it. But something has got to change. We have got to reinvent the whole process of corporate accountability and reinvent the accounting function, which is part of corporate accountability.

How?

The independent audit committee should be serving an extraordinarily important function. That should really be the

linkage. If they really, really perform their role; if they know what they are doing and if they know what they are seeing, hearing and asking, then the independent auditor would be compelled to shoot straight. The independent audit committee ought to have as advisers a consortium of experts devoted to it – and to it alone. In that way, the audit committee could do its oversight job – they would at least know what to ask.

Why is this so essential?

Because the corporation is not just something devoted to the bottom line. It is really the engine of our capitalist system, which in turn is the engine of our American democracy. And I don't believe that I am engaging in hyperbole.

Enough said. And thanks, Abe, though "thanks" is scarcely adequate.

(See related letters: "Barron's Mailbag: A Firm Replies" – Barron's Nov. 22, 1993)

Barron's Mailbag:

A Firm Replies
11/22/93

To the Editor:

In an interview ("*A Profession's Conscience*," Oct. 11), Abe Briloff suggested that accounting firms shouldn't produce competitive bids for audits because this reduces the audit function to "a commodity to be bid down."

The case Briloff used to illustrate his point, the Javits Center audit, was awarded to the New York City office of Urbach Kahn & Werlin. Our \$32,000 fee for the Javits audit was created from an effective cost analysis based on accepted 1990s auditing standards.

Our firm has nearly 30 years of experience auditing public-benefit corporations such as the Javits Center. Based on our expertise, we created a fair price for what resulted in a highly effective audit that the Javits Center's administration greatly appreciated. In our experience, high bids are often caused by a lack of understanding of the audit environment, or possibly ineffective and poorly managed audit processes. We are proud of the work we did. More importantly, we taught the Javits administrators that they shouldn't have to hemorrhage money on professional fees just because they have a familiar name and run a large operation.

Competitive bidding allows clients to evaluate the competing firms' experience, along with the value of their service. It seems that Briloff and Barron's should applaud this process. Instead, he says: "Traditionally, we were not permitted to engage in this kind of competitive hustling."

On behalf of UK&W, I applaud your interviewer, Kathryn M. Welling, for educating the professor about reality: Javits

had previously been paying "way too much."

As for Briloff's assumptions about UK&W's professional motives for taking the contract, such as "to utilize whatever spare time their staff might have . . . or to somehow or another audit that much more superficially," we can only say that this is completely unfounded, and that Briloff's behavior was, quite frankly, unprofessional.

John E. Wolfgang
Urbach Kahn & Werlin
New York City

Abraham J. Briloff replies:

In considering John E. Wolfgang's polemic, readers should be reminded that my commentary was in the context of discussion of the misbegotten competitive bidding dispensation recently granted by our code of professional conduct. The Javits Center audit was but the most recent case that had come to my attention.

My inferences regarding the possible consequences from a \$30,000 bid vs. the \$70,000-\$90,000 fees that prevailed previously were predicated, first, on the comments from others intimately familiar with the nature and extent of the work, and especially the enormous disparity in the amounts. The incongruity is exacerbated by the fact that the new successful bidder first has to master the learning curve.

While a generic product may sell for very substantially less than a name brand, I can't rationalize such a glaring disparity where professional services are involved, predicated principally on personnel costs determined by the marketplace and proceeding in accordance with the presumptive standards of the profession.

Barron's Mailbag:

On the Defensive
10/25/93

To the Editor:

Your most recent writings concerning Conesco ("*A Profession's Conscience*," Oct. 11) still miss the mark.

I share Abraham J. Briloff's admiration of Conesco's CFO, Rollie Dick. Conesco is blessed with the very best of top

management, all of whom earn the salaries they receive. Indeed, in 1992, the United Shareholders Association ranked Conseco the 95th best company in the U.S. in terms of executive compensation as it relates to corporate performance.

While Barron's takes exception to the inclusion of future stream of income from PVPB present value of purchased business, it fails to note the significant annual amortization, which offsets the accretion. This is referred to as only "some amortization," without quantifying that it has been in the tens of millions of dollars.

Perhaps my most significant quarrel is with your analysis of the prospective Western National IPO. Barron's and Briloff go through a contorted exercise to try to arrive at reasons for the IPO, ignoring the obvious – that it is a method by which Conseco can raise additional cash with which to continue its aggressive expansion. Why do you find it necessary to look for ulterior motives?

Hopefully, the impact of your latest negative writings will parallel that of your past writings on Conseco. If the past is predicate, Conseco stock should do well.

Dennis E. Murray Sr.
Murray & Murray
Sandusky, Ohio

To the Editor:

Kathryn M. Welling's interview with Abraham Briloff was priceless. What a scholar and gentleman he is! The anguish he must feel toward the subverting of sound accounting practices by some businesses is no doubt a heavy burden that he does not need at this stage in his life.

Thank heaven we had such people like him!

I could not put down the article for even a minute because it was such a gripping, revealing saga.

We are all touched by what Briloff sees. It hurts individuals. It hurts America.

Barron's is a first-rate publication that represents what is right about America. Keep up the fine work.

William K. Lynn
Sarasota, Fla.

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