

The Financial Economists Roundtable Statement on
" THE CRISIS IN ACCOUNTING, AUDITING AND CORPORATE
GOVERNANCE"

Executive Summary

The Financial Economist Roundtable met on July 14 and 15th 2002 in Montreal, Canada to discuss the crisis in corporate governance, auditing and accounting resulting from the recent revelations in the Enron, Global Crossing, Adelphia, WorldCom and other corporation cases, which has led to heightened uncertainty in US equity markets, ultimately resulting in passage of the Sarbanes-Oxley Act of 2002 (the "Act")*. The Roundtable endorses the on-going efforts to strengthen corporate governance and the accountability of management and external auditors. However, it questions whether some of the legislative proposals, subsequently enacted, are effective, and may even be counter productive. For this reason, among other things, the Roundtable also recommends the establishment of an outside blue-ribbon commission to investigate a series of questions and issues that are either not addressed or not likely to be resolved by the recent law.

*The Sarbanes-Oxley Act of 2002 was passed subsequent to our meeting. While it was clear what the general thrust of the legislation would be, we did not know all the details or specific provisions the legislation would contain. This statement reflects the Roundtable's position on those provisions of the Act that had been generally discussed in the meeting, but does not necessarily reflect the Roundtable's views on the entire legislative package.

Statement

The efficient functioning of US securities markets and valuation of publicly traded debt and equity relies upon the availability of timely and trustworthy accounting and other information on company financial performance. Audited financial statements, an important but not sole source of this information, should be constructed with the aim of providing reliable information to allow a reasoned assessment of the economic position and prospects of enterprises and to evaluate their managers' performance. A web of checks and balances supports this information flow that should assure users that the data are reliable, that company performance is reasonably transparent, and that owners, managers and others have proper incentives to reveal what is truly going on in the business. If effective, this system will minimize the conflicts of interests that might induce managers to act contrary to the interests of shareholders and other creditors. It includes: (a) a process of corporate governance, (b) laws and accounting rules, (c) internal and external auditors who determine that management follows the rules, (d) the

SEC, self regulatory bodies, and the stock exchanges that provide regulatory oversight and enforcement of the rules and laws governing disclosure and behavior, and (e) the outside rating agencies and financial analysts, who monitor and interpret financial performance.

While the current system has served the country and investors well over time, recent events surrounding Enron, Global Crossing, Adelphia, and WorldCom, to name a few, raise significant questions about whether the present set of checks and balances is defective. Do some of the components need to be changed or strengthened? For example, people question the adequacy of the oversight of management provided by boards of directors. Do current accounting and auditing rules, and the auditing process itself, assure that management follows these rules sufficiently to prevent abuses from occurring? Indeed, questions now abound about the accounting and audit profession's internal structure and practices, which can contain conflicts of interest and prevent material information about firm performance from being revealed or result in the production of misinformation. Why did these internal checks and balances break down and are there possible flaws in the internal governance structure in the remaining firms?

Numerous proposals have been offered and some have been implemented, either by the major stock exchanges or through legislation, to fix the problems exposed by recent events. These include instituting reforms to corporate governance, changing rules governing the compensation of executives, expanding corporate executives' liability for providing misleading accounting statements, enhancing oversight and enforcement by the SEC, creating a new oversight board to regulate and supervise accounting and auditing firms, establish audit standards and punish malpractice.

As is often the case when abuses surface in financial markets, the first reaction is to "do something," even if that "something" does not address the main problems at hand or may have perverse effects on incentives or markets. Witness the speed at which Congress enacted the Sarbanes-Oxley Act of 2002. Clearly, in some of these spectacular cases, management deliberately engaged in aggressive and even fraudulent accounting and other practices. Their actions generated earnings that weren't real and/or hid costs and risk indicators through reliance upon complex organizational structures and accounting gimmicks. While many of these devices may have met the letter of the law or existing accounting rules, they violated the intent of disclosing fully the firm's business to the investing public. Worse, in several spectacular cases management of these firms enriched themselves at the expense of investors and employees. All of these actions beg to be addressed.

The Financial Economists Roundtable notes that in many egregious cases, adequate laws and prohibitions were in place, but senior management, either because of avarice or hubris, failed to adhere to the rules and regulations. No system can force people who willfully decide not to follow the rules to do so anyway. In some of these cases, the oversight activities of parties who were in a position to identify and to put a stop to such

behavior broke down. Why, for example, did some boards of directors acquiesce in questionable behavior and accounting practices? Why didn't either the inside or outside auditors raise red flags with the boards of directors or SEC rather than facilitate questionable behavior by management? Why didn't the SEC examine the statements of registrants at least to determine that technically knowledgeable investors could understand them? Why has the SEC not disciplined external auditors who attested to statements that clearly violated the SEC's disclosure rules? Why were the rating agencies and financial analysts slow in recognizing the warning signs that questionable practices and inherently risky behavior was taking place?

This experience not only has negatively affected the shareholders and employees of the affected corporations, but also has imposed costs on law-abiding, well-run companies. Investor uncertainty has been heightened, and investors now question both the veracity of the accounting information and their ability to separate the firms providing trustworthy representations of their performance from those who are not. This results in higher financing costs for all firms and wider borrowing spreads for those that may appear to be relatively more risky. These increased short-term costs have predictable impacts on incentives. For example, well-run firms are attempting to reveal to investors that they are indeed truly representing their current and future expected performance honestly. This is what one would expect if markets were basically functioning as they should. The most recent announcements by Coca-Cola, General Electric and the Washington Post, amongst a growing list of firms, that they would expense employee stock options represents such a market-induced change in financial reporting.

The Financial Economists Roundtable agrees with those urging that improvements be made in the system, and many of the changes both being proposed and already included in the newly passed Act make a great deal of sense. For example, requiring external auditors to report directly to the Audit Committee of the Board of Directors is critical. Similarly, increasing incentives for CEOs truthfully to reveal their firm's performance is important. Such incentives include forfeiture of bonuses and other incentive-based compensation in the event that the financial reports are deemed to be materially in non-compliance with reporting requirements.

As a result of our discussions at our recently concluded meeting and reviews of analyses of what occurred at Enron and some other apparent failures of corporate governance and accounting, we endorse many of the provisions of the Act, and suggest that additional changes be adopted concerning the governance, auditing and financial disclosures of publicly traded corporations:

1. We agree with the newly passed requirement in the Act that CEOs and CFOs sign and affirmatively declare that the financial statements present a fair view of their corporation's financial position as of the date of the statements and changes over the previous accounting period. Generally, the "fairness" of the statements means that they accord with generally accepted accounting principles (GAAP), both in letter and spirit. However, a way with some teeth in it must be found to induce executives to embrace the "spirit" of the principles rather than just following the "letter." We are not sure that either

the proposed declarations or increased criminal sanctions will provide those teeth. The requirement that corporate managers who are convicted of criminal fraud must serve longer sentences is likely to be of small importance. The outcome of the current wave of indictments should provide some evidence on this issue.

2. The Roundtable also supports the Act's requirement that Audit committees include only independent persons. Recent proposals of the New York Stock Exchange and NASDAQ would go even farther by requiring that the entire board contain a majority of independent members. While it is not clear what the appropriate proportion of independent and inside directors should be, we do believe that the independent director requirement for the Audit committee should also be extended to other important board committees, such as the Management Compensation Committee and the Nomination Committee. The real task is to devise an operational definition of "independent," an issue that was addressed inadequately in the Act, and may require further consideration.

3. We endorse the NYSE/NASD/NASDAQ proposals that audit committee members should be financially literate. This should entail both an understanding of the transactions that their company undertakes, and an understanding of the accounting issues with respect to the recording of these transactions. Members of boards of directors need not show the requisite degree of financial literacy when they accept appointment to the audit committee. However, they should be capable of acquiring these skills and be willing to invest in maintaining them. We later suggest that research be undertaken to determine how best financial literacy might be determined.

4. We agree with the requirement in the Act that external auditors be hired by and report to the audit committee, and we suggest that this be done in meetings not attended by corporate management. We would go farther and also require that the internal auditors also report to the audit committee and do so in meetings not attended by corporate management.

5. The Roundtable does not believe that the Act's establishment of an additional regulatory structure in the form of the Public Company Accounting Oversight Board is necessary. The Board adds another layer of bureaucracy that will have to be supported by additional taxes on corporations and auditors and, hence, on shareholders. The SEC already has the mandate and authority granted this new bureaucracy, and the SEC should be held accountable through appropriate oversight for its failure to enforce its regulations and the securities laws that Congress put in place.

6. We agree that the SEC should be given a budget sufficient to allow it to carry out its responsibilities. At present, the SEC collects from registrants much more than it is authorized to budget or to spend. In fiscal year 2001, it collected \$2.06 billion in fees but

Congress provided for it a budget of only \$423 million. The Act nearly doubles this amount. What is not clear is how the SEC will choose to deploy those funds or whether the amount is sufficient.

7. At the same time, other areas are possible targets for reform and deserve careful consideration. For example, has previous tax treatment of executive compensation unintentionally provided incentives for corporations to use less transparent forms of payments? Additionally, there is a growing debate about whether it is better to have financial disclosures governed by specific accounting rules or by broader principles. It is natural, and perhaps efficient, to have a set of basic rules, which if followed, provide a "safe harbor" in terms of disclosure, but such rules should not be used as a way to disguise or otherwise hide material information relevant to investors in measuring or estimating the value of the firm. Similarly, is the structure of the accounting industry, with now only four major firms, so concentrated that the market would not be competitive, such that shareholders would bear higher audit costs? Might the "final four" perceive that they have sufficient power to be more independent of management than heretofore and that audit quality will improve as a result? Or might they perceive that they were "too-big-to-fail" and, consequently, have incentives to engage in moral hazard behavior? The Act requires the General Accounting Office (GAO) to study not only these structural issues, but also to study the impact of requiring mandatory rotation of auditing firms. The Roundtable questions whether the GAO has the necessary expertise to undertake these studies and suggests an alternative below.

The Financial Economists Roundtable believes that any additional legislative changes should be examined and fully understood before they are enacted. Our analysis suggests that some companies experienced significant breakdowns in the chain of corporate governance linking managerial performance to the conduct of the boards of directors and to the external controls systems comprised of fiduciaries, analysts, shareholders, debt holders, rating agencies, accountants and auditors, financial advisors and regulators. In one case or another, nearly every one of these links in the chain failed to operate as advertised. Some of the deficiencies are already being addressed, some in the form of loss of market reputation and firm value, some by criminal and civil litigation, some by good firms seeking to distinguish themselves from those relying upon questionable accounting practices, and some by regulation and new legislation. The process is messy, but is proceeding and in the end should result in better functioning financial markets.

The Financial Economist Roundtable believes that is important to determine how much of the current crisis represents a breakdown in the governance of individual firms that is idiosyncratic in nature and how much is due to systemic problems. We therefore urge that as part of the current reform efforts, Congress should establish an independent Blue-Ribbon study commission comprised of recognized financial and accounting experts to identify ascertain if and what additional regulatory issues should be addressed. In

addition to the questions posed earlier, list of issues is provided in the appendix at the end of this statement.

Given the large economic losses that many have incurred as a result of the recent revelations and abuses, it is a natural response of Congress, regulators and advisory boards to seek and propose changes. On the other hand, financial markets are now more aware of the issues and we are confident that solutions to many of these problems will evolve naturally. While there may be opportunities to fine-tune regulation to align better the monitoring of institutions with the interests of shareholders and employees, any changes to governance and regulatory systems should carefully consider the costs and benefits of effecting those changes, including possible perverse and unintended incentive effects of those changes.

Appendix

Questions for Further Study

Questions that should constitute part of the charge to the Blue Ribbon Commission on Corporate Governance should include:

1. Extent of the Problem

Are the problems revealed by Enron, Global Crossing, WorldCom and other well-known corporations specific or systemic? Did more than a few corporate managers fail in their fiduciary responsibilities and, if so, how and why?

2. Boards of Directors

a. How does one construct an operational and effective definition of an "independent director?" The NYSE and NASDAQ in a recent separate proposals go beyond the definitions included in the Act and provide alternatives, which consider such factors as the ability to exercise independence from management, including duration of former employment, forms and sources of compensation, familial relationship, etc. Are these sufficient criteria?

b. Of particular concern is the role, the size and form director compensation should play in defining independence, an issue that is considered more broadly in both the NASDAQ and NYSE proposals than in the Act. It has been suggested that directors' compensation should be sufficient to compensate them for the time demands and risks they have accepted, but not so great as to discourage them from risking loss of income should they make demands or take actions that might displease the CEO. Agency theory suggests that directors should have significant stakes in the long run success of the firm, so that by acting in their own interests they also act in the interests of shareholders. But what might be a significant stake to one might be insignificant to another. What form should compensation take and should there be limits on executive compensation more general? Should directors be rewarded with stock options that might give them incentives to allow

CEOs, who also have stock options, to attempt to increase share prices by misreporting the company's performance because they only have a stake in the upside? A more fundamental question about director independence is who selects them and who makes the decision about their retention? How should the Board evaluate itself? What are the performance metrics? How are they to be implemented?

c. What is the appropriate proportion of independent members for boards of directors? Indeed, should the only inside member of the board be the CEO? Is a simple majority enough, as the NYSE proposes, or should independents comprise at least 2/3rds of the board? This issue is being addressed by some firms in response to perceived market need, but will the remedies prove effective?

d. Most approaches to compensation of the board or the audit committee members have focused on direct compensation. The question is whether there should also be limits placed on acceptance of substantial indirect payments (e.g. support of organizations with which directors are associated) as proposed by the NASDAQ? What form should those limits take?

e. Shall best practice say that all independent directors be put forward by a Nominating Committee composed of only independent current directors, as proposed by the NYSE?

f. Should there be a financial literacy standard, as the Roundtable and others have recommended for boards of directors, and more specifically for the audit committee? Clearly more research is needed on the basic issue of what financial literacy means and how a literacy requirement might be implemented.

3. External Auditors

a. The Act puts severe restrictions on the kinds of other services that external auditors can provide to audit clients, such as fairness opinions, actuarial services, investment banking services, management functions, legal services, or any other services proscribed by the Public Company Accounting Oversight Board. What other activities should or should not be proscribed, and what will these restrictions do to the profitability and hence cost of audits of publicly traded corporations? Do the existing limitations go too far?

b. The Act requires the auditors to attest that audits are based upon generally accepted auditing standards (GAAS) and that management's financial statements are in accordance with GAAP, but should the requirement also be that the statements represent a true and fair assessment of the business?

c. Are the Act's auditor-in-charge rotation requirements sufficient or should publicly traded companies be required to rotate audit firms as well?

4. Self Regulation

Did the system of self-regulation of the accounting industry fail us and, if so, how and why?

5. Accounting and Audit Industry Structure

Is the structure of the accounting and audit industry so concentrated that the existing major firms might not objectively criticize the work of their competitors? Might they be subject to moral hazard behavior? Or might they act as a cartel and increase the costs of audits above the competitive level?

6. SEC

Did the SEC's regulation of accounting and accounting firms fail us and, if so, how and why? Why has the SEC taken so few actions to discipline individual CPAs who attest that financial statements conform to GAAP, when they did not to a significant extent?

7. Accounting Principles

Is our system of developing accounting principles flawed? Should the Financial Accounting Standards Board (FASB) or the SEC be the sole determiner of what should be reported and not reported in the financial statements that corporations must file with the SEC? Should greater emphasis be placed on accounting principles rather than specific rules to govern disclosure in financial statements?

8. External Rating Agencies

Did bond-rating companies fail competently to evaluate and monitor the performance of the firms they rated? If so, why was this the case?

9. Securities Analysts

Are sell-side securities analysts sufficiently independent? If not, what incentives or penalties need to be imposed?

10. Recent Legislation

What incentive or informational problems has the recent legislation addressed successfully or meaningfully, and what areas remain wanting?

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