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CONTINUING DANGERS OF DISINFORMATION
IN CORPORATE ACCOUNTING REPORTS

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ABSTRACT

Insiders can artificially deflect the market prices of financial instruments from their full-information or ‘inside value’ by issuing deceptive accounting reports. Incentive support for disinformational activity comes through forms of compensation that allow corporate insiders to profit extravagantly from temporary boosts in a firm’s accounting condition or performance. In principle, outside auditing firms and other watchdog institutions help outside investors to identify and ignore disinformation. In practice, accountants can and do earn substantial profits from credentialling loophole-ridden measurement principles that conceal adverse developments from outside stakeholders. Although the Sarbanes-Oxley Act now requires top corporate officials to affirm the essential economic accuracy of any data their firms publish, officials of outside auditing firms are not obliged to express reservations they may have about the fundamental accuracy of the reports they audit. This asymmetry in obligations permits auditing firms to continue to be compensated for knowingly and willfully certifying valuation and itemization rules that generate misleading reports without fully exposing themselves to penalties their clients face for hiding adverse information. It is ironic that what are called accounting ‘ethics’ fail to embrace the profession’s common-law duty of assuring the economic meaningfulness of the statements that clients pay it to endorse.

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CONTINUING DANGERS OF DISINFORMATION IN CORPORATE
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Children are repeatedly assured that honesty is the best policy. Reinforcing this hopeful judgment, economists build models of market equilibrium in which honest firms find ways to separate themselves from dishonest ones, helping customers and investors to impose a “lemons discount” on the products and securities of opportunistic firms. However, recurrent financial scandals and crises constitute strong evidence against the applicability of the lemons model. Managers can and do increase their firm’s perceived profitability by concealing unfavorable information, and watchdog information agents are often fooled or persuaded to cooperate in the concealment.

An unremitting flood of accounting scams, Ponzi schemes, and corporate scandals leads each new Congress to consider stronger controls on corporate wrongdoing. Congress becomes involved because, when managers or watchdog information professionals shirk their duties or act dishonestly, consequences accrue not only to corporate stakeholders, but also to society at large.

This paper traces a major part of the problem to the flawed ethics of the accounting profession. By designing and certifying reporting options that help troubled firms and rogue managers to conceal adverse information from outside stakeholders, the highly concentrated accounting industry manages to insulate from serious sanctions the returns it can earn from cleverly abetting deceitful behavior.

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Our analysis stresses the weakness of social controls on interactions between the governance systems that prevail within corporations and the ethical codes of accountants and other external watchdog institutions. Although parties to acts of negligent misrepresentation and fraud are subject to civil and criminal penalties, difficulties in identifying, preventing, and punishing corrupt exchanges of value between managers and accountants make it distressingly easy for these parties to conspire against trustful outside stakeholders.

The more effectively the ethical norms, accounting standards, and corporate laws of a given country control misrepresentation and questionable side payments, the more reliable its financial information promises to be. Despite the passage of the Sarbanes-Oxley Act of 2002, U.S. accounting rules remain riddled with safe-harbor loopholes. These rules require auditors to confirm only that specified procedures are being followed without having to express an opinion about the accuracy of the information being transmitted. Standard-setting agents value safe-harbor loopholes as ways to limit accountants' professional obligations and their resulting exposure to civil and criminal penalties. Corporate fraud, bribery, and illegal-gratuity statutes limit this exposure even further by setting hard-to-prove standards for punishing deceitful reporting. Prosecutors must establish a motivational link between the benefits managers and accountants may exchange and the particular actions or decisions that generated them. Because clever lawyers can always invent innocent rationalizations for accepting and delivering favors, the burden of proof is inordinately heavy. To establish a corrupt motive requires either that the accused stupidly fail to destroy highly incriminating records that investigators

capture by subpoena or for a third-party whistleblower to step up with irrefutable evidence of the illegal nature of the transaction.

The survival of safe-harbor loopholes and the difficulty of proving auditor malfeasance testify to the effectiveness of the accounting lobby and the strength of the incentive conflicts it transmits to members of the Security and Exchange Commission (SEC). Sooner or later, the practical ethics of the accounting profession must make its members embrace their common-law duty of assuring the economic meaningfulness of the income and net-worth figures their clients publish.

I. Role of Watchdog Institutions in Corporate Governance

Systems of corporate governance reinforce and make explicit common-law duties of loyalty, competence, and care that a firm's board and top managers implicitly owe to other parties.¹ Financial contracting theory divides these other parties into differently informed inside and outside stakeholders in the firm and recognizes that their interests frequently collide. This theory portrays top managers as responsible explicitly or implicitly to all stakeholders, but feeling little compunction to treat all interests equally.²

No matter what products or services constitute a firm's principal output, every corporation is in the information business as well. This is because the efficiency of its funding and support activities depends on its ability to collect, verify, analyze, store, and transmit relevant information. According to SEC Chairman William Donaldson, auditor testing of corporate information systems and board oversight of that process is "the bedrock upon which corporate governance has to be built." Nevertheless, at the margin,

¹ Becht, Bolton, and Röell (2002) provide a comprehensive survey of the literature on corporate governance.

² For example, Bebchuk, Fried, and Walker (2002) argue that executives routinely use their power over the appointment and reappointment of corporate directors to extract rents from other stakeholders.

outside investors have difficulty extracting from inside agents adverse information about a firm's performance and potential loss exposures that they need to price securities accurately. Under the cover provided by information asymmetries and option-based compensation, informed insiders are tempted to exploit less-informed stakeholders. The strength of this temptation varies with internal and external controls which determine the costs and expected durability of efforts to distort information flows.

A firm's internal incentive system can be termed "evenhanded" or "impartial" if it minimizes temptations for its employees (including so-called independent directors) to engage in inefficient, dishonest, or exploitive behavior. Agency theory transforms this ethical criterion into an efficiency condition based on the proposition that "counterparties have incentives to reduce or control conflicts of interest so as to reduce the losses these conflicts engender [and]...then share the gains" (Jensen, 1994). Costs of principal-agent relationships ("agency costs") are minimized when corporate-governance systems harmonize the marginal benefits and costs that managerial strategies and tactics confer on different stakeholders.

Within the corporate sector, incentive compatibility would be achieved if information flows and the web of implicit and explicit contracts that implement the goals of different enterprises leave individual participants in financial processes unable to gain an advantage from other stakeholders by acting opportunistically. To fashion an explicitly ethical perspective, it is convenient to characterize an enterprise whose incentive system offers selected employees an opportunity to pursue personal benefits or short-run advantages at the expense of unwilling or uninformed others as "institutionalizing a temptation to do wrong."

To mitigate insiders' informational advantage, voluntary contracts lean on accounting standards and corporate controls to flag irregularities, while outside stakeholders rely on watchdog institutions and the market for corporate control to investigate and correct them. Watchdogs exist to lower coordination costs by designing and enforcing disclosure requirements and by monitoring managerial behavior. Watchdogs are both internal and external. Internally, a firm's board of directors and auditing team are supposed to impose sound and comprehensive reporting safeguards and detect deviations from them. Externally, watchdogs include outside auditors, stock analysts, credit-rating agencies, standard-setting professional organizations, regulators, government examiners, law-enforcement personnel, and information media (the "press"). In turn, watchdogs face incentive conflicts that are only partially mitigated by reputational concerns and ethical codes that frown on dishonesty.

II. Discouraging and Overcoming Disinformation

Financial information may be deemed true and timely only if it conforms to all of the facts knowable at a given time. Markets whose prices reflect all true information and ignore disinformation show what economists call strong-form informational efficiency. Financial disinformation (D) consists of statements whose spurious elements or false implications are shaped for the express purpose of preventing less-informed counterparties from grasping the full-information or "inside" value (F_i) of a particular contract i . This means that disinformation is designed to be negatively correlated with the unfavorable information that insiders withhold from outsiders. Such inside information comprises adverse elements of strictly private information known only to the disinformers.

Disinformation can account for empirical evidence (summarized by Dimson and Mussavian, 1998) that security returns show weak positive correlation over weekly and monthly horizons and slight negative serial correlation over longer horizons. Abstracting from the refutational efforts of watchdog institutions, the market value V_i of any instrument or portfolio i differs from its full-information value by a hard-to-sustain wedge of “outside” value $[w_i(D)]$ which insiders to contract i manage to create by their disinformational efforts:

$$V_i = F_i + w_i(D). \quad (1)$$

When disinformation is building up or decaying, short-horizon returns would correlate positively. However, disinformational effects would be reversed over longer periods.

Watchdog institutions are supposed to help outside investors to filter disinformation out of their information sets. Individuals can counter the effects of disinformation in three ways: by directly acquiring incremental information for themselves through reading and research, by relying on professional information specialists for incremental intelligence, and by reaching out for help from law-enforcement officials and legislators when evidence of fraud surfaces.. Whenever a contract is initiated or renewed, every party to which the contract assigns an informational risk has an incentive to sort through and correct the information flowing from incentive-conflicted sources. The strength of this incentive can be measured by the difference between the marginal benefits of challenging potential disinformation and the marginal costs of the *ex ante* and *ex post* effort it takes to mount this challenge.

We assume that the marginal cost of acquiring inside information declines as it ages. Unfavorable information on any party k that is uncovered by any one of its

counterparties leaks out after a lag to other interested parties. As more parties acquire the information, the number of routes through which it can be obtained rises. The juicier the information is, the quicker it spreads as rumor on the gossip mill. Recent rumors are captured, investigated, and (if verified) disseminated at a cost by the professional information industry. Eventually, verified information becomes common knowledge that almost anyone can verify at virtually zero cost. This diffusion process implies that, in any country, the value of disinformation to the disinformers tends to decay over time and may be subject to sudden, discrete drops. The value of disinformation to insiders will decay at a faster rate, the more cheaply and more reliably timely information is collected and distributed by information specialists.

Incentive support for disinformational activity comes from forms of compensation – such as short-dated stock options – that allow insiders to profit disproportionately from artificially boosting measures of short-term performance. Such front-loaded contracts tempt insiders to believe that they can realize gains while $w_i(D)$ is high and plan either to exit the firm before the truth emerges or to set aside a portion of their ill-gotten proceeds to employ high-powered legal assistance to trivialize whatever penalties they may ultimately have to suffer.

It would be naive to presume that in all circumstances information specialists seek only to curtail the effects of insider disinformation. Incentive conflicts exist in the information industry, too. Disinformers often put political or economic pressure on information specialists to enlist their help in concealing or misrepresenting unfavorable information. Users of information must always allow for the possibility that a particular

specialist may be innocently, negligently, or even corruptly making disinformation more credible.

It is convenient to model the direct effects on contract valuation of external private and governmental information production as multiplying $w_i(D)$ by a nonnegative factor b_i that is produced at social cost c_i . If disinformation could be easily refuted, b_i and c_i would be near zero. The degree of transparency T_i that the particular contract i can offer its users increases the lower is b_i , the more cheaply counterinformation can be produced, and the larger the present value of the pain P_i that legal and reputational penalties can visit upon insiders who misrepresent the contract's value. Transparency can be defined as a function of the three variables just mentioned: $T_i = T_i(b_i^{(-)}, c_i^{(-)}, P_i^{(+)})$.

This suggests that empirical researchers could proxy unobservable differences in transparency either across time or across countries by observable measures or potential correlates of these three determinants.

The more transparency an information system displays, the more successfully outside monitoring and penalties for issuing false and inadequate disclosures can mitigate the potential harm that disinformational activity might introduce. If $b_i=0$, the information industry renders disinformation about the particular contract i perfectly ineffective. As b_i approaches 1 from below, the financial counterinformation industry becomes progressively less helpful to outside stakeholders. If b_i exceeds 1, on balance the information industry produces more disinformation about contract i than it dispels.

To allow for countervailing economic information that accumulates freely with the mere passage of time, we introduce a time subscript (t) and define freely available economic counter-information on contract i (E_{ti}) as follows:

$$E_{ti} = \sum_{j=0}^t e_{ji}, \quad (2)$$

where e_{ji} equals the incremental amount of publicly available counterinformation on contract i that surfaces at date j . Using definition (2) and introducing time and the present value of the expected pain a disinformant faces for admitting error or perverting the truth, (1) becomes:

$$V_{ti} = b_{ti}(c_{ti})w_i[D_{ti}(b_{ti}; P_{ti}) - E_{ti}] + F_{ti}. \quad (1a)$$

Issuers of securities have incentives to release favorable inside information promptly, but to conceal or distort the meaning of adverse events as they occur. This asymmetry implies [as Bakshi and Madan (1998) find for U.S. equities] that the frequency of sudden large downward movements in asset prices is somewhat greater than the frequency of sudden large asset price increases. The asymmetry and the benefits to successor managers of coming clean imply that the deep lefthand tail of the frequency distribution of asset price movements is thicker and longer than the deep righthand tail.

The gross social value (S_t) of the professional information industry lies in moderating information asymmetries and their unpleasant consequences by discouraging and refuting disinformation. Incentive support for transparency comes principally from the size and uncertain incidence of penalties imposed *ex post* by market forces and by the legal system if and when deceptive and false statements are found out. The force of this effect may be enhanced, as in 2002, by increases in the budgets of governmental watchdogs or scandal-driven decreases in the credibility coefficient b_{ti} . Such events reduce the marginal benefit of disinformational activity. The complementary effects are measured by the derivatives $\frac{\partial D_{ti}}{\partial P_{ti}}$ and $\frac{\partial D_{ti}}{\partial b_{ti}}$. For a given amount of disinformation, the

term $[1-b(c_{ti})]$ is an index of S_{ti}^R the direct refutational value of counterinformation:

$$S_{ti}^R=[1-b_{ti}(c_{ti})]w_i[D_{ti}(b_{ti}; P_{ti}) -E_{ti}]. \quad (3)$$

Society may reasonably prefer that refutational checks on disinformational activity be produced by overlapping private and governmental entities. In part, this is because both government and private suppliers are bound to be offered inducements to underproduce informational discipline. At the same time, efforts to strengthen truth-telling incentives benefit parties that cannot easily be made to pay information suppliers for producing them. Producers of external benefits can seldom collect fair compensation without invoking the enforcement and dispute-resolution powers of the state. The existence of uncompensated externalities in watchdog activities makes it easier for corporate insiders to influence information agents and suggests that neither governmental nor private cooperative entities should dominate the process of developing and enforcing disclosure standards. In the U.S., joint public-private regulation is in fact the norm for financial firms. Federal and state agencies importantly supplement private accounting and credit-rating watchdogs in formulating and enforcing disclosure standards. These agencies seek to cover the costs of their activities through fees, taxes, fines, and civil lawsuits.

The social value of information flows S_t may be expressed as the sum of informational benefits produced in the private sector (S_{Pt}) and in government (S_{Gt}):

$$S_t=S_{Pt}+S_{Gt} . \quad (4)$$

The net value of information flows to society (S_t^N) is less than this sum by the cost of the resources the two production processes absorb:

$$S_t^N = S_{Pt}^N + S_{Gt}^N . \quad (5)$$

If conflicts of interest and externalities did not exist in the financial information industry, market forces would produce the socially optimal amount of information. Information suppliers would maximize enterprise profits and social welfare by driving the net marginal value of undisclosed information to zero in their sector.

A weaker benchmark for optimality may be developed by assuming that conflicts of interest between bureaucrats and taxpayers could be reduced to negligible proportions by the intermediation of a diligent and free press if we could establish perfect accountability for decisions made in the government sector. In this case, citizens might search more energetically for effective ways to motivate public servants to direct their informational interventions to finding and correcting deficiencies in private-sector information production. Successful interventions would seek to lessen the incentive conflicts facing accountants, credit-rating agencies, and other private watchdogs, thereby curtailing management opportunities to hide material adverse information and to engage in prolonged campaigns of deceit.

III. Ethical Standards of Information Production

Good decisionmaking requires hard-to-gather information. So does responsible oversight of whatever decisions are made. The fundamental dilemma of corporate and public governance is that, at the margin and over short periods, it often pays to hide adverse information. The result is that an ethician could say that outside stakeholders deserve more complete accountability than can be fashioned from the ethical standards that insiders set and the gaps in the information flows outsiders receive.

In the U.S. today, to determine that a private or government enterprise is not run honestly, outside stakeholders need accurate and timely information both about the adverse effects of the tactics and strategies that those in authority adopt and about their motives for adopting these procedures. For both legitimate and illegitimate reasons, managers cultivate opportunities to conceal important aspects of what they are doing and to misrepresent why they are doing them and the effects they have on other parties. Similarly, for both legitimate and illegitimate reasons, watchdog institutions may assist in this process.

Gaps in reporting and governance standards imply that, without being immediately found out, managers can harm any of the following stakeholders:

- stockholders
- depositors and other creditors qua creditors
- customers generally
- guarantors
- taxpayers
- employees
- the economy.

Moreover, Securities and Exchange Commission, National Association of Securities Dealers, and Federal Deposit Insurance Corporation investigations regularly determine that corporate managers, securities professionals, and bankers do in fact harm some of these others.

A business, government, or accounting practice may be labelled unethical (and perhaps immoral) if it violates shared norms to which a society, profession, or firm has firmly committed itself. Such norms express communal preferences and generate explicit and implicit ethical standards that constrain and redirect individual behavior.

Individuals develop their character and commit to personal values in overlapping

cultural contexts. One of these contexts is the ethical subculture established by their profession, industry, or firm. While societywide processes of standard-setting typically promote altruistic values –such as compassion, truth-telling, promise-keeping, and fair play—that condemn opportunistic behaviors, subculture norms often countenance self-interested conduct that can undermine the goals of society as a whole. In the nexus between investment banking and equity research, for example, dishonest people frequently exploit trust and market liquidity built up by the efforts of honest others. In ethically well-ordered cultures, actions by managers and watchdogs that greatly damage unknowing others bring personal “shame” and external disrepute onto those who perform them. Although such societies reinforce their norms by subjecting particularly offensive behaviors to explicit and implicit governmental and commercial sanctions, when preserving one’s honor and reputation is a major goal, most individuals prefer to operate well away from bright-line legal boundaries of right and wrong.

Experience teaches two lessons about workplace ethical standards. They are vague and self-serving, and, along with explicit legal obligations, they vary both across cultures and –within cultures— over time. Both features illustrate the fact that the particular institutions that generate and promulgate ethical standards adapt to changes that relevant subcultures undergo over time. Around the world, parents, schools, churches, professional societies, news media, entertainment industries, and justice systems send distressingly mixed messages about what particular ethical limits the conscience of a business or governmental policymaker should respect.

Hard-to-resolve conflicts exist between limits set by principled and practical standards of behavior. These conflicts allow a corporate manager or information agent to

define its duties self-interestedly by drawing opportunistically from conflicting systems of business and governmental ethical standards (Jacobs, 1992). It is convenient to label the duties implied by abstract or principled standards as ethics one and the often-looser obligations imposed by practical standards that hold sway in subcultures as ethics two. Ethics one are hypothetical rules and values that --in a given society-- you and I would prefer that others would accept as governing right and wrong when they are faced with a given conflict in interest. Ethics two are the rules and values that we would accept as constraining ourselves if we would actually be presented with the same situation. This distinction may also be framed as “rules for others” and “rules for ourselves.” The Judaeo-Christian Golden Rule acknowledges this duality and advises us to do unto others as we would have them do unto us. The rule defines a right conscience as one that would make managers’ “ethics two” rules identical with those of their “ethics one.”

As a guide to forming a right conscience in working life, the reciprocity criterion dictated by the Golden Rule tells individuals how they can clean up incentive conflict.³ The Golden Rule offers a way to make principled choices of behaviors from diverse ethical guidelines. Although the standard for determining a clean conscience is permitted to be idiosyncratic, the Rule’s adherents have no reason to fear informational transparency. This is because individuals are led to behave as if every action they might be able to cover up and every motive they might be able to misrepresent will eventually be seen through and exposed to everyone they harm. The Rule requires individuals to admit mistakes quickly, to compensate individuals for the harm caused, and to make a firm purpose of amendment. However, it is only a counsel of perfection. To gather

³ Formally, the Rule inserts the welfare of counterparties on an equal basis into each individual’s own objective function.

incentive force, it must be supplemented by a substantial fear of private dishonor, public shame, or divine retribution. Where none of these fears is substantial, civil and criminal penalties carry an inevitably more selective burden of enforcement.

IV. Dialectics of the Sarbanes-Oxley Act

The U.S. Congress may be conceived as an arena in which lobbyists for diverse interests battle endlessly with one another. The outcome of every important battle is a temporary and loophole-ridden peace treaty. To understand the latest treaty and why it must eventually break down, one must understand the weaknesses in the treaty it replaces. One must also understand the objectives and relative strength of the different lobbies.

It is no accident that, in the modern U.S., incentive conflict in information production is controlled imperfectly. A strong lobby prefers loophole-ridden codes of ethics and easily evaded structural checks and balances. Opposing lobbies have pressed for societywide disclosure standards, which today are formulated and enforced by three layers of external watchdog institutions. The first layer of external watchdogs consists of professional information specialists: auditors, credit and investment analysts, and government officials charged with enforcing existing standards for reporting and disclosure. An intermediate layer consists of the entities that set the accounting standards that the first layer of institutions enforces. A third layer consists of information media whose employees -- besides paraphrasing accounting reports -- occasionally investigate the work of the first layer of watchdogs. In combination with academia and investigative arms of government, information media generate feedback to the standard-setters. They

publicize detects in accounting standards and provide a forum within which to discuss ways of closing or narrowing loopholes that are deemed to violate cultural standards.

When sizeable weaknesses in the nation's system for vetting corporate disinformation have been concealed for a long while, their sudden revelation is bound to shake the confidence that investors and the press have in the reliability of financial reports and ethical codes. This decline in confidence raises the compensation that investors demand for bearing valuation and performance risk and embarrasses standard-setting institutions. In this way, a series of outsized accounting and ethical scandals can – as indeed they did in the wake of the Enron, WorldCom, et. al. scandals of 2002 – kick off an urgent dialectical process of accounting and regulatory adjustment.

The Sarbanes-Oxley Act of 2002 strikes at the determinants of corporate incentives to block or delay the release of adverse information identified in Section II.⁴ Although a few of its provisions became effective immediately, many were routed through the Security and Exchange Commission (SEC) for followup team-building and rulemaking consistent with the purposes of the Act.

Accountants and managers who valued pre-existing gaps in reporting and governance controls labored behind the scene to exert political and economic counterpressure on the followup standard-setting process. Their counterpressure sought to sidetrack genuine reform by limiting the effectiveness of the standards, penalties, and enforcement procedures the SEC finally installed on such matters as auditor independence, attorney conduct, and off-balance-sheet transactions. Besides persuading standard-setters to transform rather than eliminate the reporting loopholes and incentive

⁴ Detailed analyses of the Act's many provisions are available on the internet. (See e.g., Fried, Frank, et al. (2003) and Scott, Sanders, and Dempsey (2003).

conflicts whose final shapes were still in play, lobbyists also worked at culling proposed appointments to the newly created Public Company Accounting Oversight Board (PCAOB).

To understand how the Act does and does not promise to help outside stakeholders, we must identify the particular links in the chain of disinformation production and refutation that the Act addresses and ascertain how firmly it recasts these links. Although preferential loans and insider trading are subjected to tougher restrictions, at its core the Act may be conceived as a trident. It is a weapon that, if used expertly, would puncture the pipeline of disinformation in three places. The first prong (which took effect almost immediately) serves to increase what section II parameterized as P: the exposure to reputational and legal penalties that top managers, outside lawyers, directors, and auditors face if they are ultimately shown to have condoned or engaged willfully, knowingly, or carelessly in deceptive accounting. The second prong serves to make it easier for directors and external auditors to recognize the truths and untruths contained in tricky or aggressive accounting claims: i.e., to lower the costs of refutation c. The third prong attacks parameter b by shifting formal control of disclosure and auditing standards for publicly trading companies from self-regulatory bodies in the accounting industry to an SEC-appointed oversight board. Given the phenomenon of Regulatory Capture, this prong seems dangerously fragile.

The first and second prongs focus on the initial procreators of financial disinformation and install important Golden Rule obligations on corporate insiders. The first prong obliges public companies to disclose material changes in financial condition or operations in “real time” (section 409). In addition, a public company’s principal

executive and financial officers must certify the material accuracy of the periodic financial reports their corporations issue. Senior officials guilty of knowing or willful miscertification would face large fines and a substantial prison sentence. The second prong requires corporations to describe their internal controls and to disclose whether they promulgate a code of ethics for senior officers. It also introduces a series of structural checks and balances designed to increase the effective independence and financial competence of corporate boards of directors and their information-handling subcommittees.

The third prong calls for writing new auditing and disclosure standards and delegates the task to the PCAOB. The politics of selecting and influencing PCAOB members recalls Groucho Marx's acid characterization of politics as the "art of looking for trouble, finding it, misdiagnosing it, and then misapplying the wrong remedies." Lobbyists are bound to pressure the PCAOB to adopt as much as possible of the codes of Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS) previously established by accounting industry. Moreover, it will seem expedient to do this, even though safe-harbor loopholes inherent in GAAP and GAAS lie at the root of the most-outrageous corporate scandals of recent history.

These principles and standards undermine practicing accountants' moral duty to promote transparency. Requiring auditors to certify only that a corporation's reports conform with GAAP circumvents the Golden Rule issue of investigating and certifying whether the reports truly and fairly reflect economic reality. Until and unless the PCAOB refocuses the auditing process on certifying the economic meaningfulness of income and net-worth calculations, the shallowness of this prong will reduce the

penetrating power of the other two.

V. Asymmetric Ethical Treatment of the Accounting Industry

Corporate officials, incumbent regulators, and accounting professionals have notably softened the edges of the reform process. Despite evidence of favoritism toward the accounting industry strong enough to force his resignation, former SEC chairman Harvey Pitt managed to stay in office as a lame duck long enough to oversee the precedent-setting first stages of the Act's followup process. As a result, the legislative response to investor dissatisfaction with inherited accounting standards and disclosure incentives was rechanneled back through the same incentive-conflicted professionals who had served society so badly in the first place. To strengthen surviving weak links in the chain of corporate governance and information control, aggrieved parties must continue to rely on an all-too-partisan SEC.

This demonstrates the strength of the accounting lobby. Its ability to exert political pressure testifies ultimately to the size of the rents that this highly concentrated industry can obtain by preserving its options to help troubled firms and rogue managers to conceal adverse information from outside stakeholders. Measuring lobbying strength by the dues revenue that can be redistributed each year by different trade associations, Table 1 indicates that accountants' warchest makes the banking, securities, and insurance industries look poorly armed.

	<u>2002 Revenues</u>	<u>% of Revenues from Derived Members Dues</u>
American Institute of Certified Public Accountants	\$130.8M	48%
American Bankers Association	\$55.9M	35%
Credit Union National Association	\$44.3M	34%
Investment Company Institute	\$43.9M	80%
Securities Industry Association	\$40.6M	58%
American Council of Life Insurers	\$38.0M	90%
American Insurance Association	\$20.9M	87%
Independent Community Bankers of America	\$17.5M	38%
America's Community Bankers	\$15.4M	46%
Independent Insurance Agents and Bankers of America	\$14.3M	45%
Financial Services Roundtable	\$9.3M	91%
Consumer Bankers Association	\$5.6M	41%
Source: 8-2-02 <u>American Banker</u> , Compiled from Internal Revenue Service 990 Forms		

In his 1820 essay “On Government,” James Mill opined: “All of the difficult questions of government relate to the means of restraining those, in whose hands are lodged the powers necessary for the protection of all, from making bad use of it.” A principal protective mission of the SEC is to safeguard investors and the integrity of U.S. securities markets from corporate disinformation. The Sarbanes-Oxley Act empowers the SEC to make it harder and more dangerous for managers to overstate revenues, understate expenses, and make deceptive use of reserve accounts. How fully the SEC proceeds to use its enhanced power is a matter of politics. And so is how well or poorly the SEC has regulated accounting standards in the past.

In 2002, lobbyists’ successes and failures in their first and second bites at the ethical apple can be benchmarked by comparing the SEC’s adjustments of governance and disclosure standards under the Sarbanes-Oxley Act with movements that would be consistent with the Golden Rule. One place to look for Golden Rule improvements is to

identify actions taken by state officials and managers who, without waiting for federal standards to be reformulated, conscientiously make reporting and corporate-governance repairs on their own. Individual firms often commit voluntarily to improvements in reporting and ethical standards that go markedly beyond mandates they might rationally expect to emerge from multilateral negotiations. Such commitments include the expensing of options and the provision of strong whistleblower protections. By Samuelson's Principle of Revealed Preference, where they are adopted, Golden Rule ethical constraints may be presumed to reduce agency costs. For example, an organization that was determined to root out unethical behavior could require its managers to avoid even the appearance of incentive conflict. To outsiders, this standard would offer informational transparency and ease of enforcement. However, in fashioning any test, one has to worry about balancing Type I and Type II error. An Appearances test would generate many false positives. For this reason, even nonopportunistic insiders may be expected to resist the career turbulence and unwelcome loss of privilege this standard would bring. That few firms enforce so transparent and unyielding an ethical standard suggests -- but does not prove -- that it may be overly scrupulous.

Across the chain of information production, SEC rulemaking has imposed vastly stronger Golden Rule obligations on investment analysts and corporate insiders than on the accounting profession. Top corporate officials are now obliged to report material events promptly and fully. Management must provide information that it believes is necessary for an understanding of its off-balance-sheet arrangements and quantitatively reconcile presentations of so-called "pro forma" information with comparable measures prepared according to GAAP. Attorneys representing public companies must report

evidence of material violations of laws or duties to a firm's CEO, chief legal officer, or board. Mutual-fund managers must publicly disclose how they vote their proxies. Investment analysts must certify that opinions expressed in research reports accurately reflect their personal views and explain any specific payments that may have influenced their research. Because the informational benefits and costs of these provisions were not specifically estimated and weighed quantitatively by the SEC, one must expect these issues to be revisited by spokespersons for the obliged parties as data on their compliance burdens accumulate.

In the absence of data on the costs and benefits of Sarbanes-Oxley obligations imposed on particular information agents, it is illogical for SEC commissioners to distrust the ethics of corporate insiders, outside financial analysts, and mutual-fund managers so severely while continuing to rely heavily on professional accountants to behave conscientiously. Making the top officers of auditing firms responsible for reviewing the overall economic accuracy of the numbers their firms certify and for explaining how specific payments might have influenced their opinions would impose enforceable obligations parallel to those placed on other parties in the information chain.

Table 2							
What the Top 25 Banks Paid Their Accountants in 2001							
	Firm	Audit Fees	Other Fees		Firm	Audit Fees	Other Fees
Citigroup	KPMG	\$26.1M	\$24.6M	Wachovia	E&Y	\$2.1M	\$1.1M
J.P. Morgan Chase	PWC	\$21.3M	\$84.2M+	First Union	KPMG	\$7.3M	\$24.9M+
Bank of America	PWC	\$13.2M	\$36.3M+	Golden State	KPMG	\$1.9M	\$1.0M
Wells Fargo	KPMG	not available		BB&T**	Andersen	\$0.7M	\$0.9M
Bank One	KPMG	\$4.4M	\$2.5M	SouthTrust**	Andersen	\$0.5M	\$1.7M
Washington Mutual	Deloitte	\$2.9M	\$7.5M	Regions	E&Y	\$0.7M	\$3.0M
FleetBoston	PWC	\$8.6M	\$33.0M+	Golden West	Deloitte	\$0.5M	\$0.2M
SunTrust*	Andersen	\$1.5M	\$4.1M	Comerica	E&Y	\$0.5M	\$1.7M
KeyCorp	E&Y	\$1.8M	\$8.1M	Fifth Third	Deloitte	\$0.7M	\$2.7M+
National City	E&Y	\$1.9M	\$3.0M	AmSouth	E&Y	\$0.9M	\$4.0M

U.S. Bankcorp	E&Y	not available		MBNA	E&Y	\$1.1M	\$2.6M
Bank of New York	E&Y	\$1.3M	\$4.1M	State Street	E&Y	\$0.7M	\$7.1M+
PNC	E&Y	not available		Charter One	Deloitte	\$0.4M	\$3.1M+
From most recent proxy filings. Figures are rounded. *SunTrust said in February it would replace Andersen as auditor **BB&T and SouthTrust still planned to keep Andersen. +Includes information systems consulting Source: 3-13-02 <u>American Banker</u> based on Figures in Bowman's Accounting Report, Atlanta							

Table 2 reproduces a table from the American Banker that breaks down expenditures the top 25 banking organizations paid their auditing firm for audit and nonaudit services in 2001. In several cases, the auditor's nonaudit income dwarfs revenues from audit fees. Congress understood the need to prevent accounting firms from making so much money selling nonaudit services to audit clients that they could be persuaded to certify a series of disinformational reports. For this reason, the Act expressly prohibits accounting firms from performing particular types of services for their audit clients. Rather than identifying and narrowing the loopholes inherent in this list, the SEC widened them. It authorized outside auditors to perform tax and other nonaudit services not expressly forbidden by the Act on the basis of Audit Committee policies and procedures for preapproval rather than requiring the specific and explicit approval of the Audit Committee as envisioned in the Act. This rule places the burden of assuring that client-auditor arrangements comply with the Act on a public company's Audit Committee rather than on the accounting firm.

In a further effort to assure auditor independence, the Act also calls for firms to rotate their auditors every few years. Final SEC rules on auditor rotation softened the burden of this provision. SEC rules require only that particular categories of audit partners leave a company's auditing team after five or seven years. However, the continuity of the team as a whole is not explicitly regulated.

The gaps in these rules authorize auditing firms to collect laundered bribes from dishonest or desperate managers for knowingly and willingly certifying disinformational reports without squarely exposing themselves to the explicit obligations and penalties that the corporate managers face themselves. To dream up a parallel situation in criminal law, one might imagine a penal code that exempted lookouts and drivers of getaway cars from penalties for participating in armed robbery.

VI. Concluding Comments

When it comes to financial reporting, investors seem increasingly more likely to be shocked by honesty than appalled by deceit. Although observers such as the Financial Economists Roundtable (2002) attribute the Sarbanes-Oxley Act to a three-way crisis in accounting, auditing, and corporate governance, SEC followup rulemaking has focused disproportionately on strengthening the corporate Audit-Committee and governance links in the informational chain. The SEC has exempted the self-interested ethical codes of the auditing industry and accounting profession from obligations to affirm the economic accuracy of audited reports that the Act ought symmetrically to have imposed on them. That accountants could preserve such asymmetric privileges underscores how difficult it is for Congress and the SEC to address even blatant market failure. To reregulate accountants' incentives may require -- not just a first-class PCAOB and another round of SEC rulemaking -- but a concerted effort by other sectors to reduce industry rents by encouraging new entry into the accounting and credit-rating industries.

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