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White Paper on Enron Implications

The attached white paper written by G. Peter Wilson (President-Elect of the American Accounting Association) is a splendid and uncommonly rational discussion of the likely causes of the Enron disaster and how the entire financial reporting system can be reformed. We believe you will find it highly readable.

DON'T THROW OUT THE REPORTING BABY WITH THE ENRON BATH WATER

CRUCIAL CONSIDERATIONS WHEN REFORMING THE REPORTING SYSTEM

G. Peter Wilson

The highly interdependent reporting system that is central to U.S. markets needs to be reformed. However, it is not in the dire state commonly perceived by the public. We are at great peril of implementing reforms that do the public interest more harm than good if those who seek reforms and those who influence them, notably the public, do not adequately understand the system.

Broadly defined, the reporting system consists of:

Corporate insiders including internal auditors, audit committees, boards of directors, and chief executive officers and other senior executives as preparers and users of reports;

External auditors, credit and equity analysts, and the business media who use corporate disclosures and other information to produce their own reports; and

Policymakers and enforcing agencies, including the FASB, AICPA, and others who determine generally accepted accounting principles, Congress, the SEC, state and federal justice departments, and the courts.

Media reports and Congressional hearings related to the Enron debacle have heightened awareness about the consequences of abusing this system and fueled a public frenzy for massive reform. They have also highlighted several gaps between the underlying reality of the reporting system and what those who institute reforms and those who influence them know about the system. These gaps are barriers to constructive, effective reforms and the consequences of not closing them will be extremely costly to society if reforms are based on the public and Congress' limited and piecemeal understanding of the phenomena they intend to regulate. To mitigate these gaps, this article identifies perceptions that must be changed as a precondition for constructive reform. It also

provides a framework that will help reformers and those who influence them analyze the system more effectively and create sufficient public support to ensure that beneficial reforms get enacted.

GETTING THE RIGHT MINDSET FOR CONSTRUCTIVE REFORM

The system largely weathered a perfect storm. It is important to fully appreciate how well the system has performed during the past five years under the most severe pressure test since the 1929 stock market collapse, and in spite of the audit failures at Enron, Global Crossing, Sunbeam, The Arizona Baptism Foundation, and Waste Management. There is plenty of room for improvement but the system performed extremely well; Consider the immense stress the system experienced in the late 90's with the remarkable run up in the stock market characterized by "irrational exuberance", new business models, an increased usage of risk sharing structures such as financial derivatives and special purpose entities (SPEs), and a get rich quick via options and equity mentality. This created an unparalleled opportunity to inadvertently or intentionally misrepresent information. Business risk was at an all time high, the underlying activities were remarkably difficult to measure reliably, and there were very strong incentives to manipulate reported numbers. This was a perfect storm that saw the convergence of two forces of unparalleled strength: *opportunities* and *incentives to misrepresent information*. Since March, 2000, as the euphoria over the "new economy" subsided, trillions of dollars have evaporated from the stock market as investors have looked more critically at companies' prospects. As a result, concerns related to financial results reported in the late 90's and the inadequacy of the other disciplining mechanisms have surfaced. In spite of this storm, only a few audit failures emerged amongst the thousands of companies that file with the SEC, and while generic concerns about analyst and media bias have been voiced, it appears, at least for now, that this bias was not blatant enough to merit specific legal charges against either of these constituencies.

This remarkable, albeit not perfect, performance under such demanding conditions suggests that the reporting system is performing effectively for the most part. This article

identifies several salient features of the system that have kept it in check, and suggests ways they can be strengthened.

There is plenty of time to diagnose the disease before recommending treatments. Before determining whether the system needs band aids or radical surgery, reformers and those who influence them need to understand how the system works and what ails it.

Additionally, policymakers must appreciate that the system's components are highly intertwined and must keep this in mind when issuing final recommendations. There is little need for Congress and others to rush through reforms without comprehensive research and rigorous analysis.

The system has been shocked into a high state of alert. In the near future at least, most companies are going to be extremely conservative when making accounting judgments, and everyone involved with the system extra diligent. Thus, the risk of significant audit or other system failures associated with reports issued in the next few years is very low. Counterbalancing this reasoning, however, are the effects of the Justice Department's indictments of Andersen. The indictments will dramatically accelerate the flight of Andersen clients and employees to other accounting firms, which will put pressure on the internal control systems of these firms and increase the likelihood of audit failures.

Accounting is more challenging than meets the public eye. The gap between what accounting is and what the general public knows about the profession is a monumental barrier to constructive reform. Accounting is the language of business. Its grammar is record keeping and the other procedures associated with the public image of accounting, but accounting is much more. Importantly, like nuances in a language, a less understood aspect of accounting is that it both depicts and influences business reality and culture. Largely because of these subtleties, honest and competent accountants face much more challenging reporting problems than the public perceives when accountants condense information about millions of current and future risky events that occur throughout the world into four pages of financial statements and 15-20 pages of footnotes. As a result, the reported numbers are virtually always estimates of the underlying events and circumstances no matter how good or diligent the accountants are who prepare and audit

them. Another misconception is that accounting reports past events, but, in fact, accounting numbers are mostly forecasts of future events.

The accounting challenge is to permit the most honest and competent managers enough latitude in their reporting decisions to demonstrate their superior performance while at the same time restricting those at the opposite end of the honesty-competency continuum from misrepresenting what they know about their business:

- The riskier the business activity, the greater the opportunity to outperform one's competitors by better managing the risk, and the more important it is to have reliable measures to identify superior performance.
- But, the wider the range of reporting options, the bigger the opportunity to inadvertently or intentionally misrepresent performance measures, and, thus the more likely that restrictive standards will be needed that mitigate misrepresentation.
- As a compromise, generally accepted accounting principles (GAAP) restrict all managers alike and thus it becomes more difficult to identify superior performers through the language of accounting, which hurts transparency.
- To the extent they are restricted by GAAP or other mechanisms, these superior performers may not be able to completely distinguish themselves from their less skillful competitors. As a result, they risk losing the opportunity to attract capital and other resources at costs that are commensurate with the company's higher expected payoffs and reduced risk. In the limit, the increased costs associated with this reporting imperfection can cause superior performers not to undertake projects that would otherwise benefit the company and consequently its shareholders.

The measurement challenge is about to become even more daunting. Under soon to be implemented standards, acquired brands and other intangibles will be stated on balance sheets, when acquired, at their "fair value" and each year thereafter tested for impairment (essentially, determining whether their fair values are less than those reported on the previous year's balance sheets). These assessments will permit considerably more

latitude than has generally been allowed under prior GAAP because these intangibles are so difficult to measure reliably. There are limited benchmarks because by definition these are proprietary assets. The increased latitude and the absence of market data will likely make it increasingly difficult for auditors to attest to these numbers and could result in more audit failures.

Pogo was correct: we are all part of the problem and the solution. All of the parties related to the reporting system need to recognize that they are part of the problem and the solution. To quote a famous Pogo cartoon, “We have found the enemy, it is us.”

Everyone involved with the system contributed to the Enron debacle to varying degrees depending on how close they were to the epicenter. Regardless of the degree to which they contributed to the problem, corporate insiders, external auditors, analysts, the media, policymakers, and enforcing agencies are individually responsible for helping fix it and collectively capable of doing so.

The system should be analyzed and reformed holistically. Another barrier to constructive reform is the tendency in government hearings and the media to analyze the components of the system separately rather than as elements of an interdependent whole. Considering reforms in piecemeal fashion is counterproductive when the combined effect is overly restrictive or punitive. Collectively, reforms are overly restrictive if they prevent honest and competent professionals from providing information that helps a company’s stakeholders to differentiate the firm from its competitors or otherwise make informed decisions. Additionally, analyzing and altering the system’s components separately is an approach that fails to recognize the built-in checks and balances that have worked remarkably well in disciplining and strengthening the overall system.

Be skeptical, but not cynical. The tendency to undervalue how well the system performed recently is reflective of a pervasive cynicism that is arguably the biggest barrier to constructive reform. To remove this barrier, all those charged with serving the public interest, especially Congress, the media, and educators must doggedly pursue skepticism rather than cynicism. Skepticism vigorously challenges the assumptions, theories, and facts that substantiate or refute all hypotheses related to an issue, yet begins

with an open mind. By contrast, cynicism assumes the worst about human behavior and vigorously seeks data that confirms these beliefs.

For example, a cynic assumes a company is necessarily manipulating its earnings if its accounting policies, while consistent with GAAP, deviate from industry norms and, as a result, increase its earnings relative to what would be reported by conforming to industry practices. By contrast, a skeptic tests this manipulation hypothesis as diligently as a cynic, but also meticulously assesses whether the company's accounting is a more appropriate way to measure its business under the hypothesis that its business practices differ significantly from those of its competitors. This distinction between skepticism and cynicism will be used extensively in this article to distinguish between constructive and destructive analysis.

Conflicts of interest are largely inescapable side effects of capitalism. Cynicism rather than skepticism about conflicts of interest is particularly problematic. Conflicts of interest are largely inescapable in any economy. However, in a capitalist economy they are natural side effects of financial incentives that create tremendous social benefits.

That conflicts of interest exist does not necessarily mean that they will be acted on. There are mechanisms in place that discourage individuals from acting in their self-interests when these interests conflict with the public good. Ironically, while representatives of virtually all of the professions associated with the system are quick to accuse members of other professions of acting on conflicts of interest (Members of Congress accuse accountants, analysts, lawyers, etc.), when reminded that they too have conflicts of interest, they steadfastly and righteously deny that they would ever act on them.

The cynics would have us remove conflicts of interest immediately via radical surgery. By contrast, a healthy skeptical perspective holds the option of radical surgery open, but also rigorously scrutinizes the proposed reforms under the light of the six questions posed in the Framework for Constructive Reform section.

A FRAMEWORK FOR CONSTRUCTIVE REFORM

The first part of this section specifies six questions that should be addressed when considering reforms that aim to mitigate or remove a conflict of interest. A few of these

questions focus on mechanisms that discipline (and/or incent) individuals not to act in their self interests when these interests conflict with the public interest. The second part of this section examines in detail ten of these mechanisms. Each of them can likely benefit from reform, but it is critical that policymakers understand and consider how the mechanisms function both individually and collectively before proceeding to reform them.

A CHECKLIST FOR ANALYZING REFORMS

Congress and other reformers should address six questions when creating and assessing reform proposals associated with a conflict of interest:

1. What are the social benefits of the financing incentives at the center of the conflicts of interest? For example, what are the advantages of having the business media financed by advertising, parent corporations whom they report on, and subscriptions, all of which occasionally create incentives for the media to serve its own interests rather than the public interest? Similarly, what are the social benefits of allowing accountants to receive auditing and consulting fees, perhaps from the same client? The tendency of reformers and those who influence them to ignore or gloss over the social benefits question substantially increases the risk of throwing out the baby with the bath water.
2. To what extent have the ten disciplining mechanisms described herein failed to align financing incentives with the public interest, and do the social costs of these failures exceed the social benefits of these incentives?
3. Can the financing incentives that produce conflicts of interest be refined to mitigate the negative side effects without unduly sacrificing the social benefits?
4. Are there ways to improve the disciplining mechanisms or add new ones?
5. What must be done to ensure that the disciplining mechanisms do not become overly restrictive such that they prevent honest and competent professionals from best serving the public interest? For example, preventing the media from being financed by advertising, corporate parents who they report on, and subscriptions

would likely leave us with a government-financed press, which is at odds with capitalism and the notion of free press.

6. If it is not possible or feasible to create a reporting system that preserves social benefits, perfectly disciplines everyone involved to serve the public interest, and distinguishes superior performers, is there a side to which we should err?

TEN DISCIPLINING MECHANISMS THAT LARGELY KEEP THE SYSTEM IN CHECK

Ten fundamental disciplining mechanisms provide counter-balancing incentives for individuals associated with the reporting system not to act in their self-interests when these interests conflict with the public interest. Generally, they collectively do a good job. However, it now appears that all of them failed, to varying degrees, to discipline the managers at Enron and Global Crossing. Each of them can likely benefit from reform, but it is critical that policymakers understand and consider how the mechanisms function both individually and collectively before instituting changes.

1. **Values:** Arguably, values and, in particular, integrity coupled with skepticism, form the self-disciplining mechanism that played the largest role recently in ensuring the vast majority of the individuals in the system served the public interest when faced with unparalleled opportunities and incentives to serve their own interests. Only a few of the millions of individuals associated with the system would likely act from self interest, at least to the extent seen in the Enron debacle. Most of these parties have very high standards of integrity and take tremendous pride in serving the public interest.

Enron and Global Crossing remind us that adherence to fiduciary values at the highest levels of an organization must be strengthened. Although integrity and skepticism cannot be legislated, education programs can have particularly significant benefits. In addition, these values can be reinforced throughout the management hierarchy by making decisions and taking actions consistent with a high level of integrity and skepticism. Management should reward honesty, punish deceit, and encourage subordinates to challenge ideas, decisions, assumptions, and actions. Additionally, they should create codes of conduct and promote awareness

about the organizational and individual benefits (negative consequences) of actions that are consistent with (violate) these codes.

2. **Markets:** Capital, product, and labor markets are powerful disciplining mechanisms. If individuals who create, audit, and disseminate information did not already comprehend the devastating consequences of losing their credibility with the capital markets, the Enron debacle has punctuated this lesson. It has made vividly clear that if a company's stock price increases because of misrepresentation, the higher price is not sustainable for long. Sooner or later, market participants will uncover the misrepresentation and punish the company's stock.

Cognizant of the potential wrath of markets, most managers are reluctant to risk their credibility when making reporting decisions — they have an incentive not to act in their self interest at the expense of the public interest because they fear the repercussions if they are caught.

The capital markets, and thus this disciplining mechanism, can be reformed directly by laws, regulations, and standards that aim to improve the usefulness of the information provided to market participants. Capital markets also are self-reforming in that market participants learn through experience, especially when they suffer extreme losses. For example, the Enron debacle has heightened awareness and motivated analysts and investors to search more diligently for accounting distortions.

Similarly, Arthur Andersen has been severely disciplined by its product and labor markets. If other auditors were not fully aware of the potential consequences of these disciplining mechanisms, they surely are now. Already several of Andersen's audit clients have announced that they will switch to a competitor. Switching auditors has traditionally been a costly move because it can be construed to mean that the company is shopping for more favorable opinions. Moreover, in the past the reputations of auditors, which are central to the assurances services they sell, have generally been considered roughly comparable across the Big-5. As a result, there was little incentive for companies to switch auditors. Right or wrong, the perception that Andersen failed to meet its audit responsibilities at Waste Management,

Sunbeam, The Baptist Foundation of Arizona, Enron, and Global Crossing has caused many of its clients to question the wisdom of staying with the firm.

If Andersen survives, it will likely continue to be disciplined by the labor market at both the entry and senior levels. At the entry level, the very best students are going to demand a substantial risk premium to join Andersen or, worse yet from Andersen's perspective, not give Andersen serious consideration. At the senior level, the partners' capital accounts, one of the major reasons partners stay with a firm, will undoubtedly take a major hit, if not disappear altogether, from the legal disputes related to Waste Management, Sunbeam, The Baptist Foundation of Arizona, Enron, and Global Crossing. Consequently, Andersen partners' switching costs will decrease significantly and they will be prime candidates for competitors to recruit.

The disciplining consequences of the product and labor markets and courts put Andersen at great peril. There is a very high probability that Andersen will not survive or, if it does, the Big-5 will become the final four because Andersen will serve too small a client base to be considered one of the "big" firms.

3. **Justice Department and the Courts:** Historically, the courts have had a significant disciplining effect on auditors in the form of financial retribution largely because the audit firms have had the deepest pockets left when there was an audit failure. Yet, they also discipline analysts and corporate officers.

Until now this mechanism has played a central role in ensuring that the reporting system serves the public interest. Still, the Justice Department and the Courts can do more harm than good to the reporting system if they are not disciplined appropriately by the other nine mechanisms. Prosecutors with political ambitions sometimes have an incentive to serve their own interests at the expense of public interest by aggressively pursuing agendas that are fueled by public opinion rather than justice. Other disciplining mechanisms and, in particular, prosecutors' values, the courts, and the media generally restrict this behavior. Still, in the politically explosive environment related to the Enron debacle, there is a substantial risk that justice departments and courts can do significant harm to the system. For instance,

some Andersen employees likely deserve to be prosecuted and if found guilty penalized severely, but this number falls considerably short of the 85,000 employees worldwide whose livelihood will be threatened by the recent indictments that charge Andersen with obstruction of justice.

A senior partner at one of Andersen's competitors suggests that Andersen's audit failures are not unique to the firm and points to a reason why only Andersen's audit failures surfaced recently. She argues that audit problems are cyclical at most of the audit firms: A firm suffers major litigation losses associated with audit failures caused either by internal control problems, a loss of management focus, or a lack of awareness about the importance of vigorously maintaining and strengthening the values and controls. It takes steps to mitigate these problems. The fixes work for several years. Over time, vigilance wanes and problems resurface, and the cycle begins once again. This suggests that litigation settlements follow a cyclical pattern.

She further argues that Andersen, unlike its competitors, had not faced major litigation losses during the 90s' and thus was not as prepared for the extreme pressure test that occurred near the end of the decade. Another former senior executive at one of Andersen's competitors agrees with her "cyclical" theory and further suggests that Andersen's central office failed to put the necessary controls in place to guard against the problems that occurred in Houston. He admits that his firm had learned this lesson through earlier audit failures.

If this cyclical theory is valid and Andersen did not have the necessary controls in place when the perfect storm hit between 1996 and 2000: (a) The problems that occurred at Andersen will likely surface elsewhere in the future if the system is not modified in such a way that this cyclical behavior is addressed. (b) There might have been many more audit failures during the past 3-5 years when the system was severely pressure tested if the other Big-5 firms had not responded recently to disciplinary actions. (c) Andersen might go out of business simply because of bad timing; it hit a low point in its awareness and internal control cycle during a period when opportunities and incentives to misrepresent information were likely at an all time high. (d) If all five firms had hit a low point simultaneously, Andersen would

have a much better chance of surviving the crisis: The SEC and Department of Justice could not have afforded to put the same pressure on all five firms for fear that the entire system would collapse.

4. **Standards and Standard Setters:** Standards discipline the reporting system by restricting the alternatives and latitude that corporate accountants have when measuring and reporting on company performance, and thus mitigating the extent to which they can act on their self-interests to the detriment of the public interest. In the limit, overly restrictive GAAP can throw out the baby with the bath water by preventing superior performers from distinguishing themselves.

The clearest example is in the case of depreciation expense. Most companies follow industry norms when reporting depreciation expense, even when these norms do not reflect differences across the industry in the way the assets are being used and thus their specific rates of obsolescence and replacement. The good news is that depreciation expense is not manipulated very much, if at all. The bad news is that depreciation expense provides very little meaningful information that would allow current and potential stakeholders to differentiate companies in the industry. As a result, and not surprisingly, most analysts remove depreciation expense from reported earnings, treating this measure as unnecessary noise.

Those involved in proposing, implementing, and enforcing reforms need to understand that accounting and auditing standards must meet the following criteria: (a) keep managers who bend but don't break the rules in check, (b) penalize others who go over the line or commit fraud, and (c) permit honest and competent managers an opportunity to best tell their story through their numbers.

5. **External Auditors:** Notwithstanding the recent audit failures associated with Andersen, external audits are significant disciplining mechanisms that provide a powerful incentive for managers to act with the public interest at heart.

As demonstrated vividly by the Enron debacle, auditors also have conflicts of interest. They receive audit fees and sometimes consulting fees from the companies they audit. Much has been made of these conflicts of interest. They are indeed significant and have become increasingly so as the Big-5 have become more

involved in, and reliant on, consulting. However, there has been very little discussion about the social benefits of permitting accounting firms to consult for the companies they audit or, more generally, about the social benefits of allowing auditors to consult. There are sound reasons why accountants have been so successful at consulting and, in particular, significant economies of scale and scope are gained by allowing accounting firms to audit and consult. Businesses rely on their auditors for business advice because accountants must understand all aspects of a business to measure and audit it effectively. Also, the consulting wings of accounting firms have significantly improved the efficiency of their clients' business processes and reporting systems, especially during the past 10-15 years. Finally, it is virtually impossible for auditors not to consult for their clients. When they discover faults in an internal control system as part of an audit, they are essentially consulting.

This does not necessarily mean that the practice of allowing accounting firms to audit and consult should continue, especially for the same client. Congress and other reformers, however, should carefully identify and assess the social benefits of this practice as part of the reform process. The social benefits of allowing public accounting firms to audit and consult may be so great that the public may instead be better served by fortifying the mechanisms that discipline the practice of, and financial incentives in, auditing and consulting, rather than remove the incentive and with it the social benefits.

There is another proposed reform for this disciplining mechanism (external auditing) that looks appealing at first glance, seems to be politically attractive, and yet may not best serve the public interest. The proposed reform would force companies to change their auditors every 3-5 years, ostensibly to sever the cozy relationships that can develop when these engagements continue for several years. The proposal to change auditors every 3-5 years has at least two major shortcomings:

- First, audit risks are very high during the first few years of an engagement because auditors have to learn about risks associated with the company's

business, accounting, and systems and build a working relationship with management that facilitates a two-way flow of credible information. Thus, forcing companies to switch auditors frequently increases the overall risk of audit failures.

- Second, forcing companies to switch auditors could actually promote more cozy relationships between companies and their auditors. For example, auditors who specialize in the automobile industry and live in Detroit will likely want to stay in Detroit and continue working in the automobile industry. As such, they are likely to become itinerant workers who switch employers but continue to work on the same audits. If so, then the problems that the term-limit reformers are trying to eliminate may actually become aggravated over the years these itinerant workers will develop cozy relationships with their clients, less loyalty to their employers, and they may be more inclined to expect side payments in the form of expected future positions with clients.

The recent audit failures would suggest that this mechanism needs to be reformed, perhaps more than any other. However, proposed reforms should have two features: (a) To the extent they address potential conflicts of interest, they should ask the six questions in the Framework for Constructive Reform section; and (b) they should take into account the interconnected effects of the other disciplining mechanisms in the reporting system, including the consequences of reforming them.

6. **Corporate Governance:** Audit committees, internal control systems, and boards of directors comprise governance systems that are largely designed to discipline managers to act in the shareholders' and public interest.

Board members and audit committees have their own conflicts of interest. Each group is nominated by management and compensated with stock and/or options. Options and stock align board members' interests with shareholders' interests and in a capitalist system this is not necessarily at odds with the public interest. Again, the critical issue is whether board members and, in particular, audit committees act from their own self-interests when these interests conflict with the public interest or whether the disciplining mechanisms keep them in check.

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7. **Business Media:** The business media reports stories about the reporting system and its participants and motivates disciplinary actions.

Still, the press has its own conflicts of interest. It receives advertising fees from corporations that can benefit significantly from favorable coverage. Also, media companies often receive financing from parent corporations, which can also benefit from positive media stories (e.g., GE owns NBC, Microsoft has significant ownership in MSNBC, and Disney owns ABC). There is a relatively high level of public awareness about these particular conflicts of interest, either because the media is required to disclose them or because they are readily apparent. As a result, the other disciplining mechanisms and the incentive to earn reputations for credible reporting do by and large deter the media from acting on these conflicts.

There are two other, more subtle conflicts involving the media that likely do more harm to the public interest than the conflict described above: First, like financial analysts, the media has an incentive to protect their corporate sources to ensure future access. Second, they have a financial incentive to sell sensational and cynical stories that the general public wants to hear, rather than stories that could better serve the public interest. This last conflict of interest is likely the most insidious and by implication one of the biggest barriers to constructive reform: It contributes to maintaining the tremendous gap between public opinion about the reporting system and what the public needs to know. The media can best serve the public interest by closing this gap, but to do so it will have to rise above the conflict of interest associated with circulation and cable revenues.

Another problem is that even those media that have presented in-depth and balanced reports of the daily events have not framed and integrated the larger issues nearly as well in editorials and commentaries. Specifically, like Congress, thus far the media has mostly taken a piecemeal approach and, by doing so, has missed an opportunity to better serve the public interest by framing the issues as part of a systematic whole.

8. **Congress:** Congress passes laws that profoundly discipline the other parties associated with the system. In principle they will play the biggest role in reforming

the system: In principle, because Congress is significantly influenced by public opinion, which in turn, is largely influenced by the media.

As with the other parties associated with disciplining mechanisms, notwithstanding their many good points, members of Congress have incentives to act with self-interest at the expense of the public interest. They are partially financed by special interest groups whom they regulate, and lawmakers and regulators often work in the private sector before or after they work in government. Also, they tend to vote in accordance with public opinion, which often is based on limited understanding and does not always serve the public interest.

The Enron debacle has motivated the media to highlight some of these conflicts of interest by emphasizing the large contributions that accounting firms and Enron have made to members of Congress and implying that these contributions were tied to recent laws that benefited the accounting profession. The media thus disciplined Congress and, as a result, campaign reform became a reality.

The critical question is whether the media will continue to discipline Congress and, in particular, to encourage more in-depth and balanced analyses. All too often, members of Congress act like iron filings in a magnetic field of public opinion. The media is in the best position to change public opinion and thus change the orientation of this magnetic field. They can also encourage Congress to serve the public interest rather than public opinion when the two continue to diverge. However, as indicated above, the media, like Congress, has an incentive to cater to public opinion.

9. **SEC:** The SEC has been at the forefront during the past five years in attempting to discipline individuals who create, audit, disseminate, and regulate information that affects stakeholders' decisions.

However, as indicated extensively in the media, the Chairman of the SEC, Harvey Pitt, has significant conflicts of interest related to the fact that he previously made a living serving many of the parties he is now regulating. As such, he may overreact to the media pressure and unduly discipline corporate accounting, auditors, analysts, and standard setters. Others at the SEC also have conflicts of interest in that the

SEC is typically viewed as a stepping-stone to lucrative careers in corporations that are regulated by the SEC.

The SEC faces another conflict of interest that could have greater consequences. A recent report from the General Accounting Office states that the SEC needs considerably more financing to meet its mission more effectively. On the one hand, it is easy to argue that the SEC simply does not have sufficient resources to adequately scrutinize the thousands of reports that it receives from companies each year. On the other hand, the SEC's recent negotiations with Andersen and the Justice Department raise serious concerns as to whether the SEC is becoming overly aggressive, perhaps because it has a financial incentive to cater to Congress which approves SEC funding.

10. **Analysts:** Notwithstanding recent criticism, credit and equity analysts discipline corporate reporting of financial and non-financial information and frequently influence GAAP.

Sell-side equity analysts have a significant conflict of interest related to the way their employers generate revenues and hence, how they are compensated to perform. Investment banks receive relatively modest fees from trades and tremendous fees related to stock offerings and mergers and acquisitions advice. As a result, sell-side analysts have an incentive to issue overly optimistic reports about current and prospective investment banking clients. Academic research confirms that analysts tend to issue significantly more buy than sell recommendations and that this bias is more severe for their investment banking clients.

Some members of Congress are proposing radical surgery for sell-side analysts who issue reports about their investment banking clients. The proposed reform would preclude analysts from issuing reports for companies from which they receive investment-banking fees. But, were the proposed reforms written without addressing the six questions posed in the Framework for Constructive Reforms section?

This is a great example of a superficial reform that is not needed because of other disciplining mechanisms and, regardless, will be almost completely ineffective. As

long as equity analysts' employers can earn investment-banking fees, analysts will have an incentive to issue overly optimistic reports to attract future investment banking engagements. In turn, corporations will hire investment bankers who share their enthusiasm about their future prospects.

Even if the proposed reform is generalized such that companies that issue analyst reports cannot receive investment banking fees, the bias in reports would still be present, albeit to a lesser degree. Analysts have good reason to follow a stock they are optimistic about, independent of how they or their employer are compensated. Issuing a report for a new stock requires large up-front learning costs and thus analysts have an incentive to pick stocks that will do well in the future so that there will continue to be a high demand for subsequent reports. Similarly, regardless of how they are financed, analysts have an incentive to issue overly optimistic reports in order to gain access to the managers at the companies they follow.

Notwithstanding the bias discussed above, currently sell-side analysts provide a social benefit by bringing significant amounts of valuable information to the market and by disciplining companies to issue financial statements and other reports that contain more reliable and relevant information than they would if there were no sell-side analysts. Sell-side analysts' institutional clients have known about the bias in reports for years and yet they continue to use them, albeit skeptically. Most of these clients ignore the recommendations and overly optimistic comments and focus on the underlying facts, arguments, and logic. In doing so, they acquire considerable information that ultimately gets into prices, suggesting that sell-side analysts help make markets more efficient. Proposals that threaten to change the way analysts are compensated, then, need to consider these social benefits and, to the extent possible, suggest compensation alternatives that will maintain or increase these benefits.

The proposal to prohibit sell-side analysts from issuing reports about their investment banking clients has another shortcoming; it does not take into account the disciplining mechanisms discussed earlier. First, while it is true that sell-side analysts have an incentive to issue overly optimistic reports, they also have a

counterbalancing incentive to earn a reputation for issuing credible reports. Second, sell-side analysts work in a competitive product market and this market will have a disciplining effect on them. Competitors who do not receive investment-banking fees and thus are more inclined to issue unbiased reports are already offering competing products. This, in turn, encourages sell-side analysts with the banking fee conflict of interest to build a reputation for issuing unbiased reports and thus disciplines them not to act on the conflict of interest. Third, requiring more transparent and prominent disclosures about these conflicts of interest will warn readers to be skeptical of the recommendations and analyses in reports. Additional disclosures are not needed for analysts' institutional customers but they are needed for their retail customers, along with increased education about how to analyze a report skeptically. Fourth, the SEC, media, and courts discipline analysts by penalizing those who deceive investors through fraudulent or misleading reports, Reforms are likely needed to mitigate the bias in analyst reports, and it is possible that after careful deliberation the proposed radical surgery would still be the best alternative. However, strengthening the disciplining mechanisms discussed above may well be preferable because it will preserve the social benefits that analysts provide, strengthen the counterbalancing incentives for analysts to serve the public interest, and makes the conflicts more transparent to the analysts' clients so that they will know to analyze the reports with increased skepticism (but not with cynicism).

CONCLUDING COMMENTS

There is an urgent need to educate Congress, other reformers, and those who influence them about the highly intertwined reporting system that is central to our markets. The overarching objective of this article is to identify a list of crucial points that reformers need to understand to avoid doing more harm than good and, more optimistically, to create constructive reforms. To summarize:

- The reporting system needs reforming but it is not in the dreadful condition as depicted by Congress and the media, having performed amazingly well during the

recent perfect storm that was its most severe stress test since the 1929 stock market collapse.

- There is plenty of time to do the job right because the system is on red alert. A thorough examination of the issues must be treated not with cynicism, which is a significant barrier to constructive reform, but rather with tenacious skepticism vigorously challenging the assumptions, theories, and facts that substantiate or refute all hypotheses related to an issue, yet starting with an open mind as to what the eventual outcome will be.
- Accounting and standard setting is much more complex and challenging than perceived by the public. The public believes that reported numbers should perfectly depict the underlying business activities. Yet this is almost always impossible. Rather, the accounting challenge is to permit the most honest and competent managers enough latitude in their accounting decisions to demonstrate their superior performance while at the same time restricting those at the opposite end of the honesty-competency continuum from misrepresenting what they know about their business.
- To the extent the most honest and competent managers are constrained by GAAP or other mechanisms, they may not be able to completely distinguish themselves from their competitors and risk losing the opportunity to attract capital and other resources at costs that are commensurate with their company's higher expected payoffs and reduced risk. In the limit, the increased costs associated with this reporting imperfection can discourage superior performers from undertaking projects that would otherwise benefit the company and, as a consequence, the efficiency of our capital markets suffers.
- Conflicts of interest are largely an inescapable side effect of capitalism. There are six questions that reformers should consider when analyzing reforms related to conflicts of interest (see the Framework for Constructive Reform section).
- All of the parties related to the reporting system need to recognize that they are part of the problem and the solution. Keeping this in mind, the system should be

analyzed and reformed holistically. To this end, ten mechanisms that discipline individuals not to act on self-interest at the expense of the public interest are included in the Framework for Constructive Reform. These mechanisms serve as checks and balances, providing incentives to discipline those throwing the system out of balance.

The consequences of reformers ignoring these points are already apparent and will likely get worse. The Justice Department's recent indictment of Andersen for obstruction of justice is a prime example of an act that likely does more damage than good. In fairness to the Justice Department, there could be solid legal grounds for the indictment and Andersen might have rejected reasonable settlement offers. Still, in its zeal, the Justice Department seems to have largely ignored the collective punitive effects that other disciplining mechanisms were already having on Andersen. Consequently, it has jeopardized the entire reporting system by creating tremendous pressure on the auditing labor and product markets:

- Prior to the indictment, the client base and labor market were already punishing Andersen: Andersen's clients were systematically leaving the firm with no signs that this hemorrhaging was slowing down. Similarly, the labor market was responding negatively to Andersen with several senior partners and key employees leaving the firm while potential new hires expected risk premiums or categorically refused to work for Andersen.
- Andersen faced civil litigation penalties or settlements that would likely end up costing the firm close to a billion dollars.
- To the extent incriminating information was uncovered by investigations, the Justice Department and courts could have prosecuted individuals at Andersen who, if found guilty, would have been severely penalized.
- The cumulative effect of the above penalties would have certainly shrunk Andersen and may very well have caused its eventual demise. But a slow death would have permitted an orderly transfer of Andersen employees and clients to competitors.

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- By contrast, the Justice Department’s indictment could kill Andersen quickly and as a result put tremendous pressure on the other four big accounting firms’ internal control systems. On average, each of them will have to assimilate 500 new clients quickly. Because new engagements are generally very risky for auditors, audit failures or decreased confidence in audits on the part of investors should likely be expected. In addition to these costs, thousands of innocent Andersen employees could lose their jobs.

The Justice Department’s action underscores the importance of taking a systemic approach. Viewed in isolation, the indictment was harsh and perhaps justified, but it would probably not have taken down Andersen on its own. The collective effects of several disciplining mechanisms, acting in isolation, will ultimately do more harm than good and the Justice Department should have sought to understand these consequences before seeking an indictment of the whole firm.

To mitigate the risk of ending up with reforms that do more harm than good, the following recommendations must be considered:

1. All parties associated with the system should do whatever is in their means to educate the public about these issues to better align public opinion and the public interest, perhaps by starting with a concerted effort on why it is so important to get these reforms right.
2. When considering reforms where there are conflicts of interest, Congress and other reformers should be encouraged to address the six questions in the Framework for Constructive Reform section so that the effect on the social benefits provided by the current system is considered in equal weight.
3. The ten disciplining mechanisms in this framework are the first place reformers should look to improve the system, especially before adding new mechanisms.
4. When reforming one of these mechanisms, policymakers should take a systemic approach. They should especially take into account the interconnected effects of the other disciplining mechanisms, including the consequences of reforming them.

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