The impact of accounting issues on recent stock market developments

The collapse of Enron, the US energy corporation, in December 2001 marked the first disclosure of a series of accounting irregularities, notably in the United States, culminating in the revelation on 26 June 2002 that WorldCom, the telecommunications company, had considerably overstated its earnings. As a result of these irregularities, greater attention was paid to the different measurements of corporate profits and, in particular, to the noticeable disparities between operating earnings (i.e. profits from a corporation’s ongoing operations) and actual earnings reported to the US Securities and Exchange Commission (SEC).¹ These irregularities led to a decline in investor confidence and played an important role in falling stock prices and heightened volatility. Although the euro area has, to a large extent, been spared gross irregularities thus far, concerns that such irregularities are not restricted to the United States have had a negative impact on stock prices in the euro area as well.

In an effort to restore investor confidence, on 27 June the SEC ordered the chief executive officers (CEOs) and the chief financial officers (CFOs) of almost 950 US corporations to sign an oath confirming the completeness and accuracy of their financial statements.² The SEC’s order applied to companies with reported annual revenues in excess of USD 1.2 billion and required the officers of those companies to file written statements verifying the accuracy of their reports. The deadline was close of business of the first applicable date on which a company was required to submit an annual report (Form 10-K) or a quarterly report (Form 10-Q) to the SEC, i.e. on or after 14 August 2002. Where companies were not able to testify to the accuracy of their reports, for instance owing to the departure of CEOs, a statement was required in writing, under oath, explaining the

¹ See p. 19 of the May 2002 issue of the ECB’s Monthly Bulletin; i.e. the Box entitled “US stock market and corporate profit measures”.
circumstances under which a statement testifying to accurate financial figures might be incorrect. This order was issued under the authority of the SEC pursuant to Section 21(a) of the Securities and Exchange Act of 1934, which has the ability to impose civil penalties; it will expire on 31 January 2003.

**Implied volatility of the Standard & Poor's 500 stock market index**

*(daily data: percentages per annum)*

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Source: Bloomberg.

Of the 941 corporations, the CEOs and CFOs of which were required to swear oaths, only 694 were obliged to do so by 14 August. The CEOs and CFOs of a further 247 corporations, which do not prepare annual reports on a calendar-year basis but rather on a fiscal-year basis, will be expected to sign this oath over a series of deadlines leading up to 27 December 2002.

The SEC’s order had a significant impact on the stock market: between 27 June and 14 August implied volatility, which measures the uncertainty of market participants with regard to future stock price changes, surged to levels previously seen only at the time of the Asian crisis and on 11 September 2001 (see the chart above). At the same time, the Standard & Poor’s 500 index fell by almost 8% possibly reflecting investors’ increased equity risk premia. However, the fact that further substantial accounting irregularities were not revealed before 14 August 2002 helped to reduce the uncertainty of market participants. This is reflected in the implied volatility, which fell by 10 percentage points from its peak in July. However, despite this recent decline, implied volatility was still regarded as historically high in the early part of September.

On 30 July President Bush signed the Sarbanes-Oxley Act of 2002 setting out further reforms. These reforms require each quarterly and annual report filed with the SEC after 29 August to be accompanied by a form of certification from the issuer’s principal executive officer and principal financial officer testifying to the accuracy and completeness of the figures. This form of certification is much more comprehensive than the certification mandated by the SEC for CEOs and CFOs of 941 domestic securities issuers. It essentially covers all companies listed on the US markets without distinguishing between US and non-US issuers.

The euro area authorities have likewise taken steps towards improving accounting standards in the light of the recent irregularities in financial reporting. In June 2002 a new reporting framework concerning all EU companies listed on regulated markets was adopted. This framework states that, from 2005 onwards, companies should publish their consolidated accounts in accordance with the International Accounting Standards (IAS).