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Corporate Accounting and Disclosure:

A Diagnosis of the Problem

Corporate governance has evolved over the past century to more effectively promote the allocation of the nation's savings to its most productive uses. And, generally speaking, it has served us well. We could not have achieved our currently level of national productivity if corporate governance was deeply flawed.

And yet, our most recent experiences with the bankruptcy of Enron, and preceding that, a number of lesser such incidents, suggest that the practice of corporate governance has strayed from our perceptions of how it is supposed to work. By law, shareholders own our corporations and direct the allocation of corporate resources in an endeavor to maximize the value of the firm. To the extent they succeeded, they foster the optimum allocation of capital in our economy.

But as our economy has grown, and our corporations have become ever larger, de facto shareholder control has diminished: ownership has dispersed, and few shareholders have sufficient stakes to individually influence the choice of boards of directors or the chief executive officer. The vast majority of corporate share ownership is for investment, not to achieve operating control of a company, notwithstanding relatively infrequent instances of "hostile" takeover attempts.

Thus, it has increasingly fallen to the CEO to guide the corporation, hopefully in what he or she perceives to be in the best interests of shareholders. The boards of directors appointed by shareholders are in the overwhelming majority of cases chosen from the slate proposed by the CEO. But for the most part, despite providing limited incentives for board members to safeguard shareholder interests, this paradigm has worked, and still works, well.

The CEO sets the business strategy of the organization and strongly influences the choice of the accounting practices that measure the ongoing degree of success or failure of that strategy. Outside auditors are generally chosen by the CEO or by an audit committee of CEO-chosen directors. Shareholders usually perfunctorily affirm such choices.

To be sure, a CEO can maintain control over corporate governance only so long as companies are not demonstrably in difficulty. When companies run into trouble, the carte blanche granted CEOs by shareholders is withdrawn. Existing shareholders or successful "hostile" bidders for the corporation will then displace boards of directors and CEOs. Such changes in corporate control have been relatively rare, but more often than not have contributed to a more effective allocation of corporate capital.

Realistically, markets have no alternative but to depend on the CEO to ensure an objective evaluation of the prospects of the corporation. Outside of those relatively few large pension funds and other institutional investors, few existing or potential shareholders have the research capability to analyze corporate reports and thereby judge the investment value of a corporation. This service has become dominated by institutions in the business of underwriting and/or selling securities. And, unfortunately, history indicates that long-term earnings forecasts of brokerage-based security analysts, on average, have been persistently overly optimistic. Presumably this is because firms that sell securities are disinclined to hire analysts with a bearish inclination.[1]

Prior to the last few decades, earnings estimates were not nearly so important an element in assessing the value of corporations. Instead investors could rely on dividends, which more closely tracked earnings and were interpreted as a reliable indicator of long-term earnings prospects.[2] But since the early 1980s corporations increasingly have been paying out cash to shareholders in the form of share repurchases rather than dividends. The substitution of share repurchases for dividends seems to have been driven by diminished concerns that repurchases could be considered market manipulation and by a desire to manage shareholder dilution from employee stock options. Investors appear to have accepted dividend pay-out ratios at a fraction of their earlier levels, and now seem of necessity to pay augmented attention to earnings.

Unlike cash dividends there is no unambiguously “correct” statement of earnings. Most assets are valuable because they can produce future income. But an appropriate judgment of that asset value depends critically on a forecast of forthcoming events that by their nature are uncertain. How one chooses to evaluate the future income potential of the balance sheet has significant impact on reported earnings. Even decidedly off-balance sheet entries, such as defined benefit pension plans, require assumptions of future returns that markedly impact corporate pension contributions, and hence, earnings.

Attention to earnings was galvanized by the emergence of an elevated upward ratcheting of productivity growth that propelled long term earning growth potentials higher, and in tandem raised price-earnings ratios. Owing to the broad flexibility of allowable assumptions under GAAP, uncertainty about the rate of productivity growth enhanced uncertainty about long term earnings projections. Quarterly earnings results have become increasingly subject to anticipation, spin, and rumor. CEOS, under increasing pressure from the investment community to meet elevated expectations, in too many instances have been drawn to accounting devices whose sole purpose is arguably to obscure potential adverse results. Outside auditors, on several well publicized occasions, have sanctioned such devices allegedly for fear of losing valued corporate clients. It is not surprising that since 1998 earrings restatements have proliferated.

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[1] The performance of analysts may be improved as a result of the recent initiative by the NASD and NYSE to require research reports to include the distribution of an analyst’s ratings and historical stock price graphs that plot when analysts issued recommendations. But it could be further improved if the NASD and NYSE systematically tracked the ex-post performance of analysts’ recommendations by brokerage firm and compiled and published comparisons of performance. The market could then assess the credibility of the firms, which, in turn, would reward or punish the performance of individual analysts. The market value of security analysts rests on their credibility.

[2] A half century ago, dividend yields on stocks typically average 6% when AAA corporates were yielding 3%. Today, dividend yields are barely above 1% while AAA corporates yield about 7%.

In this environment, a disturbing amount of corporate accounting has come to rest on little more than conforming to the principles of GAAP without endeavoring to judge whether the companies' accounts in total do, in fact, represent a full and accurate portrayal of the current financial state of the corporation.

So long as the corporate duty to disclose is viewed as limited to conforming to GAAP, disclosures will remain inadequate. Both the standards and the standard-setting process undoubtedly can and should be improved. But absent a fundamental change in the perception of the duty to disclose, firms will have incentives to continue to game the accounting system.

Such a change in perception may already be occurring. The sharp decline in stock and bond prices following Enron's collapse has chastened many of the uncritical practitioners of such gaming the accounting system. Out of the ashes of the Enron debacle corporate reputation is fortunately reemerging as a significant economic value. Markets are evidently beginning to put a price/earnings premium on reported earnings that appear free of "spin." Likewise, perceptions of the reliability of firms' financial statements are increasingly reflected in yield spreads on corporate bonds. Corporate governance is, doubtless, measurably improving as a result of this greater market discipline in the wake of the Enron Debacle.

But much more needs to be done. It is important for current corporate governance practice to further realign itself with the de jure model that served us so well in the past. The convergence must come primarily from changes in incentives for corporate officers.

Stock options are a highly desirable means of compensation to align corporate officer incentives with those of shareholders. Nonetheless, we believe that the accounting for options has created some perverse effects on the quality of corporate disclosures. The failure to include, as permitted, but not required, by FASB in 1995, the value of most stock option grants as employee compensation and, hence, to subtract them from pretax profits, has artificially increased reported earnings and presumably stock values. The Federal Reserve staff estimates that the substitution of option grants for cash compensation added about 2-1/2 percentage points to reported annual growth in earnings of our larger corporations between 1995 and 2000. One must assume that this led to some misallocation of the nation's capital assets, especially in the high-tech sector.[3]

While many of the desire adjustments in corporate governance are doubtless already in train, public policy will need to encourage and sustain those initiatives. In particular, it may be appropriate to define more clearly the duties of CEOs with respect to accounting and disclosure and to introduce

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[3] Federal Reserve analysis indicates a significantly higher degree of stock price volatility of those corporations that were relatively aggressive in their use of stock option grants. The stock prices of such firms also appeared to have risen more sharply in 1999 and early 2000 compared with stocks of firms with relatively less than expected option grants. Doubtless higher reported earnings drew increased capital investment in high tech firms, but arguably, in retrospect, much was misused. It is conceivable, of course, that the undoubted gains in national productivity may have been facilitated by an "excess" of investment in high tech industries. This presumably will become clear only in retrospect.

regulatory mechanisms and penalties that will supplement and reinforce the market incentives for disclosures that establish trust and goodwill with investors.

But we need to emphasize that official oversight and enforcement has, over the years, proven only partially successful in dissuading individuals from gaming the rules of corporate governance and accounting to serve their own narrow interests. It has proven quite difficult to engage on an ongoing basis a group of directors who see their interests as separate from those of the CEO, who effectively appointed them, and presumably, could remove them from future slates of directors submitted to shareholders. There are, without question, a significant number of directors who are fully independent of the CEO, but it is doubtful that many corporate boards are dominated by them.

More generally, laws could be passed to force selection of slates of directors who are patently independent of CEO influence, and thereby significantly diminish the role of the CEO. We suspect, however, that such an initiative, while ensuring independent directors, would create competing power centers within the corporation, thereby diluting coherent control and impairing effective governance.[4]

Likewise, efforts to make auditors independent of the CEO would not be without cost. Some proposals, such as prohibiting auditors from providing consulting services in such areas as tax preparation and audit-related data processing are likely, in fact, to do harm and very little good. Nonetheless, as in the case of CEOs, it may be useful to clarify for auditors that their duties are not limited to ensuring that a firm's financial statement conforms to GAAP. Instead, part of an auditor's duty to the CEO is to help the CEO meet his or her disclosure obligation. Here too, it may be possible to introduce regulatory mechanisms to create supplementary financial and legal incentives for auditors to fulfill their duties.

After evaluating alternate forms of corporate governance, we conclude that the current CEO-dominant paradigm, with all its faults, still appears to be the most viable alternative. All of our experience confirms that if the CEO chooses to govern in the interests of shareholders, he or she can, by example and through oversight, induce corporate colleagues and outside auditors to behave in ways that produce de facto governance that matches the de jure shareholder-led model that appears so effective in achieving the optimum allocation of the nation's corporate capital.

As already discussed, however, changes in critical areas of governance to align CEO interests more closely with those of shareholders in our judgment are essential and, indeed, overdue. The stock market has begun to place a premium on corporate disclosures that inspire trust. Government policy can, and should, reinforce this powerful market incentive.

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[4] Merely appointing directors without financial ties to the corporation will not create an "independent" director unless directors' fees are measurably lowered, which in turn, might deter effective candidates for a board. That would doubtless prove counterproductive to good governance.