Misguided Cures for Corporate Scandals

The Cato Institute held a Forum on Capitol Hill in October to discuss the recent wave of corporate scandals and Congress's response, the Sarbanes-Oxley Act. The speakers were Alan Reynolds, Cato senior fellow, and William A. Niskanen, chairman of Cato and former acting chairman of President Reagan's Council of Economic Advisers. Excerpts from their remarks follow.

Alan Reynolds: After the economy slipped into recession and profits collapsed, the stock market collapsed, and several huge companies declared bankruptcy, the political response to those problems was: "Maybe it's just a matter of accounting. If only we would count things more carefully, record them more carefully, present the information more carefully, then everything would be OK. Because the real problem, you see, is the accounting." So we were all suddenly swept up in a frenzy of accounting reform, which culminated in the Sarbanes-Oxley Act. But the crusade was founded on two fundamentally incorrect premises.

The first was that the bankruptcies of Enron and WorldCom were caused by bad accounting, rather than the other way around. A Brookings Institution paper claimed, for example, "Both bankruptcies resulted from accounting malpractice." Well, that's pretty nonsensical. Bankruptcies always result from having too much debt and too little income, and that's the case in this instance too.

The second premise was the idea that stock prices had collapsed merely for a psychological reason—lack of investor confidence. Proponents of accounting reform virtually promised that if only we would enact this kind of legislation, it would restore investor confidence and raise stock prices. That was said over and over again, and it was echoed by the press.

Implicitly, what people were saying when they claimed that the stock market was down only because of lack of investor confidence was that stocks were cheap. They were saying the price-to-earnings ratio was very low. In fact, it was quite high, but not unusually high. The only other thing that could make stocks go down, if the P/E ratio was constant and sensible, is earnings. Well, the earnings of the S&P 500 companies were down 47 percent from the peak by the second quarter of 2002, and the S&P 500 stock index was down 42 percent. That's really all you need to know about the stock market. Earnings went down; that's a real problem. For all the problems we might have with the accounting, that was the accountants' report of earnings. If you're trying to explain that decline in earnings, you might say companies had been exaggerating earlier on. But then, why didn't they continue to exaggerate? The only way you could explain the change would be to say there was a sudden rash of honesty among accountants. I don't find that very plausible, so in short, we had a misdiagnosis of the problem. The problem was real; the problem was economic.

Despite that, we began to focus on narrow bookkeeping issues, rather than economic fundamentals, rather than genuine corporate governance issues—separating CEOs from boards of directors, that sort of thing—and rather than tax policy distortions. What we got instead was the Sarbanes-Oxley bill, a bill that was unnecessary, damaging, *and* insufficient.

It was unnecessary because the Securities and Exchange Commission and the Department of Justice already had ample powers to investigate fraud, to prosecute, and to seek civil and criminal sanctions. The only things SEC officials lacked were knowledge and an incentive to blow the whistle. If you are a government official and you dare to blow the whistle on a company and you're wrong, you lose your job. Whereas if you keep your mouth shut and go about your business and pretend that you're working hard, you can keep your job and your salary's the same in either case. The whistles that were blown were always inside the companies. WorldCom? The SEC didn't find anything wrong with WorldCom. That was true of Enron, it was true of Xerox, Lucent, and a number of other cases. Internal sources always discovered the problems.

Sarbanes-Oxley is damaging because of its requirement that CFOs and CEOs vouch for the accuracy of their financial statements. That tends to criminalize failure and risk. The effort is to make the CEO and CFO accountable for complex statements that they have no part in preparing—somebody else does the work—and that CEOs (unlike EFOs) are not usually qualified to audit or to check out. The only effect this is likely to have is to cause executives to be extremely timid about taking risks. Deliberate fraud is another matter. That is and always will be punishable by prison sentences, but ignorance and incompetence are not, and probably never will be. The last thing the U.S. economy needs right now is to scare businesspeople into playing it safe and retrenching.

The bill was insufficient because it swept all of the really substantive, important issues off the table—legal obstacles to corporate takeovers, tax distortions that encourage companies to use too much tax-deductible debt rather than double-taxed equity, and so on. Many of those things were never even brought up, because the issue was defined as a bookkeeping problem.

My task at this point is to suggest that although the Sarbanes-Oxley Act had little to do with actual problems, it presents many new problems of its own, and many unintended consequences. One unintended consequence is that fewer startups will go public. More companies will remain closely held, and the reason, of course, is to avoid the extra regulatory expenses and added risk of litigation now facing public firms. Is that a problem? Well, closely held firms are outside the realm of regulation; I'm not sure that's a bad thing. But they're also outside my ability to invest in them, and that is a bad thing. I would very much like to invest in Gallo Winery, for example, but it's not a public company. Some currently public companies will probably be taken private, and foreign companies will be less likely to list on the U.S. stock exchange.

A second unintended consequence is a dilution of the talent pool. Fewer qualified people will be willing to serve as chief executives or directors—unless they are very well compensated for the extra risk of doing so. That is fairly standard economic reasoning. The folks who passed this law certainly didn't set out to fatten the pay packages of officers and directors, but that is the predictable result.

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The third unintended consequence is that stock prices will henceforth remain lower than they would otherwise be. That’s because public companies now face higher costs for executive compensation, higher costs for regulatory compliance, higher costs for insurance to cover the added risks of class action suits and other litigation. Higher costs and higher risks translate directly into lower stock prices, the exact opposite of what the legislation promised.

Aside from the ritual of having executives certify financial reports, the flashiest, most publicized reform had to do with delegation of sweeping powers to yet another new agency, an agency designed to do what the others had not. The SEC, the DOJ, the Financial Accounting Standards Board had the power, but they didn’t do anything. So we’re going to set up another agency called the Accounting Oversight Board. That new agency was being created at the same time the Senate was failing to confirm all but one appointment to the SEC, and senators were expressing doubts about the one they confirmed (Harvey Pitt). Perhaps to avoid the messy process of having the president make appointments and the Senate confirm them, otherwise known as the Appointments Clause of the Constitution, this new agency is supposedly not a government agency at all; it’s private and independent.

That’s obviously not true; if it were, it would just be a clone of the American Institute of Certified Public Accountants. That’s private and independent. But the AOB may in fact override the AICPA, though it may not, since it doesn’t know how. The AICPA in turn must conform to the rules of FASB, although FASB certainly solicits advice from the AICPA about its rules. Meanwhile, the SEC, which appoints members of the AOB and FASB, can override them both. In short, the SEC is theoretically in charge of it all, just as it was before. In fact, the SEC is charged with oversight of the new oversight board, and a congressional committee exercises oversight over the SEC’s oversight of the oversight board.

Alan Reynolds exposes the flawed premises underlying the Sarbanes-Oxley Act at a Cato Hill Briefing on October 25.

Now, all of those incestuous relationships and overlapping responsibilities can come in handy when it comes to finger-pointing, if you want to say, “Oh, that’s not my responsibility.” The trouble for those of us in the private sector is that creating more agencies means more uncertainty for investors and businesses. We don’t know what the rules are because we don’t know who’s making them.

The new AOB has been granted vast discretionary powers—very few rules, lots of discretion, powers that far exceed its likely abilities. The board registers all accounting firms and audits the publicly traded companies and inspects the biggest ones every year. The board can compel companies to provide documents and testimony, assess fees and fines, and levy “appropriate sanctions.” It is to be financed by a stealth tax, of dubious constitutionality, on the capital of publicly traded firms. It can deny registration to some accounting firms, which would effectively put them out of business, and it can dispense rather nice favors to others, including exempting them from the restrictions that are applied to other firms when it comes to nonauditing services. The whole idea that this is some sort of private agency is really a hoax.

Now, any such vast grants of new authority are bound to be politicized, if not corrupted. Just to make that result more likely, the law virtually mandates a bare minimum of professional competence: a majority of the AOB must consist of *non*accountants. You probably read in the paper that on the first list of likely appointees were a lawyer, a lobbyist, and a former director of the Central Intelligence Agency. Perfect people to supervise accounting. This mandated rule by amateurs is one reason the new board will surely have to hire experts. And where will it get the experts? From the accounting firms. So they will hire some experts from the accounting firms to inspect the accounting firms. In the end this whole idea of putting nonaccountants in charge of accounting, which wasn’t a particularly clever idea in the first place, will end up as just a dream, if not a nightmare.

To summarize, the Sarbanes-Oxley Act was a largely irrelevant and potentially troublesome response to several misdiagnosed problems. The law was unnecessary, damaging, insufficient, and a major distraction from several far more relevant issues that remain neglected.

William A. Niskanen: Our Cato project to extract policy lessons from the collapse of Enron addresses four areas of concern: accounting, auditing, taxes, and corporate governance.

First, accounting. May I first acknowledge that I am an economist, not an accountant, as will be apparent shortly. President Reagan once described economists as people who were good with numbers but without enough personality to become accountants. I have been studying a lot of accounting to understand the collapse of Enron, but my wife tells me that any side benefit

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has yet to be realized.

My primary lesson from studying the accounting issues is a caution. Don’t count too much on accounting for the following reasons: Enron and other corporations did not fail because they violated accounting standards; they violated accounting standards to cover up their financial weaknesses. The primary effect of better accounting and auditing would be to accelerate their failure, as a rule, not to avoid it. Second, accounting rules, under American accounting conventions, are very complex, and a wide range of behavior is consistent with those rules. The volumes describing the generally accepted accounting principles are now more than 4,500 pages, with over 700 pages specific to the rules for the treatment of derivatives. Most important, the best financial accounts do not provide sufficient information to assess the health of many corporations. The market value of most corporations is now a multiple of the value of the assets that they own, the differences reflecting the quality of their management and employees, the reputation of their products and services, their dependence on regulatory decisions, and so forth. A firm may experience a substantial decline in its earnings prospects with no change in its financial accounts, the result, for example, of the Food and Drug Administration not approving a drug developed by a firm at high cost, or the SEC charging a CEO with an insider trading violation, both of which have happened recently with respect to ImClone and Martha Stewart. There are many such examples; a lot can happen, for the good or bad of a firm, that is in no way reflected in the best possible financial accounts. If a firm loses its chief scientist, or for whatever reason is able to recruit unusually talented young people, that is not picked up in the financial accounts. Some of the intangibles are measurable, but they cannot be valued by accounting rules. In summary, good financial accounting is valuable but is nowhere near sufficient to describe the potential for future earnings or the value of a firm.

Now they’re asking corporate CEOs, who are not accountants and did not prepare the accounts, to do something that I could not do with my own taxes—to ensure that those accounts, to the best of their knowledge, are an accurate reflection of the financial health of the firm. As I say, I couldn’t even do that with my own taxes, and requiring CEOs or even CFOs to write that on their annual and quarterly reports under penalty of a 10- or 20-year jail sentence is going to lead to either massive lying or massive risk aversion. You just can’t solve a problem like this with that kind of affirmation and jail sentences. The difference, by the way, between a 20-year jail sentence and one of fewer than 10 years is more than a matter of time. In the 10 to 20 year range, you don’t go to Club Fed. You go to a jail with common thugs, rather than your fellow corporate thugs.

Next, auditing. My primary lesson from studying the auditing issues is also a caution. Don’t count too much on auditing for the following reasons: Every link in the audit chain in the Enron case failed—the audit committee of the board, the board, Arthur Andersen, the market specialists in Enron stock, Enron’s major creditors, the credit-rating agencies, the business press, and the Securities and Exchange Commission. It was almost as if each link in this chain was free riding, counting on some other link to detect and act on any unusual problems. That’s not unusual, by the way.

Most of the market specialists advised their clients to buy Enron stock well into the fall of 2001. Enron declared bankruptcy on the second of December of that year. The three credit-rating agencies did not downgrade the Enron debt until November 28, five days before Enron filed for bankruptcy. The SEC last reviewed Enron’s annual report for 1997 and did not renew an investigation until August 2001, after the first unfavorable press and the resignation of Jeff Skilling as Enron CEO. Moreover, those problems are in no way specific to Enron. Every major accounting firm has been subject to a massive financial fraud by one or more of its major clients. In fact, a leading consultant to the industry concluded that audit reports “are probably not worth their weight in paper,” a conclusion that is disturbing, even if possibly overdrawn. At this point, I ask you to reflect on why Congress seems to believe that a new law that focuses entirely on accounting and auditing issues will solve this problem.

Third, taxes. My primary conclusion is that our current tax code *increases* the conditions that lead to corporate bankruptcy. Firms go bankrupt because their obligations to their creditors are too high relative to their ability to meet them. They have taken on too-risky investments and incurred too much debt. The corporate income tax in the United States, by treating interest payments as a deduction from revenues that would otherwise become earnings—by treating interest as a deduction but not dividends—leads corporations to use too much debt. The U.S. corporate income tax is now the fourth highest among the industrial nations, and with some changes that have already been announced, it will be the second highest within a few months. U.S. corporations, as a consequence, have an unusually high debt burden.

Dividends are now taxed at roughly twice the rate of long-term capital gains on the personal income tax schedule. The long-term capital gains tax rate is 20 percent, and for most people who own shares, the combined federal and state tax on dividends is in the 40 to 50 percent range. This leads to several traps. Corporations rely too much on retained earnings and capital gains, relative to dividends, to distribute the returns to equity, inviting increasingly risky investments. Second, the discipline to maintain a cash flow sufficient to pay dividends is reduced. Third, the role of corporate managers in the allocation of capital is increased relative to that of investors. Corporate managers have the dominant role in deciding how all of those retained earnings are going to be invested. But if the focus were more on dividends than on retained earnings, which managers hope will lead to capital gains, there would be smaller retained earnings, more of them would be distributed as dividends, and investors rather than corporate managers would have the bigger role in deciding the allocation of capital in this country.

A provision of the 1993 tax act limits the amount of individual salary that may be deducted to a million dollars. That may

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seem like a lot of money, but at the moment the average CEO in the top 1,500 firms or so is paid about $20 million a year. That encourages firms to offer a larger proportion of executive compensation in the form of stock options, and that, in turn, invites risky investments, because stock options are a one-sided bet. People who have stock options lose nothing if the stock price does not exceed the exercise price, and they gain the difference if the stock price, for whatever reason, exceeds the exercise price. That leads to a temporary inflation of reported earnings and sometimes the hyping of the stock to increase its price. A substantial change in the corporate income tax would be necessary to address those problems.

At the Waco summit, Charles Schwab suggested the sorts of tax measures that would be most effective. Among the very few unscripted moments at Waco were Schwab's suggestions to reduce the double taxation of dividends, to increase the limits on individual retirement accounts, and to provide symmetric treatment in the tax code for capital gains and capital losses. (Those of you who have examined your taxes within the past several years may find that you're taxed on all your capital gains, but you can deduct only $3,000 in capital losses against your other earnings. That $3,000 limit was set in 1978 and it is way out of date.) Those are the kinds of tax cuts that would most help both the stock market and the general economy in the near term. President Bush was in fact quite interested in those proposals, only to find out that his Treasury Department was not at all enthusiastic.

Finally, and most important, the rules of corporate governance. My primary conclusion here is that the rules of corporate governance must be changed to restore the power of shareholders relative to that of corporate managers, for the following reasons: For 34 years, beginning with the federal Williams Act of 1968, the rules of corporate governance have progressively favored corporate managers relative to shareholders, substantially reducing the potential for hostile takeovers. Those rules of corporate governance, the effective constitution of a corporation, are a complex combination of federal laws, federal court decisions, state laws, state court decisions, and many rules that have been approved by firms' own boards. Now, as you know, in the United States corporations are chartered by states, not by the federal government, and so the states have approved a wide range of rules.

Cato chairman William Niskanen tells congressional staffers that the corporate tax code increases the likelihood of corporate bankruptcies.

One consequence of the erosion of the protection of corporate investors in favor of corporate managers has been an explosion of executive compensation, especially in the 1990s. One estimate that I have tried to check out is that in 1980 the average compensation of a major corporate CEO was about 40 times that of hourly workers; in 1990 it was about 80 times, and in the year 2000 about 500 times. There has been a massive explosion of executive compensation relative to that of hourly workers.

There is no objective basis for saying those disparities are right or wrong. What we do know, however, is that one reason compensation is exploding is that corporate boards are no longer very effective at disciplining corporate management. Basically, executive compensation is not an arms-length transaction any more, and the rules are biased in favor of corporate management.

Another consequence has been a substantially lower rate of return on investments at management-friendly firms than at shareholder-friendly firms. A Harvard Business School study of last summer did a very important service. The researchers looked at the top 1,500 firms in the United States with only a single class of shares. (They did not include some big firms like Ford or Berkshire Hathaway that have multiple classes of shares, but most firms have only a single class of shares.) Second, they came up with a complex 24-point index of whether the rules that affected the firms were management friendly or shareholder friendly, on the basis of the rules they were subject to from state courts and state legislatures, plus the rules that had been approved by their own boards. Third, the researchers looked at the stock performance of those firms over the course of the 1990s. What they found was that the top decile of the shareholder-friendly firms had 8 and a half percent higher returns per year than the top decile of the management-friendly firms. The management-friendly firms were much more casual with their investment decisions, particularly in good times when nobody minds the store.

Several knowledgeable commentators, such as Warren Buffett, have described this process as a massive transfer of wealth from shareholders to corporate managers. Reversing that process is important but will be complex. Only a few of the rules are federal; some are state laws and court decisions, and corporate boards have approved many. But it is important to start in the right direction, rather than to maintain the illusion that Sarbanes-Oxley is either necessary or sufficient to address the major policy problems raised by the collapse of Enron. ■