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Can Accounting Professors Teach Character?

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My topic today is one that you have all considered: Can Accounting Professors Teach Character? It is presumptuous of me, a non accountant, a businessman and a sometime professor to address a group of professionals in the field. On the other hand, I have had a very unusual background in dealing with this issue so I have some hope of saying something you do not already know.

Since the business debacles of the early years of this century – with the headlines of Enron, WorldCom but many others – I have been involved for over five years in commissions, boards, advisory groups focused variously on the question of how the debacles happened, what led up to them and what needs to change.

I was a Director and Audit Committee member of JPMorganChase for the last five years and witnessed close up and painfully the multi-billion dollar settlements of the Enron and WorldCom and other litigation.

As a member of the Public Oversight Board sponsored by the AICPA, I was involved in its unfortunate demise, followed immediately by our strong recommendations to the Senate Committee, chaired by Paul Sarbanes. Those recommendations led to legislation imposing on the auditing profession, a complex and severe federal regulation. The powers of the old Public Oversight Board were feeble compared to those of the PCAOB.

I had a close up and insider view of the auditing profession's leadership during that period. It was not attractive. The total intransigence to face up to the inherent conflicts in their business model was extraordinary. Greed conquered ethics. The abandonment by the AICPA and the major firms of support for the voluntary, "do-the-right thing" model represented by the private sector Public Oversight Board was incredibly short-sighted. I am personally convinced that Arthur Anderson could have been saved if their senior partners would have agreed to a strong independent board, and Paul Volcker's vision of a new trustworthy accounting firm focused on professional quality audits. That idea was effectively rejected by their senior partners.

One of the sad symptoms of the resulting disrepute of the profession – added to the draconian imposition of a severe federal regulatory regime through Sarbanes Oxley – was the destroyed reputation of all firms and all auditors. As an example, I nominated an exceptionally talented former CEO of a Big 5 firm for the board of a major U.S. company and the response was very negative – “we do not want the burden of that negative image”. This was the reaction not of politicians but of the elite business leaders of the country.

The sad history of that period is described fully in two candid and insightful books: Arthur Levitt's Take on the Street: What Wall Street and Corporate America Don't Want You to Know and Barbara Ley Toffler's Final Accounting: Ambition, Greed and the Fall of Arthur Andersen. These are two books that anyone aspiring to be an auditor should be required to read. I hope they are on your bookshelves.

Another telling symptom of the corruption of the 5 major accounting firms is that they were all included in the top ten donors to President George W. Bush's campaign. I remember the comment at that time of an astute medical doctor that the all time peak in the American Medical Association's lobbying money was just before the decline of the medical profession.

But I want to comment today on my membership on two broad gauged commissions. The American Academy of Arts and Sciences called its group Restoring Trust in American Business. The Conference Board established a Commission on Public Trust and Private Enterprise. Both had blue ribbon membership and a very broad mandate to critique what led to the failures and to propose broad ranging solutions.

In 2002-2003 the public's confidence in CEOs, the major audit firms, the investment banks, corporate lawyers, corporate governance and, indeed, American business in general reached an extraordinary low. One of our surveys for the Conference Board Commission, focusing on public trust found that only 23% believed that CEOs of large companies can be trusted while 73% believed that you “can't be too careful with them.” The only category of business leaders with lower ratings were used car dealers. Corporate wrongdoing was believed to be widespread: every company does this but only a few will get caught (46% thought that) but “many other companies will be exposed” (Another 38% thought that). The cumulative total of 84% who believed that American companies are involved in corporate wrongdoing is a frightening majority opinion.

The public may be wrong and I think they are. But our business franchise ultimately depends on their support. And they form the juries who ultimately drive multi billion dollar settlements.

A question that came up in the first meeting of the American Academy Commission was what happened to American values in the last decades of the 20th Century. Was there a pervasive change in ethics and values that led to the kind of actions taken by so many business and professional leaders? Even after long discussions and written papers, I believe the answer is elusive.

There have always been instances of fraud, embezzlement, and white collar crime and there always will be. But surely we have never had such a widespread epidemic among Controllers, CFOs', General Counsels, CEOs' and such apparent connivance by the "gate keepers" – auditors, lawyers and bankers.

At that first meeting of the Academy Commission, Amo Houghton provided an elegant story. Amo was at that time a long standing Congressman from upper New York State and a former CEO of Corning, a company originally owned by the Houghton family.

Amo's story was about a luncheon conversation with his grandfather just as Amo was becoming CEO of Corning. The elder Houghton offered to tell Amo how to run the company. Amo was puzzled but looked forward to the luncheon advice session – his grandfather was old but had a reputation as wise and astute.

After normal family talk, the grandfather gave Amo the following advice: "Think of all the actions you could take as CEO of the company that are legal, done by lots of other companies, recommended by advisors or salesman. Consider this as forming a large circle.

Then think of a smaller circle inside that large circle that represents what you think you should do based on our family values, your religious upbringing, your education and the models of the professors you most admired, the advisors you trust – in short the actions consistent with your values.

As to managing the company, just make damn sure you stay within that smaller circle."

I thought that was a wonderful preamble to the American Academy's project. We assembled a distinguished group of business and professional leaders, as well as academics, and addressed the fundamental questions suggested by Amo's two circles.

John Reed, chairing our efforts, in the Academy meeting, observed that "all is not well in corporate America...we have severely betrayed the trust and confidence essential to free market capitalism". That was written in 2004. Since then we have had stock option back dating, risk-prone mortgage abuses, and reckless financial engineering in financial markets. We have not found our way

out of the swamp. The Department of Justice reports that it has obtained 1300 corporate fraud convictions since July of 2002 (when SOX passed the Congress). More that 200 CEO's and 50 CFO's have been personally convicted. These are stunning numbers.

Marty Lipton, Larry Sonsini and Jay Lorsch, three well known leaders in the world of corporate governance and business ethics edited the book that emerged from our discussions. It is called by the name of the Commission: *Restoring the Public Trust*. Your colleague, Bill Kinney wrote a good piece on auditing for the book that documented our commission's discussion

Bill focused on the gap between the public's expectations of an audit and the reality of what auditors can actually deliver. The public expects an auditor to investigate and limit all aspects of corporate business risk and corporate misbehavior risk, as well as the traditional financial misstatement risk". Bill asks, sensibly, how can our auditors cope with these expanded responsibilities.

I would like to make some very broad comments on the role of the senior accountants and auditors over the next years, and then express a hope for introducing more broadly in their education, ethics, values, judgment and even character.

There is no question in my mind that the complexity and scale of transactions for large companies will continue to expand, and probably accelerate in the years ahead. But technical brilliance will not be enough: judgment, rather than simply knowing complex rules of compliance, will be what is most valued in the senior accounting professional. The expanding opportunities for manipulation will be substantial. The internal controller of a company will be the first line of defense. And the CFO with an accounting background will be next. The independent auditor will be a critical gatekeeper in deciding questions of correctness in proposed accounting solutions.

Standard setters are moving hesitantly toward principle based standards and away from rules, relying on the judgment of internal financial management and then outside auditors. Faster in London than in Norwalk.

The demands on senior auditors, company CFOs and controllers for judgment will grow – and perhaps enormously if standard setters do move away from hundred page standards and specific rules to general principles.

The question is whether the accounting education, with its current structure and traditions can cope with the future need. And I am sure I am not saying anything new to those in this room.

But elements of character are hard to teach. For the last 2500 years, educators and philosophers have debated how to teach "virtue". Plato wanted to

do it with stories from the Iliad and Odyssey, but expurgated all the bad actions of the gods. The British thought reading Latin and Greek authors in the original would do it and the 19th Century was led by people with that tradition.

American students are urged to study the liberal arts, including especially the humanities, to prepare them for later active life in business or the professions.

Previously I was always skeptical of how business schools could teach integrity, humility, and courage with a one semester course. In 2002 I was named as Citigroup Fellow in Ethics and Business Leadership at the NYU Stern School of Business. In a course on Professional Development, we have used good case studies and what is appearing in the daily paper to inculcate the belief that honest business dealings do pay off in the long run.

This course is exceptionally well taught by Stern faculty, with an excellent set of readings and case studies. And the effort is led by an enthusiastic senior faculty member who has recruited all the stars on the faculty to take their turn teaching a class. I have become a believer in the value of these courses since the students are so responsive and, basically, want to do the right thing – well within Amo's inner circle.

I am parachuted in as a lecturer and always use Amo's circle to introduce my topic. It is an excellent pedagogical device. I try to find relevant transactions that I was involved with personally to illustrate those that are in the spread between the two circles. We then discuss the pros and cons of limiting our companies by imposing our values and judgment. The students have good instincts on how to balance maximizing shareholder value and "doing the right thing". Actually, as you would know, that is a hard balance to hit.

The shortest educational training periods for professionals are those for accountants, engineers and architects. Traditionally lawyers and business management do not focus their education on their profession until after four years of college. Hopefully liberal arts education does lay some basis for some people for higher values once into active post schooling life. Law school, MBA classes for several years after the undergraduate schools can also imprint the softer values of humility, integrity and judgment. But surely we know it does not always work!

I look back on my liberal arts education and remember some of the great stories that now seem to me relevant to staying within Amo's smaller circle. Perhaps a course could be developed for orienting accounting majors featuring some of those stories. I give you two examples.

The most familiar is the ancient Greek story of Oedipus and his family. Sophocles' last play in the triad was *Antigone*, a play often performed on college

campuses, and it has a vivid application for business “gatekeepers”. A performance of *Antigone* by the participants in the Aspen Institute course for executives is a great finale.

Remember that three characters dominate the play. Creon is a strong willed tyrant of Thebes and demands mutilation of the corpse of Antigone’s brother who had sought to overthrow him. Antigone defies him as her beliefs commanded her to give the brother a decent burial. Her sister, Ismene pleads with her to go along with Creon; “we will only have trouble if we do not compromise”. Ismene has come to be a classic symbol of weakness and a lack of character and courage. It does not turn out well for Antigone but she ends as one of the most admired heroes of literature. A great story for future accountants. Incidentally the great French playwright, Jean Anouilh wrote a modern version of it for production in Paris during the German occupation in the Second World War.

The other example is Henrick Ibsen’s classic: An Enemy of the People. It is an incredibly dramatic play but not as well known as Antigone. It is set in Norway. A town has a huge spa complex that is crucial to the town’s tourist based economy. Doctor Stockmann discovers the bath’s drainage system is seriously contaminated. He alerts various leaders who thank him for his discovery. They then tell him to shut up. His brother, who happens to be the mayor tells him that the cost to eliminate the contamination is more than the city can afford. Dr. Stockmann does not back down in a public meeting. The townsmen then vandalize his house; he and his daughter lose their jobs. But he, with his family’s support, decides to stick it out.

Another great story for future gatekeepers.

Real history presents other great such heroes. Churchill in the 1930’s refusing to appease Hitler is not just a story. He refused to go along and the world is a very different place today thanks to his obstinance and standing on principle.

I do not wish to underestimate the political skills needed by accountants to work with their colleagues and clients to prevent an unacceptable action. Anticipation, education, establishing trust and respect, and articulating the issue are all hard to achieve. But if understanding, character and courage, do not undergird the effort, there is no hope. If there is no backup and support from the central office, there is no hope. And if fear of financial loss dominates in the firm, there is no hope.

Engineering, accounting and architecture usually start as undergraduate programs. Engineers and architects are oriented toward basic technical skills. I am always surprised at how few engineers end up in senior management

positions in spite of their technology advantage. Accountants however seem to me to need much more than technical skills.

Accounting is the language of business. It is the tool by which we take a transaction from the reality of commerce to a financial description that can be comprehended by all. Teaching the subject is to teach business.

But can we teach more than the technical words? Can we teach what the transactions mean? Can we teach judgment and values and, indeed, business wisdom?

Can we teach not only the complexity of the rules for accounting for a hedge transaction but all the appropriate uses of a hedge? The pitfalls in measuring that complex instrument? How will it be used correctly and not misunderstood? Or, put the other way, when is it used in a deliberately misleading way.

In my education as an actuary, I was imbued with the concepts of fairness, equity and careful formulation of products that could not mislead customers. Nevertheless many actuaries have designed terrible products, with unfair and misleading provisions. Take the classic annuity – an important vehicle for the accumulation and distribution of wealth. Start there and add a 2.5% year asset expense charge to compensate the hidden 10% commission paid to the salesman, and then add a tricky surrender charge that assures the company of its return and a built in incentive to the salesman to roll the product as soon as the charge is paid off. Add on a first year “bonus” to the product that is in fact paid for by the buyer through deductions over the later years of the contract. Finally you have a product that no informed and probing person would ever buy. But the disadvantages are artfully concealed.

Not just equity and fairness but morality and courage need to be taught. An accountant or actuary needs courage to tell management the product is misleading and bad for the buyer. Instead let the broker, agent or financial advisor earn their pay by a transparent open transaction. Fee based advice is open and involves no trickery. At least stocks and bonds are bought and sold without concealing the expense charge. Yet the life insurance business has always opposed any form of transparency in their sales process. The honest answer given by their leadership is that sales would drop substantially if customers knew how much the agent is taking out of the premiums.

Courses like NYU's on Professional Development can be helpful. But those courses are necessary but not sufficient. It seems to me that every accounting course should be infused with the important values of understanding, character and courage. When students have mastered the accounting rules for off-balance sheet entities, they should also understand the risks, have some examples of the misuse, and have those examples analyzed and examined by

their professors. Perhaps years later they will remember the judgment and wisdom of you whom they admired and they will stand up to management. Your judgment and your model will be part of the value imprint creating Amo's inner circle.

Professor Sunder in a recent paper on the *Adverse Effects of Accounting Uniformity* includes a paragraph I quote as support of imparting judgment and wisdom:

"In the absence of an authoritative standard for a class of transactions, text books, class discussion, and examinations are designed to explore various possible ways in which a transaction would be accounted for, consequences of alternative accounting treatment for various parties, and the economy as a whole. Such discourse develops the mind of students to think fundamentally, does not allow for black and white answers, and helps attract young people with powers of abstraction to the accounting profession. Exercise of judgment, after all, is a hallmark of a professional".

Using my language, the professor would highlight the kind of accounting that would be outside Amo Houghton's inner circle or even outside the broader one.

It is a tough assignment for the accounting professor but the business world desperately needs professional advice that is not just technically correct but also infused with values of integrity, the longer term outlook of the company, and the right way to conduct business.

A CEO I worked with and much admire, Jamie Dimon, frequently summed up his position with "it's just not right". And his inner circle was well within the larger circle of what everyone else was doing. When evaluating an employee he was hiring or promoting, he frequently added "he knows his North Star". And remember that Jamie Dimon was fired by Sandy Weill for refusing to promote Weill's unqualified daughter and thereby lost the apparently obvious path to the CEO position of Citigroup. He could not do what Sandy demanded, because simply, it was not right. He was fired, a terrible blot on the reputation of Sandy Weill, but a great example of a profile in courage for Dimon. Jamie's exceptional subsequent success at JPMorgan Chase could not be foreseen but is surely gratifying to all who followed his career.

Can we somehow teach our future controllers and auditors stories about the Jamie Dimon's of the world. Don't we have an obligation to point them to the North Star in the confusion of a complex business world filled with myriad and confusing temptations. I appreciate that teaching the basic material needed to be a competent accountant is no small task. On the other hand, infusing that with a moral sense will bring it to all to life and make an accounting course a much more memorable and exciting experience. "It sure isn't bean counting".

I close by returning to Amo Houghton's circles and his grandfather's advice. A crucial input to the defining of the inner circle is the memory of the values and standards of respected professors. I hope you welcome that challenge.

Thank you.