Only yesterday, the American system of corporate disclosure was championed as a model for the rest of the world. Indeed, the Asian financial crisis of 1997-98, which was marked by revelations of a woeful lack of transparency in financial markets, led to a chorus of demands for the adoption of U.S.-style disclosure systems.

What a difference a metaphorical day makes. The number of American corporations whose earnings have been restated passed 200 in 1999. Numerous high-profile lawsuits have been filed against accounting firms for auditing failure, generating a number of

Fixing Corporate After Enron

By Robert E. Litan

multimillion dollar settlements. Nothing has done more, however, to generate concern about the adequacy of corporate disclosure than the failure of Enron last fall and news that its auditor, Arthur Andersen, knew about the company's problems beforehand, did not force their disclosure, and later shredded documents in an apparent effort to cover up its liability.

Many fixes have been proposed, and at this writing, some are being seriously considered by the Congress. But even as policymakers deliberate, the market itself is driving change. Corporate managers and directors are paying far more attention to disclosure, and some companies whose stock prices were hammered after Enron's failure (notably AIG, GE and IBM) have provided more details about their operations and risks. The various gatekeepers who failed so miserably in warning of Enron's problems – accountants, analysts, and ratings agencies – have also tightened up their practices. The New York Stock Exchange has issued far-reaching proposals for changes in corporate governance. And the SEC has been far more aggressive about pursuing accounting discrepancies.

TOM NICK COCOTOS

What should government do? Not as much as some reformers have suggested, but more than many free-marketers want.

ACCOUNTING STANDARDS

Begin with the source of the financial problems that loomed in Enron's failure: large losses suffered by highly leveraged special-purpose entities that the company had created and effectively guaranteed. Under generally accepted accounting principles (GAAP), sponsors of these entities have been required to consolidate the assets and liabilities of the entities with their own unless outside investors contributed less than 3 percent of an entity's assets. Putting aside the cases where Enron appears to have misled its auditor about the proportion of outside investment, it is now clear that this 3 percent test was much too weak. The Financial Accounting Standards Board has since proposed raising the threshold to 10 percent, a move in the right direction. Even better, the FASB should put substance over form and mandate consolidation where (as in the case of Enron) the sponsor also guarantees the entity or otherwise effectively controls its operation.

The larger, more difficult issues relate to the standard-setting process itself. In particular, how should the twin problems of the FASB's general lethargy and the influence of interest groups be addressed?

The FASB's slowness could be tackled directly: Lynn Turner, the former SEC chief accountant, wants the SEC to impose deadlines on rule changes and act on its own if the FASB doesn't. The SEC could also speed things up by reviewing the FASB's rule-making agenda on a regular basis.

The downside to more active SEC involvement is that it could result in even greater political interference in the FASB. Witness, for example, the Congressional intervention that led the FASB to abandon its efforts to require companies to treat stock options as an expense at the time they are granted.

Arguably, politics is inherent in any rule-making process. Moreover, it can be reasonably claimed that setting accounting standards is not a science, and we should stop pretending that the process is independent of the interests of the profession that applies the standards and the firms that must abide by them.

Remember, though, that the main purpose of accounting standards for publicly held companies is to protect the investors, not the accountants or the firms' managers. Standards should help investors understand all relevant financial facts that make it possible to estimate future cash flows. Where the standards are changed or not implemented out of concern for firms, investors may pay the price.

In short, the issue is not how to keep politics out of rule-making, but how to prevent the process from favoring corporate interests over those of investors. In theory, putting more investors' or public representatives on the FASB could help rectify the imbalance. In practice, however, if Congress wants the rules to benefit narrow interests, a more balanced FASB couldn't stop it. By the same token, moving the standard-setting process to the SEC is not a panacea because it, too, is a creature of Congress.

Replacing GAAP with international accounting standards (IAS) set by the Inter-

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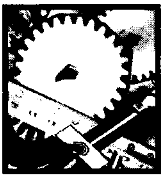
national Accounting Standards Board could help to solve the political-influence problem, since the accounting mandarins in London are likely to be less responsive to naked lobbying. As a bonus, uniform accounting standards worldwide would facilitate the cross-border movement of capital and perhaps even lower its cost.

But policymakers in the United States aren't about to let IAS replace GAAP. American firms would oppose the shift precisely because it would dilute their influence over standard setting. Similarly, U.S. regulators and legislators, not to mention the FASB itself, would most likely guard a continuing role for GAAP. And even if IAS were to replace GAAP, the single world standard could easily be fragmented in short order. The FASB might stay in business in order to interpret IAS for use here. Thus, over time, the FASB's rulings (as well as those of its counterparts elsewhere) would lead to multiple versions of IAS, resurrecting the disorder that now has many calling for IAS to replace GAAP.



There is a solution, arrived at by thinking out of the box. A core problem with any monopoly standard-setter is that it has no incentive to respond to market forces, let alone to resist political influence. As in private markets, the solution to monopoly is competition.

Competition could come in various forms. The most ambitious approach would be to let publicly listed firms choose one of the two main reporting standards now available – GAAP or IAS – provided they did not change standards for many years once they did choose. In principle, the same choice could be available for companies outside the United States. But, as a practical matter, this is not likely to happen. The European Commission already has decided that companies listed on European exchanges must report under IAS by 2005. Japan and many other countries are moving in the same direction.

Allowing firms to choose between the two standards would better insulate both the FASB and the IASB from undue political influence. That's because the standards they produced would be subject to a market test in which investors have the upper hand. Competition would also stimulate both standard-setters to keep pace with market developments, and thus help to cure the foot-dragging problem that has dogged the FASB – and that would very likely plague the IAS were it given a worldwide monopoly.

As in private markets, the solution to monopoly is competition.

To be sure, promoting competition in standard setting would mean some sacrifice in transparency, since investors would have to grapple with reports prepared under multiple standards. This should be less of a problem than it may appear, however, since private analysts would surely find it profitable to issue reports that translated the numbers.

Other forms of standards competition may be more politically feasible, although each would sacrifice some of the benefits of competition. One alternative, constrained competition, would allow firms discretion to choose a reporting standard only after a greater degree of harmonization has occurred between IAS and GAAP. To achieve this goal, both the IASB and the FASB could identify a few rules in which significant differences remain – such as revenue recognition, consolidation practices and stock options – and work to narrow them. Once these differences had been narrowed, but not necessarily eliminated, constrained competition could be launched.

Another alternative is mutual recognition, under which the United States would allow foreign companies reporting under IAS to list their shares on American exchanges without reconciling those reports to GAAP (as is now required under U.S. law), provided their host governments authorized listing of U.S. companies reporting under GAAP. This approach would stimulate competition between the two standards to only a limited extent, however, since it would preserve the monopoly status of both the FASB and the IASB in individual jurisdictions.

Still another alternative to unconstrained competition is to narrow the current reconciliation requirement. For example, instead of requiring foreign companies seeking to be listed on U.S. exchanges to reconcile their financial statements to GAAP in all respects, the requirement might be limited to reconciling only significant items, like the implications of different treatment of revenue, stock options, and consolidation practices.

Any of these alternatives would be an improvement over business as usual. But my preference would be for unconstrained competition, letting the chips fall where they may.

ENFORCEMENT

Of course, even perfect accounting standards can't protect investors unless they are enforced. And in light of the rising numbers of auditing problems culminating in Andersen's debacle in its audits of Enron, attention has wisely focused on how best to verify financial statements. Two basic approaches are mutually consistent and even mutually reinforcing: improved oversight of the auditors themselves and more finely calibrated incentives for those who conduct audits to carry them out properly.

Monitoring

The current system of overseeing the auditing profession – a combination of self-regulation and audit standard-setting by the American Institute of Certified Public Accountants along with supervision at the state level – is plainly inadequate. There is too much self-interest at the institute and its penalties are not credible, while state supervisors lack resources and expertise.

The most widely endorsed fix to the enforcement problem is the creation of a public regulatory board reporting to the SEC that would set and enforce auditing standards. At this writing, the House of Representatives has endorsed the proposal, but its fate in the Senate – where leading Democrats want to toughen the proposed board's investigatory powers and put more restrictions on accountants – is uncertain. If Congress does not create such a board before it adjourns for the midterm elections, it is virtually certain the SEC will do so on its own.

While a properly funded and staffed public regulatory board could certainly improve oversight of the auditing profession, one wonders why this is not a job for the SEC itself. The job of overseeing auditors is no more complex than overseeing the stock exchanges, investigating fraud or insider trading, or carrying out the rest of the SEC's statutory agenda. If the problem is lack of funding, there's an easy answer: Congressional appropriations, perhaps financed by user fees.

Some may argue that an independent board would be better sheltered from political interference than an internal SEC operation. But independence hasn't spared the FASB from such interference. The only plausible argument for creating such a board is the claim that the enforcement of auditing standards requires an understanding of the intent behind the standards; hence the two functions should be lodged in the same agency. And since no one wants to give the SEC authority to write auditing standards, that leaves the proposed board as the enforcer.

Yet many regulatory agencies write the rules they enforce, so in principle there is no reason why the SEC could not do both. If the SEC felt it did not have the requisite expertise to amend or to rewrite the auditing standards, it could look to the proposed board to write the first draft, then amend or bless the standards. Even if the SEC delegated the writing of audit standards to a new board, it would still retain oversight over the organization. In this capacity, the commission and its staff could be in regular contact with the board to clarify any possible misunderstandings over the meaning of particular audit standards.

The job of overseeing auditors is no more complex than overseeing the stock exchanges.

Better Incentives

Adding more and better cops to the beat is not the only way to improve auditing. Other steps may be cheaper and more effective. Auditors already have incentive to do their jobs, of course. They care about their reputations – and they certainly care about their liability exposure. Just ask the partners of Andersen, or of any the other Big Five accounting firms, who must fear that the same thing will happen to them. However, liability-based incentives can lead to overkill – to excessive caution as a reaction to the threat of going out of business. That's why more finely tuned incentives would help.

Another frequently mentioned proposal is to prohibit auditors from doing non-audit work for their audit clients. And some have suggested going further, limiting auditing firms only to audit work for all their clients.

The rationale for these various limitations, of course, is to remove auditors' incentives to compromise their role in the hope of gaining or holding onto lucrative non-audit business. In fact, all of the Big Five firms already have taken steps either to sell some of their non-audit businesses (notably, information technology consulting) or to forswear non-audit work with their audit clients.

Should these market-driven developments be enshrined in law? While there is a compelling case for preventing auditors from reviewing internal audit functions they perform, a broader prohibition is problematic. Even if audit firms were limited only to audit work, they would still face the prospects of losing their audit business if they disappointed clients – which in a world of restrictions would be the only business they have. As a result, audit firms could very well have the same incentives to compromise the quality of their work as they had before.

There are also reasons to be skeptical of another widely discussed proposal, the mandatory rotation of auditors every few years. Perhaps auditors who knew they were going to have their work scrutinized by successors would be more careful. But the opposite might be true: auditors might tacitly promise good treatment during the beauty contests that firms hold to choose their next auditors.

In short, as long as management continues to choose the auditor, the potential will always exist for a conflict that compromises the quality of the audit. So the question becomes: who else could do the job?

It is tempting to solve the conflict problem by shifting the choice of auditors to third parties – to the stock exchanges, the SEC, or perhaps the proposed public regulatory board. But each of these alternatives would face numerous practical problems growing out of the fact that fully 12,000 public companies require audits. In principle, the assignments could be made through an auction, but a large bureaucracy would be required to administer that process. Also, in principle, the cost and complexity could be reduced if the rights to audit numerous firms were bundled. But who would do the bundling, and on what basis? Should firms found negligent in audits be allowed to bid for future audits?

Then there is the problem of ensuring that no single auditing firm (or group of smaller firms) effectively corners the market for audit services. One could impose market-share limits, but any deviation from neutral competition for audits would very likely invite political interference into the selection process.

A less radical way of relieving management of the discretion to hire and fire auditors is to assign the task to the corporation's board of directors. Indeed, although the House of Representatives refused to mandate this eminently sensible idea, the New York Stock Exchange has recently proposed that it be a requirement for listing on the exchange. The exchange also recommended that the directors' audit committees be chaired by someone with financial expertise, that no member of the committee receive compensation other than directors' fees, and that the committee meet separately with management and both internal and external auditors. These are all good, practical suggestions and represent about the best that can be done to align the incentives of auditors with those of shareholders.

BEYOND ENRON: FUNDAMENTAL PROBLEMS WITH THE CURRENT DISCLOSURE REGIME

Central to the functioning of all capital markets is the continuing flow of accurate, relevant and timely information. The Enron debacle reminded a number of well-known companies of this simple truth, when their stock prices plummeted because investors feared that they were not disclosing sufficient information to enable the market to understand their businesses.

However, the financial information that is now routinely reported and subject to audit is of limited (and decreasing) value for understanding the prospects of many companies. First, financial reports are inherently backward looking – a reality magnified by the fact that, for the most part, assets and liabilities are recorded at historical costs rather than at market value. To be sure, many analysts use earnings reports to extrapolate the future. But as the recent market turmoil has demonstrated, this can be problematic, since the future for many firms will not resemble the past.

Today, the future is largely what the analysts say it is, with firms under increasing pressure to hit or exceed analysts' earnings projections. For many firms, this pressure leads to the widely derided practice of earnings management.

Second, much of the value the market assigns to companies cannot be found on their balance sheets. This is because the relevant assets are intangible and cannot be easily traded in the marketplace independent of the company itself. Intangible assets include not only intellectual property – patents, copyrights, trademarks and trade secrets – but also the value of a company's work force, its customer base, its brand name, and all the other factors that contribute to its ability to generate earnings. Intangibles are important not only for high-tech companies, but also for many old-economy enterprises with unique production processes, highly trained work forces and loyal customers.

of a new computer language, XBRL, based on another more general language, XML, that allows firms to place "tags" or identifiers on all kinds of financial and non-financial information. With these tags, users can manipulate and rearrange firm-provided data in any manner that they see fit. This is simply not possible with the current HTML-based data that companies now release on the Internet.

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Third, nonfinancial information relevant to predicting the future may never directly show up in any financial report, and in any event may be generated more frequently than mandated quarterly disclosure reports. A few examples: the gain or loss of new customers, insiders' sales or purchases of the company's stock, changes in management and new patents. To its credit, the SEC has proposed that more such information be disclosed in so-called 8-K filings, and more rapidly (within 2 days rather than 5 to 15). In addition, companies are increasingly Webcasting their analysts' conferences on the Internet so that anyone can listen in. Under the SEC's new Regulation FD companies may not give analysts information that is not simultaneously made available to the public.

Fourth, new computer-based technologies, especially the Internet, may soon make it possible for investors to crunch company-specific data on their own so that they need not rely on GAAP-based financial statements. Of special significance is the development

In short, by their very nature, GAAP-based financial statements are limited in the kinds of information they provide and on what schedule. The critical challenge for firms, their accountants, the investing public and policymakers is to accommodate this broader, less-well-defined need for timely disclosure.

DISCLOSURE FOR THE FUTURE

Begin with intangibles. One response is to require firms to put values on intangible assets, and perhaps even to estimate how those values might change over time and translate the changes into income. This is not practical, however, because there are rarely organized markets for intangible assets, and thus no objective way for auditors to verify the numbers.

A more productive approach is for firms to disclose more nonfinancial information that may change intangible value. That might include information about consumer or worker satisfaction, product quality, innovation, education and experience of the work force and of management. The SEC should use its powers of persuasion in this area, perhaps by convening industry working groups to encourage firms to make more such disclosures, and to do so consistently and regularly.

A second policy challenge is how best to harness technology – computers and the Internet – to facilitate more complete, more rapid corporate disclosure. Once the XBRL-based tags are fully developed and implemented by companies, a wide range of users – not just sophisticated ones like financial analysts – will be able to take detailed data and reconfigure it in multiple ways, using widely available spreadsheet programs.

Here, too, there is a role for the SEC in the bully pulpit, encouraging companies to participate in developing tags for information and publicizing their value to investors. The SEC may also want to consider specific ways to encourage companies to use the tags at the earliest date practical. One possibility: require documents that are required to be submitted as electronic data to be in XBRL by a specific date.

A related project is for the SEC to encourage more frequent reporting. Many companies now have, or will soon have, the ability to make available their financial reports available on a weekly, if not daily, basis. (Indeed, financial institutions already typically balance their books every night.) Why not consider ways to have this financial information communicated in the same time frame?

There will be objections to encouraging companies to make unaudited financial information available more quickly, but these can be met. Quarterly financial data is currently unaudited and will remain that way unless the SEC or a new public regulatory board comes up with guidelines for more limited audits of frequently reported data. In any event, even in the wake of Enron the financial data produced by the overwhelming preponderance of public companies is still useful. Accordingly, if in an age of computers and the Internet companies have the ability to publish their financial statements more frequently than every quarter, why shouldn't public policy encourage that result?

There may be a side benefit to more frequent financial disclosure. If companies routinely reported their financial results much more frequently, investors and analysts might be freed from their obsession with the quarterly numbers. It is highly doubtful that analysts would take the trouble to develop earnings forecasts more frequently than on a quarterly basis. Thus, there is a chance that more frequent reporting could reduce incentives for managers – and their auditors – to engage in earnings management.

But mandating more frequent reporting at this point is premature. Many firms simply wouldn't be able to comply with such a requirement, even covering periods as long as a month. Or the cost of compliance might be prohibitive. The challenge is to find a way to provide incentives to the firms that are able to report more frequently than quarterly to do so. Here, too, the SEC could be leading a visible campaign to encourage the rapid reporting suitable to the Internet age.

FINAL THOUGHTS

Pessimists worry that policymakers won't do enough, soon enough, to rectify the problems in the United States disclosure system that Enron (and previous accounting scandals) have revealed. I am more optimistic. Markets have already done a lot of self-correction. My hope is that policymakers will think more boldly, embracing a competition-based approach to accounting standards while pushing regulators and the private sector to disclose more nonfinancial information. M

The Other Social Security Solution


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by David A. Levine

Imagine *the human genome project succeeding beyond our wildest dreams. By the middle of the next century people typically live – healthy and vigorously – to the age of 200. They go to school until they are 20 and work until they are 65, leaving 135 "golden years" for golf, pinochle and reading the* Bhagavad Gita *in the original. In the meantime, compensation for workers – i.e., wages plus what employers pay in Social Security taxes – rises 50 percent from today's levels and averages approximately $51,000 per year. The federal and state income taxes levied on this are only $5,000. Medical science has not only accomplished everything we could have hoped for, but has done so cheaply; health care costs per retiree per year absorb the same fraction of national income that they did in 2002.*