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Commentary

Watchdogs and Lapdogs

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The bankruptcy of Enron -- at one time the seventh-largest company in the U.S. -- has underscored the need to reassess not only the adequacy of our financial reporting systems but also the public watchdog mission of the accounting industry, Wall Street security analysts, and corporate boards of directors. While the full story of what caused Enron to collapse has yet to be revealed, what is clear is that its accounting statements failed to give investors a complete picture of the firm's operations as well as a fair assessment of the risks involved in Enron's business model and financing structure.

Enron is not unique. Incidents of accounting irregularities at large companies such as Sunbeam and Cendant have proliferated. As Joe Berardino, CEO of Arthur Andersen, said on these pages, "Our financial reporting model is broken. It is out of date and unresponsive to today's new business models, complex financial structures, and associated business risks."

Blind Faith

It is important to recognize that losses suffered by Enron's shareholders took place in the context of an enormous bubble in the "new economy" part of the stock market during 1999 and early 2000. Stocks of Internet-related companies were doubling, then doubling again. Past standards of valuation like "buy stocks priced at reasonable multiples of earnings" had given way to blind faith that any company associated with the Internet was bound to go up. Enron was seen as the perfect "new economy" stock that could dominate the market for energy, communications, and electronic trading and commerce.

I have sympathy for the Enron workers who came before Congress to tell of how their retirement savings were wiped out as Enron's stock collapsed and how they were constrained from selling. I have long argued for broad diversification in retirement portfolios. But many of those who suffered were more than happy to concentrate their portfolios in Enron stock when it appeared that the sky was the ceiling.

Moreover, for all their problems, our financial reporting systems are still the world's gold standard, and our financial markets are the fairest and most transparent. But the dramatic collapse of Enron and the rapid destruction of \$60 billion of market value has shaken public trust in the safeguards that exist to protect the interests of individual investors. Restoring that confidence, which our capital markets rely on, is an urgent priority.

In my view, the root systemic problem is a series of conflicts of interest that have spread through our financial system. If there is one reliable principle of economics, it is that individual behavior is strongly influenced by incentives. Unfortunately, often the incentives facing accounting firms, security analysts, and even in some circumstances boards of directors militate against their functioning as effective guardians of shareholders' interests.

While I will concentrate on the conflicts facing the accounting profession, perverse incentives also compromise the integrity of much of the research product of Wall Street security analysts. Many of the most successful research analysts are compensated largely on their ability to attract investment banking clients. In turn,

corporations select underwriters partly on their ability to present positive analyst coverage of their businesses. Security analysts can get fired if they write unambiguously negative reports that might damage an existing investment banking relationship or discourage a prospective one.

Small wonder that only about 1% of all stocks covered by street analysts have "sell" recommendations. Even in October 2001, 16 out of 17 securities analysts covering Enron had "buy" or "strong buy" ratings on the stock. As long as the incentives of analysts are misaligned with the needs of investors, Wall Street cannot perform an effective watchdog function.

In some cases, boards of directors have their own conflicts. Too often, board members have personal, business, or consulting relationships with the corporations on whose boards they sit. For some "professional directors," large fees and other perks may militate against performing their proper function as a sometime thorn in management's side. Our watchdogs often behave like lapdogs.

But it is on the independent accounting profession that we most rely for assurance that a corporation's financial statements accurately reflect the firm's condition. While we cannot expect independent auditors to detect all fraud, we should expect we can rely on them for integrity of financial reporting. While public accounting firms do have reputations to maintain and legal liability to avoid, the incentives of these firms and general auditing practices can sometimes combine to cloud the transparency of financial statements.

In my own experience on several audit committees of public companies, the audit fee was only part of the total compensation paid to the public accounting firm hired to examine the financial statements. Even after the divestiture of their consulting units, revenues from tax and management advisory services comprise a large share of the revenues of the "Big Five" accounting firms. In some cases auditing services may be priced as a "loss leader" to allow the accounting firm to gain access to more lucrative non-audit business.

In such a situation, the audit partner may be loath to make too much of a fuss about some gray area of accounting if the intransigence is likely to jeopardize a profitable relationship for the accounting firm. Indeed, audit partners are often compensated by how much non-audit business they can capture. They may be incentivized, then, to overlook some particularly aggressive accounting treatment suggested by their clients.

Outside auditors also frequently perform and review the inside audit function within the corporation, as was the case with Andersen and Enron. Such a situation may weaken the safeguards that exist when two independent organizations examine complicated transactions. It's as if a professor let students grade their own papers and then had the responsibility to hear any appeals. Auditors may also be influenced by the prospect of future employment with their clients.

Unfortunately, our existing self-regulatory and standard-setting organizations fall short. The American Institute of Certified Public Accountants has neither the resources nor the power to be fully effective. The institute may even have contributed to the problem by encouraging auditors to "leverage the audit" into advising and consulting services.

The Financial Accounting Standards Board has often emphasized the correct form by which individual transactions should be reported rather than the substantive way in which the true risk of the firm may be obscured. Take "Special Purpose Entities," for example, the financing vehicles that permit companies such as Enron to access capital and increase leverage without adding debt to the balance sheet. Even if all of Enron's SPEs had met the narrow test for balance sheet exclusion (which, in fact, they did not), our accounting standard would not have illuminated the effective leverage Enron had undertaken and the true risks of the enterprise.

Given the complexity of modern business and the way it is financed, we need to develop a new set of accounting standards that can give an accurate picture of the business as a whole. FASB may have helped us measure the individual trees but it has not developed a way to give us a clear picture of the forest. The continued integrity of the financial reporting system and our capital markets must be insured. We need to modernize our accounting

system so financial statements give a clearer picture of what assets and liabilities on the balance sheet are at risk. And we must find ways to lessen the conflicts facing auditors, security analysts, and even boards of directors that undermine checks and balances our capital markets rely on.

Change Auditors

One possibility is to require that auditing firms be changed periodically the way audit partners within each firm are rotated. This would incentivize auditors to be particularly careful in approving accounting transactions for fear that leniency would be exposed by later auditors.

And, in the end, we need to create a powerful and effective self-regulatory organization with credible disciplinary authority to enforce accounting rules and standards. It would be far better for the industry to respond itself to the current crises than to await the likelihood that the political process will do so for them.

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