The Crisis in Corporate Disclosure

Chapter 1

It was only short time ago that the American system of corporate disclosure – the combination of Generally Accepted Accounting Principles (GAAP), Generally Accepted Auditing Standards (GAAS), the professionalism of auditors, and the rules and practices of corporate governance that are designed to ensure the timely dissemination of relevant and accurate corporate information -- was championed as a model for the rest of the world. In the aftermath of the Asian financial crisis of 1997-98, which was marked by among other things a woeful lack of disclosure by companies, commercial banks and even central banks, American commentators and experts were urging not only Asian countries but others as well to adopt the key features of the U.S. disclosure system.

How much has changed since then. The number of American corporations whose earnings have been restated had been modestly rising throughout the 1990s, but then took a big jump in 1998 and hit a peak of over 200 in 1999.[1] Numerous high profile lawsuits have been filed and official investigations launched against accounting firms for auditing failure, as shown in Table 1-1. All the while, concern has continued to mount about "earnings management" by many companies, a practice first decried by the previous chairman of the Securities and Exchange Commission (SEC), Arthur Levitt, whereby firms exploit the discretion allowed under accounting rules to ensure that their earnings show continued growth or at least hit the quarterly earnings estimates put out by financial analysts.

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[1] "Badly in Need of Repair," The Economist, May 4, 2002, p. 67.

Table 1-1

Major Accounting Investigations/Lawsuits

(As of June 2002)

Company	Auditor
Adelphia	Deloitte & Touche
Computer Associates	Ernst & Young
Enron	Arthur Anderson
Global Crossing	Arthur Anderson
MicroStrategy	PrinceWaterhouseCoopers
PeopleSoft	Ernst & Young
PNC Financial Services	Ernst & Young
Qwest	Arthur Anderson
Waste Management	Arthur Anderson
Worldcom	Arthur Anderson
Xerox	KPMG

Source: *Business Week*, June 10, 2002, pp. 42-43.

Until late June 2002 – when Worldcom disclosed an earnings restatement approaching $4 billion, followed by Xerox's $1.4 billion restatement – nothing had done more to generate widespread public and official concern about the usefulness of current disclosures by corporations than the failure of Enron in the fall of 2001, and disclosures of misconduct of its auditor, Arthur Anderson. Among other things, Andersen knew about the company's problems beforehand, did not force them to be revealed and even assisted Enron in creating accounting procedures to cover-up them up, shredding key documents along the way.

These developments, especially when considered against the backdrop of the other accounting fiascoes, have sent shock waves through financial and policy-making circles, not just in the United States but elsewhere around the world. The aftershocks will be felt for some time to come. Criminal and civil lawsuits against Enron, its managers

and auditors have yet to wend their way through the courts. Numerous Congressional hearings have been held in the wake of the Enron affair. We suspect that while the pace of activity will slow, it will continue for some time.

Much more than the fate of the companies involved, their current or former officers and directors, and their auditors is at stake. The events relating to Enron, Worldcom, Xerox, and some of the other companies listed in Table 1-1 have raised much broader concerns about current accounting standards themselves, whether they are too slow in the making and too heavily influenced by narrow interests. In addition, concerns have been expressed about the effectiveness of existing rules and the institutions that are charged with designing and enforcing them – legal and ethical duties of corporate officers and directors, financial and market regulation, litigation, and self-regulation of the auditing profession – that are supposed to ensure that companies and their auditors serve the interests of their shareholders. Indeed, the various accounting-related debacles have called into question the efficacy of the entire system of corporate governance in the United States, prompting not only thorough soul-searching in executive suites, but tougher governance requirements for companies listed on organized exchanges.

The situation was summed up in a widely noted speech in June 2002, delivered by the Chief Executive Officer of Goldman Sachs, Henry M. Paulson, Jr.: "In my life, American business has never been under such scrutiny. To be blunt, much of it is deserved."[2] By late June 2002, the markets had delivered the same message. Stock prices were well off their earlier highs, a decline widely attributed to a crisis in investor confidence about earnings figures and perhaps the corporate governance more broadly.

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[2] Quoted in *Business Week*, June 24, 2002, p. 164.

As we write this, Congress and the SEC are considering a range of reforms designed to improve disclosure, in particular, and to increase investor confidence in the financial and other information that corporations routinely release. We share the view that the U.S. system of corporate disclosure has problems and is in need of change, and have been prompted to write this book for this reason. But we are also concerned that in the rush to assign blame for Enron and the other accounting debacles, policy makers could either over-react or act in the wrong fashion, by taking actions that are ineffective or even counter-productive. In addition, we write here to urge that policy makers not miss the golden opportunity that has been created by the intense interest that has now been aroused in corporate disclosure to consider more far-reaching reforms to disclosure practices and rules. Such measures should be designed to respond to the forces that call for more fundamental change: the increasing global character of capital markets, the ability of the Internet and new computer languages to speed up and enhance investor access to corporate information, and the rising importance of intangible assets in creating shareholder value for many corporations.

One word about whom we expect to read this book. We suspect that many, if not most, of our readers will be from the United States, where the companies whose books have been questioned are domiciled and where the broader concerns about disclosure have been raised. Understandably, therefore, much of focus will be on the U.S. disclosure system. But as we hope to make clear in this initial chapter, the issues discussed here have much broader significance and import: they affect or should affect thinking elsewhere around the world about the effectiveness of corporate disclosure systems in other countries. One of our modest hopes in writing this book therefore is to help others

who share this interest and concern to come to grips with the same issues and questions that are, at this writing, very much on the minds of American policy makers and the wider public.

Corporate Disclosure: Why It Matters

Markets of all types require information in order to function. Buyers must know what sellers are offering, or otherwise transactions are not likely to occur; or, if they do, prices will be higher than they otherwise need be in order to account for the risks that buyers assume when they are not well informed.

The capital markets are no exception in this respect. Lenders certainly must know much about the financial details of the borrowers to whom they provide funds. Moreover, the typical bank loan or bond has a series of covenants, requiring the borrower to continue to meet certain financial obligations or face the prospect of higher interest rates or even default.

We concentrate in this book for several reasons on disclosure of information to equities investors, and by implication to the equities markets. The overriding reason is that the current system of disclosure – by law and by practice – has developed to satisfy the needs of equities investors in particular. Accounting standards in the United States are set by the Financial Accounting Standards Board (FASB), which derives its authority from the regulatory body charged with protecting investors, the SEC. A related reason is that equities markets are of increasing importance and interest, not just in the United States, but around the world.

For example, in the United States, the share of households investing in stock directly or through mutual funds rose from 32 percent in 1989 to 49 percent in 1998.

Excluding pension fund holdings, equities have also climbed sharply as a share of household financial assets: from a low of 11 percent in 1982 to a high of 46 percent in the first quarter of 2000, before falling back to 33 percent in the third quarter of 2001.[3]

Table 1-2 illustrates that stock ownership has also risen in many other countries. The increase in equity ownership in Canada also looks very much like the United States. However, stock ownership in Europe and Japan still lags the United States significantly.

Table 1-2

Equity Ownership In Selected Countries

Country	Initial Share/Number	Later Share/Number	Definition
Canada[4]	23% (1989)	49% (2000)	Share of adults who own directly or indirectly
China[5]	11 million	55 million	Number of investors
Germany[6]	3.5% (1998)	7% (1999)	Share of adults who own Directly or indirectly
Japan[7]	14% (1989)	5% (2000)	Equity ownership of Individual investors
Korea[8]	2-3 million (1990)	7-8 million (2000)	Number of investors
Norway[9]	14% (1994)	17% (1998)	Direct or indirect ownership

[3] E.S. Browning, "Where Is The Love? It Isn't Oozing From Stocks", *The Wall Street Journal*, December 24, 2001, p. C1.
[4] *Canadian Shareowners Study 2000,* conducted by Market Probe Canada on behalf of the Toronto Stock Exchange, www.tse.com/news/monthly_22.html.
[5] "The Rise of a Global 'Shareholder Culture," Christian Science Monitor, July 2000, www.csmonitor.com/durable/2000/07/03/p14s2.htm.
[6] "Go Global," Kiplinger's Personal Finance, May 2000, www.kiplinger.com/magazine/archives/2000/May/investing/global1.htm
[7] "Japan's Missed Opportunity," The Globalist, June 2001, www.theglobalist.com/nor/gdiary/2001/06-29.shtml.
[8] Christian Science Monitor, July 2000.
[9] "Stock Markets Win the Masses," Christian Science Monitor, March 1998, www.csmonitor.com/durable/1998/03/25/intl/intl.7.htm.

Equities investors are interested in information that enables them to project future cash flows of the companies in which they hold stock, since the price of a share of stock, after all, is simply the present discounted value of those flows. Accounting information contained in income statements and balance sheets, while by definition backward looking, is nonetheless a critical input in most attempts to project future performance of firms. To the extent the market deems accounting information unreliable, investors confront greater risks when and where they put their cash. Higher risks, in turn, make stocks less attractive than alternative investments, depressing stock prices.

In short, investors have a very real interest in what corporations disclose, how they disclose it, and when they do so. Enron and the other accounting episodes, at least at this writing, have cast a pall over U.S. equities and until confidence in the numbers returns, that pall is not likely to be completely lifted.

The "Problem"

We begin our analysis in chapter 2, where we provide our view of what is wrong with the current system of financial statement disclosure in the United States, using the Enron case as a point of departure, but also generalizing from prior events and trends. In brief, we argue that the major problem revealed by Enron, as well as by other recent accounting scandals, is that the system of *enforcing* accounting and auditing standards has proved defective, not so much the standards themselves. Somewhat surprisingly, the litigation system, and its threat of liability, that will no doubt prove to be very real when the Enron and Arthur Andersen litigation is over, did not deter bad conduct by Enron's management, its directors and its auditors. Nor has the legal system, even the threat of

criminal liability for those engaging in misconduct, deterred accounting abuses in the other instances summarized earlier in Table 1-1.

This isn't to say that current accounting standards are perfect, however. We note in chapter 2 that one major initiative of the FASB and its international counterpart, the International Accounting Standards Board (IASB), to move toward "fair value" accounting is misplaced. The problem, we believe, is that fair value values need not be based on arm's-length market transactions, but can be calculated from corporate managers' estimates of expected cash flows. Enron used fair-value accounting to report income of doubtful validity and, thereby, give the appearance of superior performance that did not, in fact, exist. If accounting standards-setters want to reduce the likelihood of future Enrons, they should abandon current efforts to rely further on "fair values." This is perhaps one of the more important, and lesser publicized lessons, of the Enron failure for accounting standards.

In contrast, we believe too much attention has paid during the entire Enron episode to the accounting rules governing the many "special purpose entities" (SPEs) that Enron created and did not consolidate. There was a problem with the SPEs, but they were "old-fashioned" disclosure problems: Enron possibly misled its auditor and certainly misled the public about whether certain SPEs complied with the GAAP rule regarding consolidation, and the company did not reveal the extent of its guarantees of the losses of the many SPEs. The then-current SPE rule specified that SPEs should be consolidated only if outside investors committed capital of less than 3 percent of an SPE's assets. This rule may or may not have been too weak, but the Enron case doesn't prove it is or isn't. The essential problem was Enron's failure to follow the GAAP requirement to disclose,

in footnote form, the amount and other relevant details about the SPEs' debt for which Enron was liable. Consequently, the Enron case doesn't justify one way or the other FASB's subsequent lifting of the 3-percent-of-asset test for outside investment to 10 percent.

There are larger problems with the process by which accounting standards are developed, however. Because FASB has been given a monopoly on standard-setting, it is not surprising that its rule development is slow and often highly technical. Perhaps most problematic is the fact that FASB rulemaking has been subject to excessive political influence. Although FASB is a technical body, it effectively reports to the SEC, which in turn reports to the Congress. It should not surprising, therefore, that on occasion – the highest profile examples being the accounting treatment for stock options and derivatives – politics rather than substance drives the rulemaking process.

Fixing The Problems

Chapter 3 outlines what we believe to be prudent solutions to the problems identified in chapter 2. The "fix" for the movement toward fair value accounting is an easy one: just stop it and require that all numbers presented in financial statements be reliable (trustworthy), and that external auditors be held to their responsibility to inform investors that the numbers follow the dictates of GAAP, however specified.

The solutions to the more generic problems with FASB rulemaking are inherently more difficult to fashion. For example, it has been suggested that the fundamental problems with FASB and its rulemaking process possibly could be fixed if U.S. GAAP simply were replaced with international standards, IAS, developed by the IASB. To be sure, a standard-setter in London that has dominion over many countries might be less

prone to political influence, at least from narrowly drawn groups in the United States. But politics may surface in a different form in the international arena. Furthermore, an international accounting body with representatives from many different countries is as likely to become bogged down over time in developing new rules as is now the case with FASB in the United States. In any event, for various reasons we discuss in the chapter, replacing U.S. GAAP with IAS is politically unrealistic.

We believe instead that a more promising approach for shortening any delay in rulemaking and for reducing undue political influence is to allow some form of *competition* in standard setting. We consider a range of options in chapter 3:

(1) "true" competition under which companies listing their shares, regardless of their country of domicile, would be allowed to choose between U.S. GAAP and IAS, *without reconciling the differences attributed to the use of one standard rather than the other*;

(2) "constrained competition", under which companies would be allowed the same choice as in (1), but only when government authorities decide that some (but not all) of the key differences between U.S. GAAP and IAS (such as the rules relating to consolidation and stock options) have been narrowed;

(3) "limited competition" under which companies would be allowed to choose between the two standards, but still be required to reconcile "material" differences between them; and

(4) "mutual recognition", in which FASB and IASB each would maintain their monopoly rulemaking authority, but the United States authorities in particular

would recognize foreign-domiciled companies' use of IAS (but still require U.S. companies to report under U.S. GAAP).

Of these options, we prefer the first on theoretical grounds, but recognize that it has the lowest likelihood of being adopted. Constrained or limited competition may be more feasible, but by definition, either would generate less benefit from competition. Mutual recognition, the most politically palatable of the options, would produce the least competitive benefits, since it would leave undisturbed the monopoly power of the two standards-setting organizations.

We restrict our attention to the competition between IAS and U.S. GAAP for practical reasons. There is a growing movement worldwide toward the adoption of IAS as the single standard. Indeed, the European Commission already has required all companies listing their shares on European exchanges to use only IAS by 2005. That leaves U.S. GAAP as the only real practical alternative to IAS.

We recognize that in recommending a competition in standards of some type we are advocating some sacrifice in consistency, and even perhaps in transparency, for the benefits of competition. The clear virtue of having a single standard is that it makes use of financial statement data more efficient in that users would not have to learn and apply several standards. But the costs of allowing multiple standards can be easily overstated.

We strongly suspect, and indeed expect, that if competition were allowed, third party analysts would provide some sort of company-by-company reconciliation – as is now required by the SEC for foreign companies using IAS that want to list their shares on U.S. exchanges -- for investors as a way of demonstrating their value as analysts. These reconciliations may be limited if companies reporting under one standard do not disclose

as much information as they would be required to prepare any reconciliations. Nonetheless, market pressure might cause companies to provide this level of information, or approximations performed by third parties might be more than adequate for investors to make informed decisions, including a decision to forbear from investing because the available information is inadequate.

Meanwhile, the benefits of a single standard can also be easily overstated. As it is now, investors rarely can make true “apples to apples” comparisons of financial statements of companies in the same country under that country’s accounting principles. For example, many important accounting numbers, such as depreciation and the reported figures for the many assets that are not traded at arms’-length-determined prices in active markets, do not reflect economic values. Companies that group activities in ways that are most meaningful to their operations may, as a consequence, report figures that are not universally comparable. Many accounting rules are based on judgments that are likely reasonably to differ, such as the useful economic lives of buildings and equipment and the amount of future employment benefits. Hence, adoption of a single accounting standard worldwide still would not allow analysts to make “apples-to-apples” comparisons.

Furthermore, there is a significant likelihood that any single set of standards announced by IASB may not retain their monopoly status for long. Precisely because international standards have been crafted in more general terms than U.S. GAAP, leaving more discretion with professional accountants and firms, standard setters in different countries may issue their own interpretive rulings. Over time, this process would lead to a fragmentation of the single standard and thus back to the current situation, or at least a

co-existence of U.S. GAAP and IAS (assuming the United States retained some role for the FASB, while other countries ceded their standard setting authority to the IASB).

What about fixing the enforcement problems exposed by Enron and the other accounting investigations listed in Table 1-1? The most widely discussed solution is the creation of yet another body – a new Public Regulatory Board reporting to the SEC – to oversee and discipline the auditing profession. At this writing, the House of Representatives and the Senate Banking Committee have endorsed different versions of the idea. In June 2002, the SEC also has proposed the creation of a PRB, although its legal status may be questioned if created with statutory authorization. In any event, it seems virtually certain that some kind of new auditing oversight entity will be created before the end of 2002.

We are skeptical of the need for a PRB or something like it, however, preferring to see instead this job carried out more effectively by the SEC itself, which to its credit, has been more aggressive in recent years in uncovering accounting abuses and thus laying the foundation for possible civil liability and criminal sanctions against individual firms and their auditors. But the SEC, as well as the state regulators and certainly the accounting profession, have been far less effective in actually disciplining individual auditors and their employers. Still, we see no reason why the SEC should not itself in the future be the main body investigating and punishing auditors. To the extent additional legislative authority is required, the Congress should provide it. Meanwhile, the additional monies that Congress appears poised to give the Commission to support its review of financial statements should be welcomed – although the additional appropriations and the added scrutiny they will make possible may not calm the markets

any time soon. To the contrary, at least in the short run, investors may have even more reason to worry that companies whose shares they hold may be the subject to an accounting-related inquiry if the agency charged with overseeing "the numbers" has more resources to carry out its duties.

A more fundamental question, in any event, is whether the *incentives* confronting auditors can be changed in a way to ensure that they carry out their professional responsibilities – so that after-the-fact investigation and punishment is not necessary. In principle, the prospect of liability for damages – which in Arthur Anderson's case has proved to be the undoing of the firm – should be sufficient in this regard. But liability law can be too blunt an instrument for creating the right kind of incentives, and could lead to excessive caution. A more finely calibrated approach toward incentives is called for: of all the various alternatives that have been proposed, the one we favor is for auditors to be hired and fired by the independent members of the audit committees of boards of directors rather than corporate officers. We disagree with two other commonly suggested "solutions," mandatory rotation of auditors and broad prohibitions of non-audit work by auditing firms. Neither remedy will alter incentives of managers to hire auditors who, in order to acquire or retain the audit engagement, endorse financial statements that potentially mislead investors by not adhering to the spirit as well as the letter of GAAP. Furthermore, both of these supposed "remedies" would increase the cost of audits to corporations and, hence, to investors, probably far in excess of any benefits that investors might reap.

Beyond Enron

As important as the issues and problems immediately exposed by Enron may be, there are a number of more fundamental developments affecting capital markets that ultimately call for new thinking about corporate disclosure policies and practices. We identify and briefly discuss several of these factors in chapter 4 and explore their implications in chapter 5.

One of these trends is the increasing globalization of capital markets, reflected in rising flows of capital across borders, linkages among stock exchanges in different countries, and the globalization of financial service firms. Yet while finance has become increasingly global, there remain different accounting standards, principally U.S. GAAP and IAS. Some believe the solution to this disjunction is to have a single set of world standards, or IAS. But for reasons outlined earlier, we believe such a solution is neither likely nor stable. A more productive approach is to facilitate greater competition in standards, which should both improve their quality and accelerate the rate at which they are developed and updated.

A second major trend that will affect disclosure practices is the increased use of the Internet, which allows companies to provide almost instantly all interested investors simultaneously with information. In principle, this should make securities markets even more efficient.

Another potential benefit related to the Internet is development of a common financial language designed for the Net, XBRL, which assigns “tags” to all kinds of financial and non-financial data reported by companies for various purposes. Provided that commonly accepted definitions for different types of information can be agreed on –

and there is evidence that this process is well under way -- these tags not only may become widely used inside companies for organizing data and between companies for completing transactions, but they could help transform the way financial statements, and reports of non-financial information to regulatory agencies and for other purposes, are presented to the public. Armed with a simple computer program and access to the Internet – where company-specific data increasingly will reside – investors may some day (soon) be able easily to pull apart financial and non-financial statements in various ways and under different assumptions about reporting conventions, such as whether to record stock options as an expense; recognize unrealized gains or losses on securities available for sale or held to maturity in the income statement; or use last-in, first-out (LIFO) inventory accounting for both the balance sheet as well as the income statement (although economic opportunity costs and values -- such as those that may be relevant for valuing inventory -- could not be used if they were not recorded). Investors could then either on their own, or with the help of outside services, attempt to make their own comparisons of such financial information, using whatever reporting conventions they deem most useful for investment analysis. They could perform similar analyses of non-financial information that is "tagged" by XBRL and publicly reported. In such a world, financial statements based on one particular set of conventions may become far less meaningful than the preceding discussion has supposed.

One caveat to this futuristic view, however, is worth noting. While technologies and standards governing the identification of accounts, such as XBRL, are likely to be very useful for investors and analysts, they do not eliminate the demand by investors for *reliable* information across firms and countries. Audits would be needed to assure users

that companies are identifying their accounts in accordance with an XBRL manual and the definitions of the various “tags.” That is why auditing and enforcement remain important, even if there is never agreement on rules governing the presentation of information rather than its trustworthiness. Indeed, until any additional non-financial information in particular is subject to some type of auditing process, it will in some fundamental sense be less reliable than the audited financial data (although non-financial data may be more relevant to projecting the future economic health companies, if it is accurate).

Nonetheless, it still remains possible that, in the future if not already, non-financial information may become as important, if not more important, to projecting future earnings growth and thus to stock price valuation, than currently reported financial information. This grows out of the third key trend that should affect corporate disclosure: the growing importance over time, especially in the last decade, of intangible assets to the creation of shareholder wealth.

One response to this development would be to put as much effort as into harmonizing the reporting and verification of the most useful non-financial data as is now being expended to harmonize similar standards for financial information. But, as we discuss in the closing chapter, this is much too premature. There is much uncertainty over which types of non-financial data are and will be most useful to investors, let alone the fact that this will vary by industry. For now, we believe the best course is to encourage companies to experiment with the release of non-financial information and let the market sort out what kinds of disclosures will be most valued by investors. At the same time, it would behoove regulators or standards-setters to begin thinking hard about what, if any,

features of these new experiments in non-financial disclosures ought to be mandated, as some countries (such as the United Kingdom) are beginning to do, and the extent to which their trustworthiness should be attested to by independent public accountants.

Conclusion

For those interested in the subject of corporate disclosure, these are interesting – and indeed exciting – times. But not by choice. The scandals surrounding the disclosure failures and shortcomings associated with Enron, Worldcom, and certain other large public companies have put the spotlight of public attention on accounting and disclosure policies in a way many may never have imagined, or certainly welcomed.

The challenge now for policy makers is to make the right "fixes" without damaging the disclosure process. We outline in this book what we believe is a prudent agenda for achieving this objective. We hope readers will agree, or if not, at least recognize that the issues relating to corporate disclosure are more interesting and more complicated than they may have thought before.