**Sarbanes-Oxley**

**In Week 1 we studied the general importance of the "rules of the game" (property rights and the rule of law) to a well-functioning economy. This week, we focused in more closely on the "rules of the game" regarding corporate governance and financial reporting. The Week 6 topic of fraudulent financial reporting relates to corporate top management that enriches itself and abandons its obligations to shareholders, employees, creditors, government, and the general public.**

**The Agency Problem**

**Economists call this failure of duty the problem of "agency." Top management is supposed to be the fiduciary (faithful agent) of the shareholders that own the enterprise. But a corrupt agent neglects fiduciary duty to the principal in favor of his/her own selfish interest. Lawyers refer to this same problem as a failure to perform “fiduciary duty” and a "conflict of interest." Ethicists see the problem as deviation from moral conduct. But, whatever terminology is used, the problem remains the same: how can the management agency be kept faithful to its fiduciary duty to the owners, and to the other stakeholders (employees, creditors, government, and the general public)?**

**This is a fundamental and difficult problem. The founders of the United States confronted it in attempting to create a federal government that would be powerful enough to perform its functions, but not so powerful that it would become as oppressive to Americans as the English government the American Revolution had overthrown. The founders used the Constitution to achieve these objectives by the means of the separation of powers, the Bill of Rights, and various checks and balances.**

**The SEC and Full Disclosure**

**After the great depression of the 1930's the U.S. government formed the Securities and Exchange Commission (SEC) to oversee the U.S. financial markets. The basic policy of the SEC has been to promote transparency in corporate finance by requiring corporations to make full disclosure of their financial performance to their stockholders and bondholders. The guiding concept is that "sunshine is the best disinfectant." Among the devices used to create the sunshine of full disclosure are the legal requirements for public companies to issue:**

* **Quarterly financial statements, reviewed[[1]](#footnote-1) by independent auditors,**
* **Annual financial statements subject to compulsory independent audits,**
* **All public company financial statements in conformity with GAAP.**

**The benefits to society from financial transparency are efficient capital markets that link investors with businesses seeking funds. Efficient capital markets lower the cost of capital by reducing the risks to investors from fraud and from other undisclosed business hazards. When financial reporting becomes corrupted, capital markets lose efficiency, and the cost of capital increases due to the increased risks. In fact, the efficient functioning of free markets is totally dependent on ethical conduct. Corruption in public or private sector organizations does extreme damage to the economy and to the fabric of society.**

**Under the full disclosure approach, independent auditors, corporate directors (especially independent directors), and the SEC are key players that serve as checks and balances on corrupt top managements and provide the sunshine that disinfects. Unfortunately, in recent years independent auditors, corporate directors (especially independent directors), and the SEC have sometimes failed to play their important roles, and many corporate top managements have become dominant and unrestrained. This increasing power and lack of restraint of corporate top managements has been evidenced in many ways, including the following:**

* **Exorbitant executive pay, including vastly excessive salaries, bonuses, and "perks."**
* **Large increases in executive pay despite poor corporate financial performance or even the incurring of losses.**
* **Repricing of "underwater" stock options to more favorable terms, even in the face of declining financial results.**
* **"Evergreen" stock option plans that are renewed without stockholder approval**
* **Boards of directors who are handpicked by top management to be docile, and who are seduced by lavish pay, lush benefits, generous "perks", and lordly privileges.**
* **The "race to the bottom" where corporations register in states (such as Delaware) that have the most lax corporate laws and that make it difficult for reformers to sue or challenge corporation managements.**
* **Adoption of corporate devices such as "poison pills", "golden parachutes", "golden handcuffs", "white knights", "greenmail", and staggered terms of office for directors in order to insulate and protect incumbent management from corporate raiders[[2]](#footnote-2) and dissident investors.**
* **The large and increasing percentage of corporate securities being held by passive institutional investors such as public and private pension funds, mutual funds, trusts and foundations, college and university endowment funds, and other organizations that feel no incentive or experience no pressure to oppose corporate top managements that are not maximizing stockholder value.**

**Watchdogs or Lapdogs?**

**Auditors have a clear and compelling duty to report honestly and to resist management pressure to close their eyes to fraudulent financial reporting. But, in some cases, auditors have buckled under or - even worse – actually facilitated fraudulent financial reporting. There is no excuse for these lapses. But, from a pragmatic point of view, auditor lapses can be expected when some corporate directors have become CEO poodles, and the SEC has at times fallen asleep at the switch. Despite the failures of directors and regulators to act as and when they should, it is hoped that CPA's will do their moral duty. However, it is realistic to fear that some CPA's will fail as watchdogs, and turn into lapdogs.**

**Sarbanes-Oxley**

**Sarbanes-Oxley (SOX) was cobbled together by a Congress feeling pressure to "do something" quickly, and it has several flaws. It also has some virtues, mainly because it raises the risks to transgressors, and increases the penalties to those who are found out to be corrupt. Large fines or liability to pay large money damages may not intimidate top executives. But the prospect of going to prison induces fear even in hard core crooked executives. But SOX does too little to reverse rampant management power or to create substantial countervailing forces among passive institutional investors, or other potential power players.**

1. **SOX does something, but not enough, to encourage whistle-blowers, who could become important guardians of financial integrity if they were provided with protection against retaliation by corrupt management, and encouraged to speak out by substantial rewards.**
2. **SOX does little to protect auditors from being fired if they resist pressures from corrupt top management. It would not have been difficult to put substantial hurdles in the way of any top management seeking to get rid of auditors who displayed too much backbone. For example, SOX could have required a 75% majority vote of stockholders to dismiss an auditor, and also perhaps automatically triggered an SEC investigation whenever an auditor was fired.**
3. **SOX does little to provide funds to compensate stockholders for losses caused by corrupt management, or to compensate employees who lose their jobs and their retirement pensions due to losses caused by corrupt management.**
4. **SOX imposes significant extra expense upon corporations, much of which is for improvement to internal control systems. In my opinion this is largely a waste.** 
   1. **First, internal controls are easily defeated by collaboration of two or more employees, or by top management overrides. In fact, all of the major financial reporting frauds, such as Enron, were overrides of controls by top management.**
   2. **Second, upgrading internal controls are by far the most expensive part of SOX. Therefore it seems that the most costly part of SOX is the part least likely to be effective.**

**These rigid legal requirements cause significant expense, but are not subject to a cost-benefit test of effectiveness.**

**Myths**

**In analyzing the issues related to fraudulent financial reporting, there are several common myths that can hamper understanding. Here are some of these myths that may sound plausible, but are actually false.**

* **"Generally accepted accounting principles are vague and ambiguous." This is not true. In occasional cases there are some unclear issues. But these are the exception and not the rule. For the most part GAAP are reasonably clear and well defined. GAAP are continuously revised and updated to remove loopholes, clarify ambiguities, and block end runs. In any case, it has long been the SEC rule that complying with GAAP is necessary, but not sufficient, to meet the legal standard of full disclosure. It is also an SEC requirement that the financial statements must not be misleading in any material sense, and must make full and fair disclosure of all material information. The claim that GAAP are "vague and ambiguous" usually signals a party that has an ax to grind, and who thinks the audience is sufficiently gullible to swallow this misleading claim. In any event, virtually all of the recent fraudulent financial reporting scandals involved clear and convincing violations of GAAP. So GAAP vagueness and ambiguity were not relevant issues.**
* **"Cash flow is a more reliable indicator of performance than net income or any other accrual accounting measure." This claim is sometimes made by people who are trying to mislead, or naive enough to believe this fiction. The truth is that cash flow is an unreliable indicator of performance. Consider a business that sells on credit. This year it makes sales of $10 million, and next year sales increase to $12 million. This year it collects cash of $11 million from customers, but next year it collects only $9 million in cash from customers. Which is the better indicator of performance: sales increasing from $10 to $12 million, or cash collections from customers decreasing from $11 to $9 million? Continuing this example, say the business purchases new equipment next year for $20 million in cash. Should this entire expenditure of $20 million be charged to expense next year, as cash accounting would require, or should the $20 million be charged to expense over the expected equipment service life of 5 years? Clearly, cash flow is not as reliable an indicator of performance as accrual accounting. That is why GAAP requires accrual accounting to be used. Further, cash flow is easy for a corrupt management to manipulate. Want to report higher earnings this year? Just collect receivables faster by offering larger cash discounts, slow down payments to suppliers, and postpone plant maintenance. Want to report lower earnings? Do the opposite.**
* **GAAP is too dependent on soft numbers and estimates made by management for contingencies such as allowances for uncollectible accounts, depreciation and amortization of fixed assets, and other imprecise amounts. It is true that financial statements are dependent on estimates of this kind, which are inherently inexact. As that great philosopher Yogi Berra said, "Predictions are difficult, especially if they are about the future." But, while it may not be possible to be exact, it is often possible to analyze whether an estimate is reasonable or at least within a reasonable range. It is better to be roughly right than to be precisely wrong.**

**Restatements of previously published financial statements**

**Probably the best indicator of accounting and auditing failures is when a corporation restates its previously issued financial statements. Restatements are required by law when material misstatements are found to have occurred in previously issued financial statements. These restatements are sometimes proper and appropriate due to mergers and acquisitions, (which is a legitimate, but infrequent, reason for restatement).**

**Restatements (other than the legitimate few) should be viewed with skepticism. In the case of public companies, the materially misstated financial statements had been produced by the professional accountants who regularly perform this task inside corporations, and had been audited by the outside independent auditors. It seems very unlikely that material misstatements would not be detected by the inside professional accountants or by the outside independent auditors. A reasonable suspicion is that the material misstatements were not accidental, but rather deliberate. In other words, one suspects fraud.**

**It is an acute embarrassment to a corporation, and to its outside auditors, when the audited financial statements that had been issued have to be restated. Corporations and their auditors have every incentive to avoid this embarrassment by getting the financial statements right the first time around. Naturally everything of a material nature would be very carefully checked to ensure that it is correct and in compliance with GAAP. One would think that restatements would very seldom be required if management was honest and audits were thorough. One would also think that restatements are a sign that the auditors had failed.**

**Most restatements are a red flag, and raise a suspicion of fraud. That is why restatements are considered an  indicator of accounting and auditing failures. And that is why there are studies published every year about financial statement restatements. In past years, restatements were rare. In recent years, they have become more frequent.**

**Here is a website where you can read all about the nature and frequency of restatements.**

[**http://www.huronconsultinggroup.com/general01.asp?id=539&relatedResourceID=515**](http://www.huronconsultinggroup.com/general01.asp?id=539&relatedResourceID=515)

**Early Warning Signs**

**Last, but not least, are there signs that can foretell that financial statements are being materially misstated? There is no sure-fire indicator. But there are clues that can warn one of potential trouble ahead. Here are some examples:**

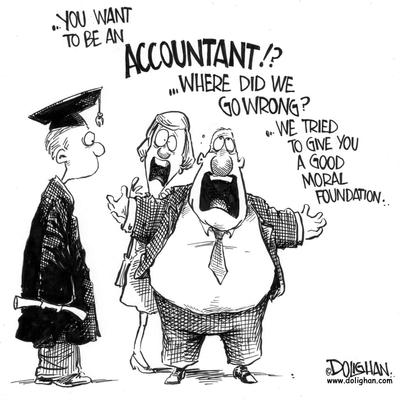
* **Watch out for companies that have a unbroken string of steadily improving earnings per share. But isn't this a desirable thing? Yes, but not when it becomes imperative for management to keep the string going in order to stay in office, collect more stock options and keep stockholders quiet. That is a slippery slope that can lead to fraudulent financial reporting.**
* **Be alert for major acquisitions made by means of exchanges of stock, rather than for cash. For one thing, research has shown that stock mergers are considerably less successful over time than cash mergers. When real cash is on the line there is more pressure to succeed than when stock is used as a currency for a merger. For another thing, when stock is used as a currency for acquisitions, management has a powerful incentive to boost the stock price in order to enhance the value of their stock and make bigger acquisitions. Unfortunately one of the quickest and easiest ways to boost the stock price in a hurry is to inflate earnings by fraud.**
* **Be wary of boards of directors that include celebrities (such as retired generals, politicians, professional athletes, and entertainers – all of whom may lack business experience), or CEO's of other companies (who may sit on each other's boards or have other reasons to turn a blind eye or not to rock the boat when push comes to shove). And be wary of CEO's who frequently appear on TV, or play in celebrity golf tournaments, or serve on more than one or two boards of trustees of charities, universities, hospitals, or foundations. CEO's are paid to run their companies, not to bask in publicity or hobnob with the rich and famous.**
* **The CEO who is also Chairman of the Board. Separating these two important positions helps to create a check and balance of power. But when one person holds both of these positions, there is too much concentration of power.**
* **Exorbitant executive pay is evidence of a weak board of directors and a dominating CEO: a toxic combination.**
* **Large increases in executive pay despite poor corporate financial performance or even the incurring of losses. This too may be evidence of a weak board of directors and a dominating CEO.**
* **Read financial statement notes very closely, paying attention to:**
  + **Related party transactions (these are dealings that are not at arms length, and are therefore inherently suspect). GAAP requires related party transactions to be disclosed.**
  + **Contingencies (which may include pending lawsuits against the company for fraudulent financial reporting),**
  + **Management estimates which are of significant importance, such as:**
    - **Profits on major construction contracts, which can take years to complete, and where interim estimated profits can legitimately be recognized, but are tricky to measure and subject to future uncertainties,**
    - **Underground reserves of oil, gas, precious minerals, or coal, which are subject to revision, and which can fluctuate in value when prices fall steeply and unexpectedly,**
    - **Substantial amounts of loans receivable, which may not be fully collectible if borrowers are corrupt, unstable or lack financial substance (for example, bank loans to countries with corrupt or insecure regimes – think of the problems the French and Russians are having with getting repaid on their large loans to Iraq).**
* **Analyze financial statements and ratios very thoroughly. In particular, watch out for cases where cash from operations is falling as a percentage of funds for financing investment in the business, and cash from outside financing is a rising percentage of funds for financing investment in the business. Also be vigilant for declining short-term solvency (such as deteriorating current and quick ratios, and slowing turnover of receivables, inventories, and payables). The reason? When companies fraudulently inflate reported earnings, there is no corresponding increase in cash flow. So there is an increasing need for outside funds to prop up the company.**
* **We hear a lot about systems of internal control. These are various checks and balances designed to prevent fraud and to protect corporate assets. Examples of checks and balances are:**
  + **Requiring not one but two signatures on all company checks;**
  + **Rotation of duties, so that any employee who is committing fraud gets rotated out of that position before they can operate long term;**
  + **Separation of duties, so that someone who writes out purchase orders does not write checks to pay suppliers – which prevents someone from writing fake purchase orders followed by writing payment checks that they steal and deposit in their own bank account;**
  + **Requiring authorization of all expenditures above a certain limit, such as $5,000, in order to prevent unauthorized expenditures;**

**But, as noted above, internal controls can be defeated when:**

1. **Two or more employees collaborate, or**
2. **Top management overrides the controls, as has happened in some of the very big frauds like Adelphia, Enron, Sunbeam, Tyco and WorldCom.**
3. **An important link about top management overrides of internal control is:**

[**http://www.aicpa.org/audcommctr/download/achilles\_heel.pdf**](http://www.aicpa.org/audcommctr/download/achilles_heel.pdf)

* **Avoid companies that publish "pro forma" earnings. GAAP earnings are the legally required standard for measuring earnings. "Pro forma" earnings are a device to make disappointing GAAP earnings look better. They are cosmetics designed to cover flaws and blemishes. Managements who publish "pro forma" earnings are not trying to communicate, but to obfuscate. This is a clear red flag. Don't stand for it.**
* **Last, but not least, do not invest in stocks of only a very few companies. If just one of these companies is a future Enron, you will incur a substantial loss. So be sure to broadly diversify your stock investments. Often an index fund is the best choice for investing in stocks. Good index funds usually beat more than 80% of actively managed stock mutual funds. And high-performing stock mutual funds in one year seldom continue to be high performers in following years. Rather, they tend to revert to the mean – which is inferior to good index funds.**

****

1. A "Review" is an examination by an auditor that is less extensive than an audit, and which therefore provides a lesser degree of assurance than a full audit. [↑](#footnote-ref-1)
2. Corporate raiders often perform a useful function. They target underperforming companies in order to acquire them, to cut out lavish management "perks" and manage more efficiently in order to improve returns to investors. [↑](#footnote-ref-2)