



Editorial

Policy reforms in the aftermath of accounting scandals ☆

Last fall, Enron's collapse stunned the nation. A shocking series of revelations of accounting irregularities by major corporations followed. What happened?

Several culprits have been suggested: investors' irrational exuberance, infectious greed, and foolishness; the bursting of the bubble; the impoverished morality of CEOs; the tendency to cook the books; the failure of the gatekeepers; and the bright line financial reporting standards, which have encouraged auditors to acquiesce in accounting gimmicks.

Unfortunately, these alleged causes cannot be remedied with equal effectiveness. Prosecution and punishment may not adequately deter wrongdoing, as intentional misrepresentation is difficult to discover or prove. Overhauling the regulatory structure and adding layers of supervision and monitoring by the government would be inefficient and socially wasteful. Little can be done in the short run to cultivate ethical personalities, and it is not necessarily desirable to curb investors' enthusiasm. Rather, the solution lies in market mechanisms that eliminate the perverse incentives of gatekeepers, most notably the auditors. Financial statement insurance is such a market mechanism. It holds the promise of improved alignment of incentives, and hence better quality audits.

Currently, the incentives driving auditors' behavior may not elicit unbiased reports. Auditors are paid by the companies they audit and thus depend on CEOs and CFOs, who effectively decide on their employment and compensation. This creates an inherent conflict of interest that is endemic to the relation between the client's management (the principal) and the auditor (the agent). The former structures the financial relation with the auditor to induce a clean opinion on the financial statements even when it is not justified. The fear of losing an indefinite stream of future audit fees—even without the added allure of non-audit services now mostly barred by the Sarbanes–Oxley Act—effectively guarantees that the auditor complies with management's wishes.

☆ This editorial is based on policy recommendations detailed in Ronen (2002).

The threat of legal liability is not at present properly crafted to eliminate the incentive to do management's bidding. Moreover, the expected cost of litigation and other penalties is recouped in the aggregate from the auditees, but not in such a way that each of the auditees defrays the expected cost it imposes: high-quality auditees subsidize lower-quality auditees. This results in an inefficient allocation of risk and resources. Furthermore, the recoupment is made out of the client-corporation's resources, diminishing the wealth of the shareholders, who purchased the shares at prices potentially inflated as a result of misrepresentations. Thus, instead of being protected, the shareholders end up partially shouldering the costs. Only severing the agency relation between the client-management and the auditors can remove the inherent conflict of interest. We need to create instead an agency relationship between the auditor and an appropriate principal—one whose economic interests are aligned with those of investors, who are the ultimate intended beneficiaries of the auditor's attestation. Insurance carriers are eminently reasonable candidates.

Financial statement insurance (FSI) would change the principal-agent relationship. Instead of appointing and paying auditors, companies would purchase insurance that provides coverage to investors against losses suffered as a result of misrepresentation in financial reports. The insurance coverage the companies obtain would be publicized, along with the premiums paid for the coverage. The insurance carriers would appoint—and pay—the auditors, who would attest to the accuracy of the financial statements of the insurance company's prospective clients.

Companies announcing higher limits of coverage and smaller premiums would distinguish themselves in the eyes of the investors as companies with higher-quality financial statements. In contrast, those with smaller or no coverage or higher premiums would reveal themselves as those with lower quality financial statements. Every company would be eager to avoid this characterization. A sort of Gresham's law in reverse would be set in operation, resulting in a flight to quality.

The FSI scheme effectively eliminates the conflict of interest that came to light in the aftermath of Enron. But financial statement insurance has other important benefits: the credible signaling of financial statement quality and the consequent improvement of such quality, the decrease in shareholder losses, and the better channeling of savings to socially desirable projects.

This solution can be complemented and reinforced by GAAP and GAAS reforms, resulting in significant additional indirect benefits. If implemented, FSI would facilitate an accounting approach based on underlying principles rather than detailed rules. It has been argued in this journal that the US model of specifying rules that must be applied has allowed or encouraged firms such as Andersen to accept procedures that, while they conformed to the letter of the rules, violated the basic objectives of GAAP accounting. For example, although SPEs in Enron usually appeared to have the minimum required three

percent of independent equity, Enron in fact bore most of the risk. The contention is that general principles such as UK GAAP, which require auditors to report a “true and fair view” of an enterprise, are preferable to the over-specified US model, and that the US model encourages corporate officers to view accounting rules as analogous to the Tax Code.¹

In fact, general principles already exist in the United States: the seven concepts that now constitute the FASB’s Conceptual Framework. These concepts articulate the objectives of financial statements and offer criteria for measurement and reporting that are designed to satisfy the objectives. Akin to a constitution, the Conceptual Framework was and still is viewed as the “principles” that guide the FASB’s formulation of detailed standards (rules). Hence, I interpret the plea for requiring auditors to report a “true and fair view” of an enterprise to be an appeal for sole reliance on the Conceptual Framework and the annulling of the many scores of rules that have been issued by the FASB.

Traditionally, detailed rules have been championed because they enhance credibility. Uniform application decreases the ambiguity of results and variation in reported numbers. Hence, it enhances comparability and possibly decreases audit costs (by minimizing disputes with clients about accounting choices). Yet detailed rules also decrease the flexibility of management in making accounting choices and thus limit its ability to signal expectations about the prospects of the company that are not shared by the public. If discretion is accorded the manager over which accounting methods to apply in a particular instance, he will, if he wishes to report honestly, employ methods that best reflect the “economic reality” of the company. Restricting his choice by imposing detailed rules limits his ability to convey truthful information if he is so inclined. Along with the flexibility, therefore, incentives should be aligned to elicit truthful information from management.

Yet the events of the past year have made it clear that incentives are not now properly aligned with those of shareholders. The use of general principles, including those prevalent in the UK, as a sole guide for practice therefore is a hazardous proposition. The creation of the FASB as a full-time board, and the formulation of objectives of financial statements, came on the heels of major accounting abuses and the “pooling mania” of the 60’s. Indeed, left on its own under the “guidance” of the general principles—far less detailed than the FASB’s standards—promulgated by the FASB’s predecessor, the Accounting Principles Board, the profession did not curb the abuses. The accounting profession created the full-member board (the FASB) with the promise to issue detailed standards to avert a governmental take-over of the standard-setting function. Standards were issued mostly to plug exploitable loopholes. The

¹ See Benston and Hartgraves (2002).

problem was then, and still is now, the perverse incentives causing the abuses, not the detailed standards. Both the abuses and the detailed standards they triggered were symptoms of the bad incentives. With the implementation of FSI, incentives will become aligned, and reliance on general principles will become possible.

Of course, GAAP can be improved, too. Current financial statements are a blend of largely verifiable, but uninformative, depictions of past transactions and largely unverifiable, but possibly informative, projections of future outcomes. Under existing GAAP, many of those projections show up in the balance sheets as assets, and even as revenues. Consider the interest only strip, shown as an asset in the balance sheets of specialty finance companies under Financial Accounting Standard 140. This asset is simply the present value of a future stream of unrealized income, recorded as current income. Its valuation is highly subjective and acutely sensitive to changes in assumptions. It is extremely difficult, even for a well-intentioned auditor, to dispute and reject the projection of a manager wishing to improve the appearance of his financial statements. Or consider Rebecca Smith's report (*Wall Street Journal*; January, 17, 2002) on Enron's Braveheart venture (incorporated on December 28, 2000): "Enron assigned the partnership a value of \$124.8 million based on its projections of the revenue and earnings potential of the Blockbuster Venture, according to company documents." Such largely unverifiable intangibles make financial statements difficult to audit.² They constitute private information that cannot be perfectly verified *ex post*. We can only observe whether a manager's forecasts were accurate; we cannot know that he did not truly believe that the forecasts were accurate when made. Under these circumstances, in equilibrium, and on average, managers' presentations will not be truthful (Ronen and Yarri, 2002). Even detailed standards have not prevented unverifiable intangibles from creeping into the financial statements. Imagine what would happen if we rely only on "underlying principles" without the incentive alignment offered by FSI!

The solution is to separate the verifiable past from the unverifiable future while providing both in the financials. Present systematically the projections (the unverifiable), and along with these but separately from them an account, over time, of how the projected future unfolded, as evident in what now has become the past—the realizations (the verifiable).³ The Conceptual Framework could be expanded to require this unbundling of projections and real-

² We do encounter sweeping admonitions in the press to the effect that accountants should make sure that "...the overall impression created by GAAP fairly portrays the underlying economics" (Michael Young's statement in Liesman (2002)). Easier said than done!

³ For a detailed description of how such a financial reporting system can be implemented, see Ronen and Sorter (1972).

ization. Investors will reap two benefits from this explicit reporting of expectations and realizations.

First, over time they will be able to evaluate how managements' projections pan out and thereby judge their ability to anticipate the future or their proclivity to be optimistic or deceitful. Admittedly, this will not cure the occasional ambitious executive's unsavory proclivities if he reckons his rosy projections will inflate the value of his stock or options, which he can then sell at great profit and jump ship before the storm (Enron, Worldcom, Global Crossing, Tyco, and the like come to mind again).

Yet investors would not be fooled; and herein lies the second benefit of this suggested solution. Once the realizations are decoupled from the expectations, auditors will attest only to the former; this is what they do best. The projections—chancy and unreliable—cannot be verified, so they cannot be audited. Knowing that the projections are unverifiable and potentially hazardous, investors will beware. A more efficient economy will emerge.

If a modified Conceptual Framework as suggested above governs, where there is no demand for the promulgation of detailed standards, the FASB's role could evolve to become one of laying down the “case law” of financial reporting.

Disputes will inevitably arise between the auditor working for the insurer and the management of the company being audited with respect to how best to apply the Conceptual Framework to a particular transaction or situation. It is in this context that the FASB can play a role akin to that of a court. As they possess accounting expertise and rich practical experience, the accounting board members can offer guidance that helps resolve disputes that arise in the process of auditing. The FASB can develop a compendium of specific applications of the Conceptual Framework (or the general principles) to transactions in the process of providing guidance to the disputing partners. Such a compendium could serve successfully as the “case law” of financial reporting, just as the case law in the judicial domain successfully serves the nation's judges.

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