RESEARCH IN ACCOUNTING REGULATION

VOLUME 17

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PART I:
MAIN PAPERS

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SHELF REGISTERED SECURITIES: IS IT TIME TO RE-EVALUATE THE PROCESS?

Stephen R. Moehrle, Jennifer A. Reynolds-Moehrle and Pamela S. Stuerke

ABSTRACT

Firms that meet certain criteria can register debt or equity securities for issuance any time during the subsequent two years. This process is known as shelf registration. Key shelf registration qualification criteria include $75 million market capitalization held by outsiders, timely SEC filings, investment-grade ratings of debt, no defaults on debt payments, and listing on national stock exchanges. During the last few years, several visible companies have suffered quick financial collapses. Many of these companies had debt securities available for issuance from the shelf at the time of collapse. In this study, we examine shelf registrants to address whether shelf registrants of debt, on average, are riskier firms than those that do not have shelf registrations. Using various measures of risk, we assess the risk profiles of shelf registrants versus non-shelf registrants. We find that shelf registrant firms are more highly leveraged, slightly less profitable, and have greater bankruptcy probability than non-shelf registrant firms. Collectively, these findings raise concerns about the overall safety of shelf registrations, and suggest the need for regulators to reconsider the appropriate qualifications for shelf registration. The findings also suggest that investors and analysts

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should beware of the additional risk posed by the average firm that has shelf-registered debt securities.

INTRODUCTION

Securities and Exchange Commission (SEC) Rule 415 allows for the delayed or continuous offering and sale of debt or equity securities. Under Rule 415, qualifying firms can register a limited amount of debt or equity securities, or an unspecified combination thereof, and then sell them any time during a two-year period with virtually no advance notice.[1] This is commonly referred to as shelf registration of securities. Many of the firms involved in recent high-profile financial collapses (e.g. Adelphia; Enron; Global Crossing; K-Mart; WorldCom) had registered debt securities on the shelf at or near the time of their collapse. The existence of shelf-registered debt for these firms raises the question whether shelf registration has become a means for riskier firms to approach the capital markets on short notice. Investors' surprise at these collapses, evidenced by extreme market reactions, calls to question whether the current criteria sufficiently protect market participants.

The intent of Rule 415 is to afford large, high profile, and relatively stable firms additional financial flexibility. Key shelf registration qualification criteria include $75 million market capitalization held by outsiders, timely SEC filings, investment-grade ratings of debt, no defaults on debt payments, and listing on national stock exchanges. The criteria to qualify for shelf registration were intended to limit shelf registration to stable, highly visible firms. The minimum market capitalization and stock exchange listing requirements are designed to ensure shelf registrants are larger, highly visible firms about which investors have sufficient information. The criteria regarding timely SEC filings, debt ratings, and no default on payments are all related to the risk of the firm. In this study, we examine the relative risk of shelf registrants to provide evidence regarding the effectiveness of the shelf qualification criteria. First, we set forth the criteria that firms must meet to qualify for shelf registration. Next, we provide a general comparison between debt shelf registrants and non-shelf registrants. Finally, we assess whether average risk profiles differ between these shelf registrants and non-shelf registrants.

We find that primarily larger firms shelf register securities. However, some small firms take advantage of shelf registration as well. In contrast to the apparent intent of Rule 415, we find that firms with shelf-registered securities, on average, are more highly leveraged, slightly less profitable, and have a greater bankruptcy risk. Our findings suggest a need for regulators to consider revising the shelf registration qualification criteria to ensure that the criteria provide adequate

protection for investors while still affording appropriate firms the advantages of shelf registration. The results also suggest that investors and analysts should beware of the additional risk related to firms with shelf registered debt securities.[2]

BACKGROUND: SHELF REGISTRATION

In February 1982, the SEC first authorized Rule 415 for an experimental period of nine months, with the intent of simplifying firms' access to capital markets. They extended the experimental period in September 1982, and permanently adopted the rule in November 1983. Rule 415 permits qualifying firms to offer and sell debt or equity securities in the primary market up to two years after registering the securities.[3] Rule 415 also allows for registration of securities for issuance on the secondary market pursuant to dividend reinvestment plans, outstanding options, convertible securities, or collateral for the same period of up to two years.

Originally, only larger firms qualified for shelf registration, under the assumption that there was sufficient information available about these firms.[4] Denis (1993) summarized the original qualifications for shelf registration as follows:

> (1) The aggregate market value of shares held by investors is greater than $150 million, or greater than $100 million if the annual trading volume in the firm's shares exceeds 3 million shares; (2) the firm has not defaulted on any debt, preferred stock, or rental payments in three years; (3) the firm meets all SEC disclosure requirements in the previous three years; and (4) the firm's debt is investment grade.

However, thresholds for some of the shelf registration criteria have been reduced from the initial requirements, while changes in the economy have made some of these thresholds far more achievable. In 1993, the SEC relaxed the first three of these criteria. Firms now need only $75 million of market capitalization held by outsiders (market float) to qualify for shelf registration. This is a substantial change considering that the original requirement of $150 million was at 1982 price levels, and based on the 1982 stock market, when the Dow Jones Industrial Average was less than 1000.[5] Further, the relevant time period for the second criterion was reduced to the time since the end of the last fiscal year versus three years, and required timely reporting history was reduced to the last 12 months.[6] All three of these changes made shelf registration substantially more accessible for companies.

PRIOR LITERATURE AND RESEARCH QUESTIONS

The SEC's goal is to ensure that issuers provide adequate, timely, and truthful disclosure so that investors can make informed decisions. Opponents of shelf

registration argue that the risk of material misstatements or omissions in the issuer's registration statement is increased because underwriters do not have time to conduct thorough due diligence procedures.[7] Evidence in Blackwell et al. (1990) suggests that underwriters charge higher fees for shelf issues than for non-shelf issues to compensate for the additional risk introduced by reduced time for due diligence procedures. Supporters of shelf registration argue that reduction of due diligence is not detrimental to investors. Blackwell et al. (1990) summarize reasons for this belief as follows:

> (1) The system of integrated disclosures ensure that relevant corporate information is available to investors; (2) firms eligible for shelf registration are likely to be followed by several analysts who provide timely information to the market; (3) the market for underwriting services penalizes any firm attempting to deceive the market; and (4) many shelf registered issues are purchased by large securities dealers who conduct their own thorough investigation of the issues.

The flexibility of shelf registration allows firms to respond quickly to financing needs, and to issue the securities at favorable market prices (i.e. issue stocks when prices are high or issue bonds when rates are low) and maximize proceeds. Kadapakkam and Kon (1989) find price increases before shelf issues and price declines after the issue, which suggests that firms are able to effectively time the issuance of shelf registered securities. In addition, there is mixed evidence that shelf registration may lower underwriting costs by creating increased competition among investment bankers. Bhagat et al. (1985) find that equity issue costs are lower for shelf issues than for non-shelf issues. Kidwell et al. (1984) and Rogowski and Sorensen (1985) find that debt issue costs are also lower for shelf issues than for non-shelf issues. However, Allen et al. (1990) and Denis (1993) argue that underwriting cost reductions for debt and equity issues respectively, demonstrated by the above studies, are overstated because of a selection bias. Firms that select shelf registration experience lower underwriting costs for shelf or non-shelf issues. The conclusions in the earlier research described above were based on firms meeting the original, more stringent, criteria for shelf registration.

While prior research has scrutinized issues pertaining to due diligence, the risk of firms that choose financing through shelf registration has not been examined. Shelf registration qualification is based on the assumptions that: (1) firms that meet the SEC's criteria are large, well known, and reputable; and (2) additional financial flexibility should be available to the large, well-established firms qualifying for shelf registration. Considering that Tyco, Enron, Adelphia, K-Mart, WorldCom, and Global Crossing all had shelf registered securities available for issuance at or near the time of their descent into bankruptcy, this assumption

warrants examination. In this study, we examine the relative risk profile of shelf registrants for debt or a combination of debt and equity securities. We test whether shelf registrants are more, less, or similarly risky relative to non-shelf registrants. Our overarching goal is to provide information to regulators regarding whether current shelf registration criteria warrant reexamination.

SAMPLE SELECTION, DESCRIPTIVE STATISTICS AND RESULTS

Our sample period is 1993–2001. We chose this period because shelf registration qualification was reduced to one year for timely filings and no defaults on debt beginning in 1993, and was maintained throughout this period. We present descriptive statistics and tests on an annual basis to avoid including observations of the same firm at different points in time, thereby maintaining independence within our tests. Table 1 contains descriptive statistics of firms that conducted shelf registrations for debt or a combination of debt and equity, and firms that did not conduct shelf registrations during the period 1993–2001.[8] We provide data related to market value, total assets, revenues, net income, earnings per share, book to market, gross profit margin, return on equity, and debt to equity.

The minimum market capitalization requirement for shelf registration qualification is rooted in the notion that ample information is available about larger firms such that the risks associated with shelf-registered securities are mitigated. Indeed, we find that most registrants are very large firms. Mean and median market value and total assets for shelf registrants are consistently greater by a magnitude of several times that of non-shelf registrants.

While shelf registrants are large on average, two potential problems remain. First, even very large firms can go bankrupt quickly and unexpectedly, as Enron and WorldCom demonstrated. Second, while small firms do not shelf register securities nearly as often as larger firms, some smaller firms do. Thus, quick issuance of securities with deteriorated fundamentals that are not yet detected remains a possibility. Median and mean revenues, net income, and earnings per share are larger for shelf registrants roughly proportionate with the greater size of the average shelf firm. The median and mean shelf firm also has greater return on equity than non-shelf registrants, but the shelf registrants have considerably higher mean and median debt-to-equity. The latter finding suggests a higher risk of default. In the following sections, we compare key risk and profitability variables to obtain a more sophisticated risk profile of shelf-registering firms.

Table 1. Descriptive Statistics: Non-shelf Registrants and Shelf Registrants for the years 1993–2001.

Year	Non-Shelf Registrants				Shelf Registrants			
	N	Mean	Median	Std. Dev.	*N*	Mean	Median	Std. Dev.
2001								
Market value	4,515	7,372.26	413.85	47,216.99	101	10,963.26	4,840.03	17,179.85
Total assets		5,597.47	522.41	32,970.66		36,790.35	8,255.01	82,152.00
Revenues		2,386.24	303.90	8,988.02		11,195.63	3,940.82	25,799.46
Net income		25.18	5.59	926.87		123.17	165.30	1,435.41
Earnings per share		0.037	0.350	14.28		0.382	1.250	3.80
Book to market		0.443	0.509	6.27		0.598	0.519	0.46
Gross profit margin		−220.59	37.96	8,567.00		23.49	33.74	140.85
Return on equity		155.48	5.59	12,900.47		−118.85	8.14	1,825.65
Debt to equity		54.55	36.14	1,947.24		113.52	125.48	1,136.29
2000								
Market value	5,326	3,472.76	285.19	15,701.27	246	16,394.69	3,085.32	47,004.47
Total assets		5,431.21	430.68	32,651.24		27,214.66	3,817.85	76,814.35
Revenues		2,319.56	262.01	9,154.56		9,522.26	2,276.63	20,983.32
Net income		117.19	7.98	713.77		497.71	122.60	1,658.58
Earnings per share		0.709	0.520	47.76		0.911	1.120	3.01
Book to market		1.678	0.563	60.55		0.542	0.378	1.33
Gross profit margin		−149.15	37.95	4,866.98		−79.06	32.87	891.21
Return on equity		−10.07	7.81	257.94		7.50	11.08	106.19
Debt to equity		89.51	38.30	504.83		125.66	88.00	326.48
1999								
Market value	3,478	4,545.26	358.50	24,666.69	221	20,049.90	3,706.55	57,622.34
Total assets		3,656.27	326.23	20,856.78		21,279.16	5,608.99	55,142.07
Revenues		2,196.87	277.03	8,661.58		10,438.60	2,869.01	22,902.68
Net income		103.26	8.27	524.26		653.88	151.26	1,511.16
Earnings per share		0.726	0.490	24.99		1.438	1.430	2.77
Book to market		0.612	0.445	2.62		0.519	0.429	0.49
Gross profit margin		0.170	34.51	424.47		34.87	33.74	53.08
Return on equity		3.94	8.27	339.14		4.16	11.91	84.82
Debt to equity		68.15	37.41	691.05		206.42	98.03	463.89
1998								
Market value	5,799	2,761.60	209.95	16,452.75	317	11,514.65	3,122.28	29,342.49
Total assets		3,683.95	299.35	22,627.00		20,606.47	5,051.50	51,481.84
Revenues		1,714.59	202.47	7,200.59		7,265.59	2,574.40	16,120.91
Net income		78.61	7.09	401.87		443.80	135.26	1,526.63
Earnings per share		0.234	0.540	75.78		1.366	1.370	3.178
Book to market		0.931	0.509	15.09		0.519	0.450	0.668
Gross profit margin		−41.46	36.40	2,281.92		31.71	35.87	106.40
Return on equity		−1.36	9.04	539.77		9.65	12.18	43.91
Debt to equity		104.08	41.30	734.97		198.00	112.95	317.90
1997								
Market value	5,718	2,218.96	254.81	8,910.10	254	7,971.49	3,049.09	19,707.17
Total assets		3,449.59	250.52	20,505.45		17,776.81	4,341.63	48,856.79
Revenues		1,675.63	179.93	7,192.47		6,080.33	1,894.92	13,740.21
Net income		84.49	7.41	393.25		373.15	126.76	947.84
Earnings per share		−0.759	0.560	46.25		1.327	1.290	2.274
Book to market		−0.756	0.399	85.36		0.401	0.378	0.279
Gross profit margin		51.34	36.52	5,736.77		17.93	37.37	324.01
Return on equity		−0.74	9.91	368.02		8.318	12.79	46.35
Debt to equity		105.70	36.25	1,660.25		189.82	104.23	378.17

Table 1. *(Continued)*

Year	Non-Shelf Registrants				Shelf Registrants			
	N	Mean	Median	Std. Dev.	*N*	Mean	Median	Std. Dev.
1996								
Market value	4,549	1,774.85	216.97	6,864.26	207	7,622.34	3,095.61	15,348.17
Total assets		3,195.60	235.97	18,003.75		19,831.37	3,700.90	49,750.56
Revenues		1,643.37	172.61	7,132.54		6,722.13	2,324.59	14,898.78
Net income		82.26	7.73	369.19		433.40	153.83	841.15
Earnings per share		−0.510	0.520	53.71		1.337	1.38	1.509
Book to market		0.490	0.451	0.768		0.425	0.406	0.223
Gross profit margin		−16.48	35.89	786.08		25.489	37.05	155.73
Return on equity		−11.47	9.95	747.89		16.21	13.70	48.40
Debt to equity		118.20	33.85	1,543.19		184.53	96.20	345.95
1995								
Market value	3,652	1,526.51	208.79	5,850.41	198	6,698.28	2,891.55	11,672.93
Total assets		2,993.78	235.81	16,467.67		18,097.15	4,372.80	43,179.69
Revenues		1,587.65	190.45	6,616.75		6,512.15	2,647.81	12,694.08
Net income		77.85	7.80	356.89		397.71	180.30	731.73
Earnings per share		−1.154	0.558	55.74		1.392	1.268	1.73
Book to market		0.498	0.471	2.03		0.471	0.461	0.27
Gross profit margin		−58.54	34.92	2211.14		32.58	34.92	93.90
Return on equity		27.53	10.71	735.22		11.00	13.25	27.47
Debt to equity		67.49	34.58	573.84		229.70	107.09	425.34
1994								
Market value	3,359	1,307.42	187.31	4,280.86	180	6,228.20	2,702.33	11,357.97
Total assets		3,332.84	249.03	16,625.50		18,569.67	5,426.57	36,424.52
Revenues		1629.42	207.14	6,356.33		7,620.81	2,914.70	15,457.60
Net income		77.47	9.54	297.52		425.00	155.70	797.32
Earnings per share		−0.554	0.580	38.81		1.210	1.250	1.76
Book to market		0.579	0.520	0.65		0.590	0.587	0.28
Gross profit margin		−101.79	34.52	3687.32		35.78	32.19	19.35
Return on equity		15.18	11.34	813.02		15.63	13.16	45.94
Debt to equity		78.50	36.38	393.13		214.05	105.75	454.44
1993								
Market value	2,811	1,401.92	218.42	4,440.07	230	6,250.09	2,717.45	10,420.42
Total assets		3,223.14	239.77	15,827.62		16,095.63	5,143.52	32,438.06
Revenues		1,761.92	206.38	8,461.72		6,387.09	2,742.41	11,664.54
Net income		57.17	7.90	263.92		277.06	137.03	835.12
Earnings per share		0.08	0.48	30.15		0.120	1.07	11.31
Book to market		0.520	0.47	0.47		0.495	0.51	0.29
Gross profit margin		−39.731	34.46	1297.08		22.81	30.80	153.70
Return on equity		14.30	10.85	458.69		7.20	12.71	55.64
Debt to equity		147.61	34.11	3955.48		195.26	100.91	598.81

Note: Market value: Market capitalization, measured as stock price multiplied by number of shares outstanding at year-end. Total assets: Total assets at the end of the indicated year. Revenues: Total revenues for the indicated year. Net income: Net income for the indicated year. Earnings per share: Earnings per common share for the indicated year. Book to market: [Book value of common equity/Market value of common equity]. Gross profit margin: [Sales − Cost of goods sold/Sales]. Return on equity: [Net income/Total common equity]. Debt to equity: [Total debt/Total stockholders' equity].

Relative Risk of Firms with Shelf-Registered Securities

To develop a relative risk profile, we compared firms with shelf-registered debt or combined debt/equity securities (shelf firms) to firms that do not have shelf-registered securities (non-shelf firms). For each year, we divided our sample into five groups. The first group is comprised of firms with a market capitalization less than \$75 million.[9] We divided the firms with market capitalization greater than \$75 million (potential shelf-registration firms) into quartiles partitioned on size, measured as market capitalization (small, medium, large, giant). The number of observations in certain quartiles differs because of missing data for one or more of the variables.

There are 41,167 firm-years for which market value data is available in our sample period. Of these, 26,947 had market value greater than \$75 million (one of the shelf registration qualification criteria), and 1,954 had shelf-registered securities. The data suggests that filings for shelf registration are most prevalent among the larger firms. Over the sample period, 89.6% of the 1,954 firms with shelf-registered securities were in the large or giant groups. Thus, while shelf registration is available to all firms with market capitalization greater than \$75 million that meet the other requirements, most firms choosing to conduct shelf registration of securities are very large.[10] In fact, there were no shelf-registrant firm-year observations in the small firm quartile in 1993 and 1994. This finding is indicative of the diminishing relevance of the fixed \$75 million criteria.

We examine market valuation measured as book value to market value, leverage measured as the debt-to-equity ratio, profitability measured as return on equity, and a summary bankruptcy measure – the Altman's Z-score (Altman, 1968).[11] The results are summarized in Tables 2–5. We find that shelf-registrant firms are more risky in terms of leverage, profitability, and bankruptcy risk. Table 2 presents results for firms in the first quartile of all firms greater than \$75 million in market capital (small firms). Tables 3–5 present results for firms in the second quartile (medium firms), third quartile (large firms), and fourth quartile (giant firms), respectively. Numbers of shelf registrants in the small and medium firm quartiles are small, especially in the earlier years in the study. Thus, comparisons in these quartiles are less meaningful. As a result, while statistics for these quartiles are presented, our discussion of results emphasizes the findings for the large and giant firms, where the numbers of shelf-registrant firm-year observations are larger. We also emphasize median values since outliers strongly influence many of the mean values, and report p-values for a two-tailed non-parametric test of differences in medians between non-shelf and shelf registrants.

Table 2. Key Risk Attributes: Non-shelf Registrants versus Shelf Registrants (Small Firms).

	Non-Shelf Registrants			Shelf Registrants			*p*-Value
	N	Mean	Median	*N*	Mean	Median	
2001							
Book to market	694	0.723	0.625	1	1.550	N/A	N/A
Debt to equity (%)		91.61	24.61		138.72	N/A	N/A
Return on equity (%)		−53.67	0.67		4.89	N/A	N/A
Z-Score		5.20	3.22		5.43	N/A	N/A
2000							
Book to market	831	0.890	0.752	9	0.131	1.150	0.2063
Debt to equity (%)		69.65	22.94		6.11	80.67	0.0503
Return on equity (%)		−10.32	5.14		−1.59	−18.83	0.0500
Z-Score		6.49	3.29		0.18	0.10	0.0070
1999							
Book to market	671	0.770	0.600	11	1.085	1.050	0.0638
Debt to equity (%)		56.01	29.25		363.81	80.60	0.0654
Return on equity (%)		11.27	6.50		−11.92	3.41	0.0650
Z-Score		6.20	3.62		4.40	1.41	0.1282
1998							
Book to market	892	0.726	0.587	8	1.370	1.390	0.0165
Debt to equity (%)		106.48	29.91		476.38	276.96	0.0039
Return on equity (%)		19.21	8.29		6.18	7.36	0.2399
Z-Score		5.78	3.69		3.19	1.27	0.0892
1997							
Book to market	1,009	0.476	0.433	6	0.857	0.830	0.0070
Debt to equity (%)		127.19	20.63		326.98	69.05	0.2057
Return on equity (%)		−3.55	7.86		−0.99	5.68	0.2072
Z-Score		8.64	4.65		3.36	3.94	0.0416
1996							
Book to market	880	0.473	0.519	6	0.446	0.394	0.2064
Debt to equity (%)		75.92	19.30		436.73	306.63	0.0507
Return on equity (%)		8.13	8.12		−3.01	4.79	0.0500
Z-Score		8.33	4.79		3.92	3.92	0.2821
1995							
Book to market	720	0.551	0.499	3	0.638	0.620	0.2816
Debt to equity (%)		55.10	26.11		93.62	101.58	0.0414
Return on equity (%)		48.11	9.67		11.91	12.53	0.2412
Z-Score		7.52	4.61		1.22	1.22	0.0788

Table 2. (*Continued*)

	Non-Shelf Registrants			Shelf Registrants			*p*-Value
	N	Mean	Median	*N*	Mean	Median	
1994							
Book to market	614	0.585	0.536	0	N/A	N/A	N/A
Debt to equity (%)		67.03	28.22				
Return on equity (%)		76.24	10.48				
Z-Score		6.88	4.17				
1993							
Book to market	549	0.523	0.492	0	N/A	N/A	N/A
Debt to equity (%)		56.49	25.00				
Return on equity (%)		54.35	10.02				
Z-Score		7.21	4.50				

Note: "Small" firms are those in the first quartile of firms with market capitalization greater than $75 million. "Medium" firms are those in the second quartile of firms with market capitalization greater than $75 million. "Large" firms are those in the third quartile of firms with market capitalization greater than $75 million. "Giant" firms are those in the fourth quartile of firms with market capitalization greater than $75 million. *p*-Value = Two-tailed non-parametric test of median differences. Book to market = [Book value of common equity/Market value of common equity]. Debt to equity = [Total debt/Total stockholders' equity]. Return on equity = [Net income/Total common equity]. *Z*-Score: Altman's *Z*-score. N/A: Not applicable.

Table 3. Key Risk Attributes: Non-shelf Registrants versus Shelf Registrants (Medium Firms).

	Non-Shelf Registrants			Shelf Registrants			*p*-Value
	N	Mean	Median	*N*	Mean	Median	
2001							
Book to market	758	0.548	0.512	11	0.575	0.627	0.1562
Debt to equity (%)		89.68	28.88		132.02	143.42	0.0464
Return on equity (%)		−1.26	5.51		46.83	3.87	0.3704
Z-Score		7.27	3.95		0.68	0.76	0.0166
2000							
Book to market	810	0.652	0.499	24	0.714	0.691	0.0971
Debt to equity (%)		91.19	26.31		166.48	130.14	0.0001
Return on equity (%)		0.72	8.82		37.92	8.62	0.4974
Z-Score		9.46	4.21		2.70	1.61	0.0003
1999							
Book to market	664	0.603	0.423	20	0.525	0.501	0.0343
Debt to equity (%)		68.83	31.36		177.25	133.68	0.0117
Return on equity (%)		−2.92	9.88		8.32	6.18	0.0879
Z-Score		8.85	3.84		4.82	1.83	0.0215

Table 3. (*Continued*)

	Non-Shelf Registrants			Shelf Registrants			*p*-Value
	N	Mean	Median	*N*	Mean	Median	
1998							
Book to market	878	0.564	0.482	25	0.768	0.714	0.0281
Debt to equity (%)		106.90	35.44		271.94	140.77	0.0001
Return on equity (%)		−27.52	9.97		−2.25	6.57	0.0289
Z-Score		6.30	3.64		2.16	1.56	0.0012
1997							
Book to market	984	0.414	0.389	14	0.515	0.697	0.0407
Debt to equity (%)		220.57	32.15		300.63	172.55	0.0101
Return on equity (%)		−0.71	10.74		7.26	8.37	0.1226
Z-Score		7.71	4.48		3.08	2.59	0.0289
1996							
Book to market	884	0.407	0.441	10	0.452	0.369	0.2637
Debt to equity (%)		188.24	24.02		133.21	100.22	0.0283
Return on equity (%)		4.82	10.19		6.56	11.15	0.1018
Z-Score		9.35	4.69		4.34	2.30	0.0777
1995							
Book to market	708	0.433	0.397	16	0.656	0.655	0.0057
Debt to equity (%)		82.83	25.92		245.14	100.89	0.0058
Return on equity (%)		1.89	10.66		−7.07	5.41	0.0216
Z-Score		8.99	4.85		4.17	2.56	0.0018
1994							
Book to market	595	0.492	0.473	19	0.782	0.775	0.0001
Debt to equity (%)		55.71	32.63		242.60	147.06	0.0001
Return on equity (%)		8.11	11.89		6.19	10.87	0.1236
Z-Score		6.87	4.42		1.70	1.27	0.0007
1993							
Book to market	526	0.460	0.432	21	0.584	0.574	0.0337
Debt to equity (%)		50.72	26.60		681.24	121.11	0.0001
Return on equity (%)		11.36	11.60		−34.52	11.57	0.5000
Z-Score		9.32	5.03		1.93	2.14	0.0007

Note: "Small" firms are those in the first quartile of firms with market capitalization greater than $75 million. "Medium" firms are those in the second quartile of firms with market capitalization greater than $75 million. "Large" firms are those in the third quartile of firms with market capitalization greater than $75 million. "Giant" firms are those in the fourth quartile of firms with market capitalization greater than $75 million. *p*-Value = Two-tailed non-parametric test of median differences. Book to market = [Book value of common equity/Market value of common equity]. Debt to equity = [Total debt/Total stockholders' equity]. Return on equity = [Net income/Total common equity]. *Z*-score: Altman's *Z*-score.

Table 4. Key Risk Attributes: Non-shelf Registrants versus Shelf Registrants (Large Firms).

	Non-Shelf Registrants			Shelf Registrants			*p*-Value
	N	Mean	Median	*N*	Mean	Median	
2001							
Book to market	722	0.491	0.413	21	0.755	0.579	0.0517
Debt to equity (%)		89.11	40.72		187.69	132.43	0.0012
Return on equity (%)		−8.72	8.07		−296.12	9.62	0.2426
Z-Score		7.39	4.01		0.32	1.12	0.0002
2000							
Book to market	786	0.481	0.379	49	0.571	0.492	0.0179
Debt to equity (%)		49.32	34.49		4.05	75.88	0.0001
Return on equity (%)		4.71	11.20		−4.74	8.05	0.2135
Z-Score		11.81	4.42		3.30	2.83	0.0009
1999							
Book to market	630	0.397	0.294	54	0.689	0.639	0.0001
Debt to equity (%)		33.25	32.05		189.78	104.22	0.0001
Return on equity (%)		10.85	10.75		−16.25	12.01	0.2816
Z-Score		17.00	4.77		3.90	1.55	0.0001
1998							
Book to market	839	0.428	0.377	65	0.665	0.595	0.0001
Debt to equity (%)		72.13	48.65		202.74	92.32	0.0001
Return on equity (%)		12.35	11.73		11.35	10.87	0.2896
Z-Score		8.37	3.75		2.55	2.29	0.0001
1997							
Book to market	921	0.357	0.327	51	0.433	0.414	0.0003
Debt to equity (%)		103.20	47.65		183.84	132.77	0.0001
Return on equity (%)		4.35	12.77		5.09	13.22	0.3234
Z-Score		7.59	3.99		2.55	2.19	0.0001
1996							
Book to market	815	0.382	0.403	41	0.508	0.455	0.0392
Debt to equity (%)		106.48	39.92		173.66	112.25	0.0001
Return on equity (%)		12.39	12.61		11.15	12.10	0.2141
Z-Score		8.09	4.21		2.17	1.95	0.0001
1995							
Book to market	621	0.456	0.399	45	0.487	0.530	0.0016
Debt to equity (%)		94.42	38.71		170.11	107.47	0.0001
Return on equity (%)		12.33	13.02		9.52	12.29	0.3255
Z-Score		7.52	4.08		2.49	2.19	0.0001

Table 4. *(Continued)*

	Non-Shelf Registrants			Shelf Registrants			*p*-Value
	N	Mean	Median	*N*	Mean	Median	
1994							
Book to market	550	0.461	0.427	45	0.633	0.619	0.0001
Debt to equity (%)		78.23	42.87		152.52	106.62	0.0001
Return on equity (%)		5.71	13.22		13.23	12.52	0.0834
Z-Score		5.62	3.70		2.14	1.69	0.0001
1993							
Book to market	469	0.417	0.365	68	0.500	0.537	0.0004
Debt to equity (%)		33.92	39.36		129.23	102.07	0.0001
Return on equity (%)		9.96	12.98		11.27	12.09	0.1537
Z-Score		6.20	4.13		2.26	1.95	0.0001

Note: "Small" firms are those in the first quartile of firms with market capitalization greater than \$75 million. "Medium" firms are those in the second quartile of firms with market capitalization greater than \$75 million. "Large" firms are those in the third quartile of firms with market capitalization greater than \$75 million. "Giant" firms are those in the fourth quartile of firms with market capitalization greater than \$75 million. *p*-Value = Two-tailed non-parametric test of median differences. Book to market = [Book value of common equity/Market value of common equity]. Debt to equity = [Total debt / Total stockholders' equity]. Return on equity = [Net income/Total common equity]. *Z*-score: Altman's *Z*-score.

Table 5. Key Risk Attributes: Non-shelf Registrants versus Shelf Registrants (Giant Firms).

	Non-Shelf Registrants			Shelf Registrants			*p*-Value
	N	Mean	Median	*N*	Mean	Median	
2001							
Book to market	631	0.402	0.330	68	0.520	0.460	0.0002
Debt to equity (%)		106.14	53.47		233.84	119.71	0.0001
Return on equity (%)		12.95	11.42		−2.01	9.10	0.2438
Z-Score		6.53	3.73		2.16	1.78	0.0001
2000							
Book to market	677	0.378	0.314	164	0.386	0.344	0.1749
Debt to equity (%)		114.38	51.04		169.79	100.24	0.0001
Return on equity (%)		11.49	13.71		16.31	15.51	0.4062
Z-Score		10.46	3.98		4.13	2.66	0.0001
1999							
Book to market	549	0.294	0.213	136	0.374	0.327	0.0001
Debt to equity (%)		90.84	40.83		190.71	93.01	0.0001
Return on equity (%)		11.94	12.64		10.39	14.20	0.1213
Z-Score		23.97	4.65		3.72	2.89	0.0001

Table 5. *(Continued)*

	Non-Shelf Registrants			Shelf Registrants			p-Value
	N	Mean	Median	N	Mean	Median	
1998							
Book to market	683	0.345	0.294	219	0.404	0.379	0.0001
Debt to equity (%)		79.58	56.50		179.12	114.88	0.0001
Return on equity (%)		8.12	13.87		14.38	13.72	0.4101
Z-Score		7.84	3.92		3.05	2.36	0.0001
1997							
Book to market	682	0.337	0.296	183	0.357	0.338	0.0040
Debt to equity (%)		62.69	53.26		213.25	113.21	0.0001
Return on equity (%)		12.48	14.67		12.38	13.73	0.0620
Z-Score		5.65	3.81		3.04	2.42	0.0001
1996							
Book to market	617	0.362	0.382	150	0.403	0.395	0.1374
Debt to equity (%)		91.25	52.85		202.68	93.13	0.0001
Return on equity (%)		16.92	14.98		19.87	15.51	0.2558
Z-Score		5.73	3.62		2.95	2.64	0.0001
1995							
Book to market	425	0.398	0.354	134	0.472	0.443	0.0001
Debt to equity (%)		77.06	51.04		252.93	107.09	0.0001
Return on equity (%)		16.02	15.48		14.86	14.83	0.1857
Z-Score		6.31	3.83		2.85	2.59	0.0001
1994							
Book to market	416	0.457	0.423	116	0.537	0.556	0.0059
Debt to equity (%)		86.88	53.32		236.48	97.02	0.0001
Return on equity (%)		15.27	18.19		18.77	14.66	0.2007
Z-Score		4.62	3.42		2.65	2.47	0.0001
1993							
Book to market	283	0.395	0.341	141	0.496	0.500	0.0001
Debt to equity (%)		83.28	61.05		166.68	96.97	0.0001
Return on equity (%)		16.01	15.09		12.61	12.88	0.0008
Z-Score		5.34	3.65		2.54	2.04	0.0001

Note: "Small" firms are those in the first quartile of firms with market capitalization greater than $75 million. "Medium" firms are those in the second quartile of firms with market capitalization greater than $75 million. "Large" firms are those in the third quartile of firms with market capitalization greater than $75 million. "Giant" firms are those in the fourth quartile of firms with market capitalization greater than $75 million. p-Value = Two-tailed non-parametric test of median differences. Book to market = [Book value of common equity/Market value of common equity]. Debt to equity = [Total debt/Total stockholders' equity]. Return on equity = [Net income/Total common equity]. Z-score: Altman's Z-score.

First, we find that book value is generally a higher percentage of market value for shelf firms. Shelf firms have higher median book-to-market ratios in all of the years for the large and giant firms although the difference is not statistically significant in two of the years. This suggests that the market values each dollar of non-shelf firm net assets more highly than each dollar of shelf firm net assets. The presence of the shelf-registered securities and the possibility of imminent increased leverage may contribute to this finding. In addition, approximately one-third of these shelf registrants have registrations for a combination of debt and equity, and hence the potential for dilution from shelf registered equity securities. However, given the magnitude of the difference, it is more likely that shelf firms are priced based on a market perception that they are more risky than non-shelf firms.

Analysis of the debt-to-equity ratio provides evidence that shelf firms are more highly leveraged than non-shelf firms. The large and giant shelf firms have significantly higher median debt-to-equity ratios than the non-shelf firms in each year. The median debt-to-equity ratio for large shelf firms (75.88–132.77%) is often twice to nearly three times that of non-shelf firms (32.05–48.65%). The median debt-to-equity ratio for giant shelf firms (93.01–119.71%) is roughly twice that of giant non-shelf firms (40.83–61.05%). The medium and small shelf firms also have higher debt-to-equity ratios than the medium and small non-shelf firms. However, the difference in a few of the years does not reach statistical significance because of the small number of shelf firm-year observations. Overall, these findings provide direct evidence that shelf firms are more highly leveraged, and thus riskier, than non-shelf firms.

Non-shelf firms were slightly more profitable in most of the years. Large and giant non-shelf firms had higher median return-on-equity (ROE) in six of the nine years.[12] However, the difference was only statistically significant at greater than the 10% level in three of these instances. Similar results are generally observed for the medium and small firm populations.

Non-shelf firms had higher Altman's *Z*-scores than shelf firms. The Altman's *Z*-score (*Z*-score) uses firm-specific accounting and market measures to assess the probability of bankruptcy within one year. Firms with higher *Z*-scores have a lower probability of bankruptcy. Firms with a *Z*-score of 1.8 or less have a relatively high probability of bankruptcy within one year. The median *Z*-score for large and giant shelf firms (ranging from 1.12 to 2.83 and from 1.78 to 2.89, respectively) is statistically significantly lower than that of large and giant non-shelf firms (3.70–4.77 and 3.42–4.65) in all of the years shown. Indeed, the median large shelf firm has a relatively high probability of bankruptcy according to the *Z*-score measure in several of the years examined, indicating that over 50% of these firms are at risk for bankruptcy. Again, we generally find similar results for the medium and small firms.

However, Altman's *Z*-score was originally developed to categorize firms by likelihood of bankruptcy, rather than as an interval measure. Hence, we examine the proportions of shelf and non-shelf firms in each category. In Table 6, we present the *Z*-scores for the sample firm-year observations by year, by size, and by *Z*-score

Table 6. Altman's *Z*-Scores for Shelf and Non-Shelf Registrants by Size.

Year	*Z*-Score	Small Firms		Medium Firms		Large Firms		Giant Firms	
		Shelf (%)	Non-Shelf (%)	Shelf (%)	Non-Shelf (%)	Shelf (%)	Non-Shelf (%)	Shelf (%)	Non-Shelf (%)
2001	Distressed	0.00	28.22	75.00	20.57	58.33	18.12	51.12	18.44
	Marginal	0.00	18.64	12.50	19.40	25.00	18.97	24.44	19.84
	Stable	100.00	53.14	12.50	60.03	16.67	62.91	24.44	61.72
2000	Distressed	66.67	26.40	60.00	18.72	35.90	17.15	35.96	16.58
	Marginal	33.33	18.10	33.33	17.98	15.38	17.45	19.30	20.36
	Stable	0.00	55.50	6.67	63.30	48.72	65.40	44.74	63.06
1999	Distressed	50.00	22.60	50.00	18.69	55.26	14.16	30.36	15.73
	Marginal	12.50	17.56	25.00	19.34	21.05	17.27	23.21	16.73
	Stable	37.50	59.84	25.00	61.97	23.69	68.57	46.43	67.54
1998	Distressed	100.00	17.54	68.75	20.32	32.56	18.52	30.82	16.48
	Marginal	0.00	22.03	18.75	20.75	37.21	20.84	31.44	21.67
	Stable	0.00	60.43	12.50	58.93	30.23	60.64	37.74	61.85
1997	Distressed	33.33	16.93	42.86	15.11	27.27	14.67	28.69	14.79
	Marginal	0.00	13.13	28.57	17.16	39.39	19.33	36.43	23.29
	Stable	66.67	69.94	28.57	67.73	33.34	66.00	34.88	61.92
1996	Distressed	33.33	13.30	50.00	14.30	34.48	12.48	27.62	14.29
	Marginal	0.00	15.79	0.00	15.78	48.28	19.70	29.52	25.44
	Stable	66.67	70.91	50.00	69.92	17.24	67.82	42.86	60.27
1995	Distressed	100.00	11.65	41.67	10.93	30.00	14.40	28.57	14.56
	Marginal	0.00	18.13	25.00	16.88	40.00	20.49	34.07	24.45
	Stable	0.00	70.22	33.33	72.19	30.00	65.11	37.36	60.99
1994	Distressed		11.83	70.00	13.56	53.57	17.90	28.75	16.76
	Marginal		17.94	20.00	16.40	25.00	20.58	42.50	24.15
	Stable		70.23	10.00	70.04	21.43	61.52	28.75	59.09
1993	Distressed		11.26	40.00	9.47	40.82	15.97	45.10	7.86
	Marginal		15.58	60.00	15.70	32.65	19.63	27.45	27.07
	Stable		73.16	0.00	74.83	26.53	64.40	27.45	65.07

Note: Small firms: Firm-year observations in the first quartile of firms with market capitalization greater than $75 million. Medium firms: Firm-year observations in the second quartile of firms with market capitalization greater than $75 million. Large firms: Firm-year observations in the third quartile of firms with market capitalization greater than $75 million. Giant firms: Firm-year observations in the fourth quartile of firms with market capitalization greater than $75 million. Shelf: Shelf registrants. Non-shelf: Non-shelf registrants. Distressed: Altman's *Z*-Score of less than 1.81. Marginal: Altman's *Z*-Score of 1.81–3.0. Stable: Altman's *Z*-Score of greater than 3.0.

Table 7. Shelf Registrant Industry Concentration.

Year	One-Digit SIC Code									
	1 (%)	2 (%)	3 (%)	4 (%)	49 (%)	5 (%)	6 (%)	7 (%)	8 (%)	9 (%)
2001										
Nonshelf	4.13	14.88	27.66	5.35	1.78	8.88	16.25	16.55	4.34	0.18
Shelf	5.68	10.26	15.91	14.77	19.32	6.82	22.73	4.55	0.00	0.00
2000										
Nonshelf	3.83	14.16	26.48	6.61	2.04	9.48	14.73	18.31	4.11	0.25
Shelf	6.88	14.67	18.35	12.39	11.47	6.88	22.02	5.50	1.38	0.46
1999										
Nonshelf	3.81	15.49	27.87	7.19	2.24	11.22	10.33	17.15	4.33	0.37
Shelf	12.81	12.80	21.67	10.84	12.81	7.39	14.29	5.91	0.99	0.49
1998										
Nonshelf	4.24	14.78	26.72	5.64	2.31	9.58	18.95	13.64	3.86	0.28
Shelf	5.22	16.04	15.30	8.96	12.69	7.09	28.36	5.22	0.75	0.37
1997										
Nonshelf	4.42	15.03	27.17	5.46	2.72	9.78	17.94	13.30	3.91	0.27
Shelf	7.58	13.62	15.66	9.09	11.62	7.07	28.28	4.55	1.52	1.01
1996										
Nonshelf	4.84	15.53	28.52	5.34	2.85	10.42	16.23	12.36	3.63	0.28
Shelf	4.10	14.36	12.82	8.72	13.85	10.77	26.15	7.69	1.03	0.51
1995										
Nonshelf	5.05	16.66	30.01	4.77	2.78	11.50	15.78	10.03	3.18	0.24
Shelf	4.81	19.79	9.63	8.56	15.51	9.09	27.27	3.21	1.60	0.53
1994										
Nonshelf	4.77	18.12	29.16	4.87	3.58	11.73	15.71	8.55	3.18	0.33
Shelf	7.88	13.32	15.76	9.70	14.55	7.88	27.27	3.03	0.61	0.00
1993										
Nonshelf	5.11	18.83	28.91	3.85	3.08	11.88	16.50	8.48	3.16	0.20
Shelf	2.79	13.94	10.70	10.70	25.12	6.51	24.65	3.72	1.40	0.47

Note: SIC Codes:

1. Mining and construction.
2. Manufacturing.
3. Manufacturing.
4. Transportation and Public Utilities.
49. The Public Utilities SIC Category (4900).
5. Wholesale and Retail Trade.
6. Finance, Insurance, and Real Estate.
7. Services.
8. Services.
9. Public Administration.

category. The *Z*-scores categories, "distressed," "marginal" or "stable" correspond to *Z*-scores of less than 1.81, 1.81 to 3.0, and greater than 3.0, respectively. The results suggest that shelf firms are generally two to three times more likely to have a *Z*-score that suggests a high probability of financial distress. For example, in 2001, 58 and 51% of large and giant shelf registrants have *Z*-scores below 1.8, versus only 18% of both large and giant non-shelf registrants. Conversely, over 60% of large and giant non-shelf registrants, but only 17 and 24% of shelf registrants, fall into the "stable" category. Similar results are found for almost all of the years and firm size categories. One notable exception is the small firm category in 2001, but that category contains only 1 firm-year observation.

Shelf Registrant Industry Concentration

Table 7 reports the percentage of shelf and non-shelf firm-year observations by four-digit SIC code industry classification. There is a concentration of shelf registrants in the 4000 SIC code classification. Most of this concentration was in the 4900 SIC code classification, which includes traditionally highly leveraged Public Utility Companies. For example, in 2001, over 19% of shelf but only about 2% of non-shelf firm-year observations are from this industry. Because such industry concentration in highly leveraged firms could bias the leverage-related risk findings, we conducted our empirical analyses without the 4900 SIC firm-year observations. The results of this sensitivity analysis support the conclusions reported in the main analyses. For example, large and giant shelf firms still have significantly higher book-to-market and debt-to-equity ratios, and significantly lower *Z*-scores. Thus, while there is a concentration of Public Utility shelf registrants, this group of firms is not the source of the overall findings in this study.

CONCLUSION

Currently, firms meeting specified criteria can register debt and/or equity securities for immediate issuance any time in the two-year period following registration. This is known as shelf registration of securities. The primary criterion is that the firm must have market capitalization held by outsiders of at least $75 million. The premise is that firms of this size are highly visible, such that the market will have enough information about the value and risk of the firm to appropriately price the securities. Since many firms experiencing high profile collapses had securities available on the shelf at the time of their collapse, shelf registration qualification criteria may warrant reexamination. In this study, we provide evidence that debt shelf registrants are, on average, riskier than non-shelf firms.

We find that most debt and combined debt/equity shelf registrants are large firms. Nevertheless, risks exist for small or large shelf-registrants. The financial position of even giant firms can deteriorate quickly, as was the case with Enron and WorldCom. In this study, we compared shelf registrant and non-shelf registrant firms to determine whether shelf firms are more, less, or similarly risky than non-shelf firms. We found that shelf registrants have higher book-to-market ratios than non-shelf firms. This suggests that the market values each dollar of non-shelf firm net assets more highly than each dollar of shelf firm net assets. We also found that shelf firms were more highly leveraged and slightly less profitable than non-shelf firms. Last, we found that shelf registrants have worse Altman's *Z*-score profiles than non-shelf firms. We found that shelf registrants are generally two to three times more likely to have a *Z*-score that suggests a high probability of financial distress. We even find that, in some years, shelf firms have a median Altman's *Z*-score that suggests a relatively high probability of bankruptcy. Conversely, non-shelf registrants are much more likely to have *Z*-scores that suggest financial stability. Thus, shelf registrants appear to be, on average, riskier firms, which is not consistent with the spirit of shelf registration. This suggests that the qualifications for shelf registration may warrant reexamination to mitigate the risks of market losses from the securities of these firms. Further, our findings suggest that investors and analysts should beware of the additional risks associated with shelf-registered firms.

Our findings are subject to at least the following caveats. First, while underwriter due diligence is not required for the public offering of shelf securities, timely filings are. Thus, investors can examine 8-K's, 10-Q's, and 10-K's to obtain recent information related to issuing firms. Second, most of our motivation is based solely on the existence of shelf securities for failing firms. We cannot know whether these firms would have actually successfully issued those shelf-registered securities.

Considered as a whole, our findings suggest that an SEC review of the shelf registration criteria is warranted. In the mean time, investors should beware of the inherent risks of shelf-registered securities. Future research should assess actual loss rates related to shelf securities and identify other variables that could be used to qualify firms for shelf registration of securities.

NOTES

1. However, firms are required to disclose any material information that has arisen since registration before issuing securities.
2. We do not directly address the issue of self-selection in our sample. It might be that distressed firms choose to shelf register securities to obtain flexibility with debt financing

that might be otherwise difficult to achieve. Alternatively, it could be that firms that seek substantial debt financing choose to shelf register in conjunction with several other financing avenues. Either scenario is consistent with our findings.

3. The majority of shelf registrations are for debt, or some combination of debt and equity. Only approximately 10% of all shelf registrations are purely for equity securities. Typically, shelf registrations for a combination of debt and equity are written to allow the firm complete discretion in whether debt, equity, or a combination of the two is issued. Our sample contains only firms that have shelf registrations of debt or debt and equity combined.

4. When the SEC commissioners voted to extend the experimental period, Commissioner Barbara S. Thomas dissented, citing issues pertaining to both the capital markets and disclosure system. In Thomas (1983), she articulated the risks she perceived as inherent in the legislation.

5. The December 1982 Consumer Price Index was 97.6; the December 2001 Consumer Price Index was 176.6. In 1982, a firm with $150 market capitalization was relatively large, whereas a firm with $75 million market capitalization in 2001 was a small firm. This difference highlights the importance of revisiting regulatory criteria periodically.

6. These criteria are required in order to file for shelf-registered securities. The criteria to subsequently issue securities include the requirement that companies must disclose relevant information before the issuance of those securities.

7. Underwriters' due diligence procedures are designed to discover any adverse information about the issuing firm that is not disclosed in the registration of the securities.

8. Firms with shelf registrations for only equity are omitted from both groups in our tests.

9. Interestingly, we identified firms in this group in 1997–2001 that successfully shelf registered securities. These were firms with market capitalization above $75 million at the time of shelf registration, but below $75 million at the end of the year.

10. We did not examine the non-shelf firms to identify firms that would have been disqualified from shelf registration for reasons other than market capitalization. It is possible that our non-shelf sample includes disqualified firms. However, inclusion of those firms would create a bias against our findings.

11. We also measured leverage using the debt-to-tangible-assets ratio and profitability using return on assets, and found results that supported those reported using the debt-to-equity ratio and return on equity without exception.

12. Shelf firms are, on average, more highly leveraged. If shelf firms were equally profitably nominally, they would have higher returns on equity. This magnifies the likely practical significance of the slightly lower profitability we find for shelf firms. Further, our tests of profitability using return on assets more strongly indicated that shelf firms were less profitable than non-shelf firms.

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APPENDIX: RESEARCH DESIGN ADDENDUM

Data Sources

In this paper, market capitalization and accounting data are from Compustat. Shelf registrations of debt securities were identified using the SDC Platinum database. We identified all firm-years that have shelf-registered debt or a shelf-registered combination of debt and equity securities during the sample period January 1993–April 2001, and have all necessary information available through Compustat. Approximately 35.7% of the observations in our sample are registrations of a combination of debt and equity (26.4% of the filings are for debt combined with both preferred and common equity, 4.6% are for debt and preferred equity, and 4.7% are for debt and common equity).

Variable calculations

Market capitalization is measured as stock price multiplied by shares outstanding on the last day of the fiscal year. Debt to equity is measured as total debt divided by total book value of equity. Return on total equity is net income divided by total

book value of equity. Altman's *Z*-score, a bankruptcy prediction model developed by Edward Altman (1968), is calculated as

[1.2 × (Working capital/Total assets)
+ 1.4 × (Retained Earnings/Total assets)
+ 3.3 × (Earnings before interest and taxes/Total assets)
+ 0.6 × ((market value+preferred stock)(total assets-common equity–preferred stock))
+ 0.999 × (Sales/total assets)]

This model is designed to forecast failure within the next two years. If a value less than 1.81 is returned, there is a high probability of bankruptcy. If a value greater than 3.0 is returned, there is a low probability of bankruptcy.

POLITICALLY-CONNECTED FIRMS: ARE THEY CONNECTED TO EARNINGS OPACITY?

Ahmed Riahi-Belkaoui

ABSTRACT

This paper is an investigation of the relationship between earnings opacity in 32 countries and elements of the political order. What the picture shows is a clear manifestation of earnings opacity internationally. What is interesting with this picture is the findings that earnings opacity is positively related to the percentage of politically connected listed firms and negatively related to the connected firms as a percentage of market capitalization and the degree of law enforcement. What is puzzling with this picture is the findings that the level of disclosure, the number of auditors per 100,000 inhabitants, and the adoption of International Accounting Standards (as elements of the accounting order) are not significantly related to earnings opacity internationally. It is the political climate rather than the technical accounting climate that is at the core of accounting quality in general and earnings opacity in particular.

1. INTRODUCTION

Earnings opacity is a measure that reflects how little information there is in a firm's earnings number about its true, but unobservable, economic performance

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(Bhattacharya, Daouk & Welker, 2003).[1] Both anecdotal and empirical evidence point to international differences in earnings opacity with serious implications for equity and other markets (Bhattacharya et al., 2003; Bushman & Smith, 2001; Leuz, Nanda & Wysocki, 2001). While earnings opacity may just be viewed as a technical accounting matter, its excesses may be corrected by the enforcement of laws. This calls for two possibilities:

(a) Where the enforcement laws may not work effectively, as in the case of political connectedness of firms that benefit from government-created rents and protection. In this case of political connectedness, management may feel more empowered to be aggressive in their choices of accounting methods leading to a higher level of earnings opacity.
(b) Where the enforcement of laws may work even with instances of political connectedness as in the presence of market discipline. Where the percentage of market capitalization of connected firms is high, a lower level of earnings opacity may be expected, as better accounting quality may be required by market participants.

Accordingly, the goal of this paper is to test the relationships between earnings opacity on one hand and political connectedness, market capitalization of connected firms, and degree of law enforcement on the other hand. The results of empirical study on data from 32 countries indicate that: (a) the level of earnings opacity is positively related to the percentage of politically connected listed firms; and (b) negatively related to both the percentage of market capitalization of connected firms and the degree of law enforcement in the country. An expansion of the model to test the impact of accounting order indicates that earnings opacity was not significantly related to the level of disclosure, the number of auditors per 100,000 inhabitants and the adoption of international accounting standards. The remainder of the paper is organized as follows. Section 2 presents an earnings opacity model contingent on political, market and legal factors. Section 3 discusses the sample, data estimation, and presents summary statistics and correlations. Section 4 presents and discusses the results of the determinants of earnings opacity internationally. Section 5 discusses the robustness of the results, and Section 6 concludes.

2. EARNINGS OPACITY MODEL

The political analyses of accounting (e.g. Arnold, 1991; Miller, 1990) argue that the technical and political aspects of accounting are intricately linked in the sense that the technical cannot be studied by neglecting the political (Burchell et al., 1980;

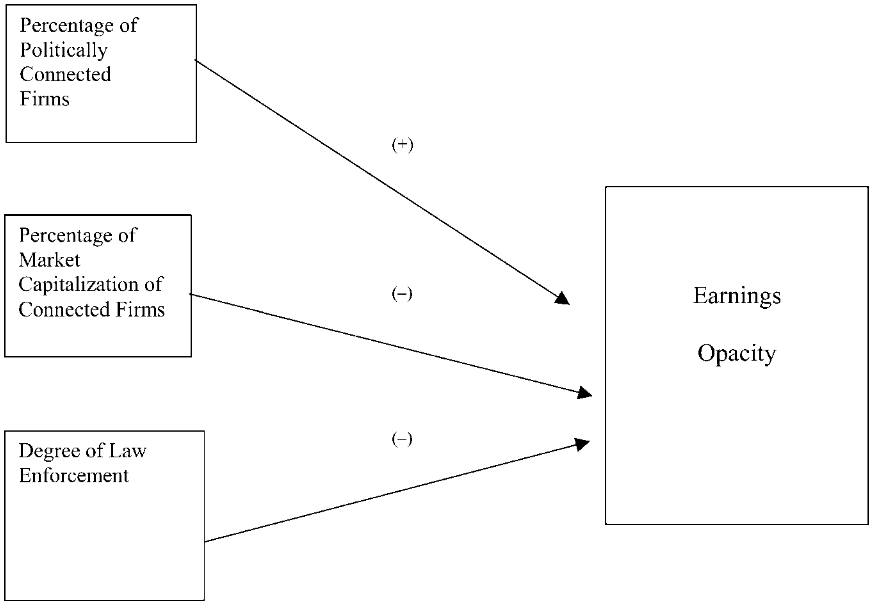

Fig. 1. Determinants of Earnings Opacity Internationally.

Stulz & Williamson, 2001). In the context of this study, the technical is expressed by earnings opacity and it can only be studied in the total political context. It results from a contingency theory of accounting that argues that accounting and its phenomenon are a function of its environment in general and the political environment in particular (Gernon & Wallace, 1995; Wallace & Gernon, 1991). Applied to the context of this study, earnings opacity arises essentially from the political culture and environment in a particular country. Figure 1 indicates the hypothesized relationships between earnings opacity and the main characteristics of the political environment. The political environment is depicted by: (a) the percentage of politically connected firms; (b) the connected firms as percentage of market capitalization; and (c) the degree of law enforcement. Each of these relationships is explicated as follows:

(1) The model posits a positive relationship between earnings opacity and the percentage of politically connected firms in a given country. Political connectedness of a firm is generally defined by the fact that a large shareholder (holding at least 10% of the votes) or top directors (i.e. CEO, president, vice-president or secretary) is a member of parliament, a minister (including the Prime minister) or the Chief of the State (i.e. dictator, president, King or

Queen), or is "closely-related" to a top politician (Faccio, 2002). The situation, known as "crony capitalism," implies that the dominant political leaders use their power to the advantages of their families and friends, individuals or firms, who benefit from government-created rents. It amounts to a form of capitalism in which politicians channel resources toward favored and connected firms, distorting incentives, misallocating investments, and increasing the extend of corruption (Shleifer & Vishny, 1994). The significance of the benefits extracted by connected firms is supported both in U.S. (i.e. Agrawal & Knoeber, 2001; Ang & Boyer, 2000; Kroszner & Stratmann, 1998; Roberts, 1990) and abroad (Fishman, 2001; Hellman, Jones & Kaufmann, 2000; Johnson & Mitton, 2002). Faccio (2002) finds that connected companies enjoy easier access to debt financing, lower taxation and stronger market power. However, in spite of these significant benefits, Faccio (2002) finds that connected firms underperform their peers on an ex-ante basis. The end result of this situation is the potential for more aggressive opportunism from managers of politically connected firms in the form of shirking and sharking (Orts, 1958), and managerial rent-seeking (Edlin & Stiglitz, 1997; Shauer, 2000). The increase in opportunism has also important economic consequences (Gaballero & Hammom, 1998). To camouflage their bad performance and feeling empowered by their political connectedness, managers will likely resort to more alternations of firms' reported economic performance leading to an increase in earnings opacity.

(2) The model posits a negative relationship between the connected firms as a percentage of market capitalization and the level of earnings opacity. The principal-agent conflict between the firm's insiders and its outside investors suggests that insiders are more inclined to mask firm performance to minimize outsider and/or legal intervention and/or to present a financial picture that can be deemed as financially attractive by outsiders. This "camouflage" activity is at the essence of the concepts and techniques of earnings opacity. The main private gain is the weakening of outsiders' ability to monitor and discipline insiders as a result of information asymmetries between insiders and outsiders created by earnings opacity. The only resources left to outsiders are to: (a) write contracts that confer them rights to discipline insiders (e.g. to replace managers); and/or (b) to vote with their feet and reinvest their capital on less earnings management prone firms. Both actions are more likely to depend on the level of market capitalization. Firms in general, and politically connected firms in particular are more likely to be scrutinized by outsiders on all aspects of their activities, including the level of accounting quality they provide. One may argue that earnings opacity will be more widespread in countries where the politically connected firms have a low market capitalization.

(3) The model posits a negative relationship between the degree of law enforcement and earnings opacity. The degree of law enforcement was first seen as comprising three fundamental characteristics: (a) the supremacy of regular law as opposed to arbitrary power, i.e. the rule of law, not men; (b) equality before the law of all persons and classes, including government officials; and (c) the incorporation of constitutional law as a binding part of the ordinary law of the land (Dicey, 1915).[2] Law enforcement requires that individuals and firms be able to practically conform their behavior to the laws. Therefore, managers of firms, including politically connected firms, feel the legal pressure to present information compatible with the law and degree of law enforcement. The higher the degree of law enforcement, the less likely managers will resort to opportunistic choices of accounting techniques, resulting in lower level of earnings opacity. The prediction in this study is that the degree of law enforcement predisposes to a lower level of earnings opacity.

3. SAMPLE AND DATA ISSUES

3.1. Sample

The determination of the sample rested on securing the necessary data in the variables of interest as specified by the earnings opacity model in Fig. 1. A total of 32 countries met this test. They are shown in Table 1. The dependent variable of earnings opacity as well as the independent variables of: (a) percentage of politically connected firms; (b) percentage of market capitalization of connected firms; and (c) degree of law enforcement are explicated next.

3.2. Measures of Earnings Opacity

The quality of accounting in a given country is measured by three dimensions of earnings opacity – earnings aggressiveness, loss avoidance, and earnings smoothing – where opacity is viewed as a complex interaction between the three factors of managerial motivation, accounting standards and the enforcement of accounting standards (audit quality) (Bhattacharya et al., 2003). In brief, earnings are opaque because of: (a) the motivation of managers to manipulate earnings; (b) the accounting standards are either loose or just bad; and (c) the enforcement is lax. The three measures of earnings opacity derived from the study by Bhattacharya et al. (2003) are explicated and measured as follows:

Table 1. Data Used.

Name of Country	OEO	EAG	LA	ES	PCLF	DLE	CFMC
Australia	4.9487	6.0769	4.0769	4.6923	0.70	10.00	0.32
Austria	5.4537	4.5833	6.0833	5.6944	0.91	10.00	0.25
Belgium	3.8547	2.0769	5.0769	4.4102	3.82	10.00	18.77
Brazil	4.9583	6.8750	3.6250	4.3750	0.00	6.32	0.00
Canada	4.8034	4.6154	5.3076	4.4871	1.31	10.00	2.53
Chile	6.9333	6.6000	7.2000	7.0000	2.25	7.02	1.43
Denmark	4.7878	4.0909	4.9090	5.3636	3.07	10.00	2.52
Finland	5.5726	4.3846	6.6923	5.6410	1.52	10.00	0.14
France	4.5726	4.1538	4.9230	4.6410	2.19	8.98	8.03
Germany	5.0769	3.4615	6.3076	5.4615	1.55	9.23	1.20
Greece	8.0000	8.8889	7.2222	7.8888	0.65	6.18	0.09
Hong Kong	6.2500	7.3333	5.4166	6.0000	1.98	8.22	2.33
India	7.6825	8.2857	7.7142	7.0476	2.79	4.17	1.83
Indonesia	7.7142	8.0000	8.0000	7.1428	22.08	3.98	12.76
Ireland	5.5213	5.9231	4.8461	5.7948	2.44	3.98	22.83
Italy	6.0427	5.2308	6.3076	6.5897	10.30	8.39	11.27
Japan	6.7265	6.6154	6.6153	6.9487	1.34	8.57	1.34
Korea	7.1305	7.9000	6.2000	7.2916	2.56	5.35	8.95
Malaysia	6.8205	7.6923	6.2307	6.5384	19.78	7.80	27.24
Mexico	5.0493	6.8889	3.7777	4.4814	8.51	6.78	8.14
Netherlands	4.8119	3.3077	5.6153	5.5128	0.42	10.00	0.01
Norway	4.4545	4.7273	4.6363	4.0000	0.00	10.00	0.00
Portugal	3.5555	1.5000	5.1666	4.0000	2.97	8.98	2.00
Singapore	6.1481	6.2222	6.1111	6.1111	7.86	8.68	2.59
South Africa	6.2906	6.6923	5.9230	6.2564	0.00	4.42	0.00
Spain	5.2020	4.1818	6.3636	5.0606	1.50	7.80	0.82
Sweden	5.5213	6.0769	5.0769	5.4102	1.07	10.00	1.02
Switzerland	5.2906	3.9231	6.5384	5.4102	2.47	10.00	0.69
Thailand	6.0000	4.7143	7.5714	5.7142	15.05	6.25	41.62
Turkey	7.8518	10.0000	7.3333	6.2222	1.19	5.18	0.14
U.K.	5.0769	5.2308	4.9230	5.0769	7.17	8.57	39.02
USA	4.0170	4.0769	4.4615	3.5128	0.20	10.00	4.94

Note: EAG = Earnings aggressiveness (Bhattacharya et al., 2001). LA = Loss avoidance (Bhattacharya et al., 2001). ES = Earnings smoothiness (Bhattacharya et al., 2001). OEO = Average of EAG, LA, and ES (Bhattacharya et al., 2001). DLE = Degree of law enforcement measured by a "Rule of Law" score (La Porta et al., 1997) and represents the legal environment in each country. PCLF = Percentage of politically connected listed firms (Faccio, 2002). CFMC = Connected firms as percent of market capitalization (Faccio, 2002).

(A) Earnings aggressiveness, the opposite of accounting conservatism, results from the tendency of managers to increase reported earnings numbers. To understand these managerial motivations, see for example, Rangan (1998), Teoh et a1. (1998), Shivakumar (2000), Healy (1985) and Barth et al. (1999).

It is expected to be positively related to earnings opacity, as it is the tendency to delay the realization of losses and speed the realization of gains. It is measured at a point in time as the median for country *i*, year *t*, of accruals divided by lagged assets.[3] Scaled accruals are defined as:

$$\begin{aligned} \mathrm{ACC}_{kt} = (&\Delta \mathrm{CA}_{kt} - \Delta \mathrm{CL}_{kt} - \Delta \mathrm{CASH}_{kt} + \Delta \mathrm{STD}_{kt} - \mathrm{DEP}_{kt} \\ &+ \Delta \mathrm{TP}_{kt})\mathrm{TA}_{kt-1} \end{aligned}$$

ACC_{kt} = Scaled accruals for firm *k*, year *t*
$\Delta\mathrm{CA}_{kt}$ = Change in total current assets for firm *k*, year *t*
$\Delta\mathrm{CL}_{kt}$ = Change in total current liabilities for firm *k*, year *t*
$\Delta\mathrm{CASH}_{kt}$ = Change in cash for firm *k*, year *t*
$\Delta\mathrm{STD}_{kt}$ = Change in current portion of long-term debt included in total current liabilities for firm *k*, year *t*
DEP_{kt} = Depreciation and amortization expenses for firm *k*, year *t*
$\Delta\mathrm{TP}_{kt}$ = Change in income taxes payable for firm *k*, year *t*
TA_{kt-1} = Total assets for firm *k*, year $t-1$

The higher the median observation of scaled accruals of country *i* in year *t*, the higher is the earnings aggressiveness in country *i* in year *t*.

(B) Loss avoidance behavior is the second measure of earnings opacity following evidence that U.S. firms engage in earnings management to avoid reporting negative earnings (Burgstahler & Dichev, 1997; Degeorge et al., 1999; Hayn, 1995). It is measured by the ratio of the number of firms with small positive earnings minus the number of firms with small negative earnings divided by their sum. The higher this ratio for country *i* in year *t*, the higher is the loss avoidance in country *i*, year *t*.

(C) Earnings smoothing is the third measure of earnings opacity as artificially smoothed earnings fail to depict the swings in underlying firm performance and increase earnings opacity. It is measured by the cross-sectional correlation between the change in accruals and the change in cash flows, both scaled by lagged total assets, in country *i*, year *t*. The lower this correlation in country *i* in year *t*, the higher is the earnings smoothing in country *i*, year *t*.

Bhattacharya et al. (2003) computed these three measures of earnings opacity for a sample of 34 countries for the year 1985 through 1998 using variables from Worldscope. They are shown in Table 1. Only 32 countries from the original sample are used in this study based on the availability of data on the independent variables. An average of the three measures is used in this study as a measure of the earnings opacity and accounting quality for each country. The higher the value of this variable, the higher is the degree of earnings opacity.

3.3. Measure of Connectedness and Law Enforcement

The measures of connectedness were taken from a study by Faccio (2002). He identified 17,033 names of top directors of 19,844 listed companies covered in world scope as well as those of major shareholders. Overall, 532 firms (2.68% of all listed corporations) were found to be politically linked, representing 7.76% of the world's market capitalization. Two variables are used to measure the diffusion of political connections at the country level. The first, "percent of politically connected listed firms," is the ratio of connected firms over the total number of firms listed in a particular country. The second measure, "connected firms as percent of market capitalization" is the ratio of market capitalization of connected firms over the overall capitalization of each country. Both variables are shown in Table 1.

The degree of law enforcement is measured by the law enforcement index provided in La Porta et al. (1997). Constructed on the basis of a survey of investors, this index estimates the quality of the rule of law in a country. As reported in Table 1, the degree of law enforcement index ranges from 3.98 to 10 in one sample (with 10 indicating best quality of rule of law).[4]

3.4. Summary Statistics and Correlations

Table 1 includes the data for the dependent and independent variables used. The earnings quality, as measured by the overall measure of earnings opacity, is the best for Belgium and Portugal followed by the USA and Norway. The worst countries in the sample for earnings quality are Turkey and Korea followed by Indonesia. The best countries in terms of lower percentage of politically connected firms are Brazil, Norway and South Africa. The worst countries in terms of higher percentage of politically connected firms are Indonesia, Thailand, Malaysia and Italy. Table 2 presents the descriptive statistics for the main variables in the study while Table 3 presents the Pearson correlations among the same variables.

Table 2. Descriptive Statistics.[a]

Variables	*N*	Mean	Std. Dev.	Minimum	Maximum
OEO	32	5.7429	1.1711	3.5555	8.000
PCLF	32	3.7210	5.2841	0.0000	22.080
CFMC	32	6.7327	10.6528	0.0000	41.620
DLE	32	7.6886	2.3299	2.7300	10.000

[a] Variables are defined in Table 1.

Table 3. Pearson Correlations.[a]

	OEO	PCLF	CFMC	DLE
OEO	1.000	0.307 (0.087)	0.001 (0.994)	−0.656 (0.0001)
PCLF		1.000	0.648 (0.080)	−0.259 (0.132)
CFMC			1.000	−0.236 (0.171)
DLE				1.000

[a] Variables are defined in Table 1.

4. DETERMINANTS OF EARNINGS OPACITY INTERNATIONALLY

To determine the impact of political connectedness, market capitalization of connected firms and degree of law enforcement on earnings opacity internationally, the following regression was used:

$$\mathrm{OEO}_i = \alpha_0 + \alpha_1\,\mathrm{PCLF}_i + \alpha_2\,\mathrm{CFMC}_i + \alpha_3\,\mathrm{DLE}_i + U_i$$

where

OEO_i = Overall earnings opacity measure for country i (obtained from Bhattacharya et al., 2003)
PCLF_i = percentage of politically connected listed firms (obtained from Faccio, 2002)
CFMC_i = Connected firms as percentage of market capitalization (obtained from Faccio, 2002)
DLE_i = Degree of law enforcement (La Porta et al., 1997)

Table 4, column 1, presents results on the impact of the selected variables on earnings opacity. The results and discussions are presented as follows:

(1) The impact of the percentage of connected listed firms is positive and significant level ($t = 2.01$, $p = 0.05$). This is in conformity with our thesis that the high level of political connectedness leads to more managerial opportunism in general and an increase in earnings opacity. Managers of politically connected firms feel more empowered to hide their rent-seeking activities and henceforth the level of earnings opacity.
(2) The impact of the connected firms as a percentage of total market capitalization is negative and significant ($t = -0.037$, $p = 0.05$). This is in line with a "diversion" thesis whereby insiders are more inclined to provide better quality accounting and less earnings opacity, as the likelihood of outsiders scrutinizing their activities is higher with high market capitalization of the connected firms.

Table 4. Determinants of Earnings Opacity.

Independent Variables	Dependent Variable: OEO (Overall Earnings Opacity)	
	1	2
Intercept	8.640 (13.05)*	6.017 (2.90)*
PCLF	0.072 (2.01)**	0.119 (2.32)**
CFMC	−0.037 (−2.15)**	−0.045 (−2.59)*
DLE	−0.373 (−4.96)*	−0.309 (−3.18)*
GL	–	0.429 (0.84)
RGDP	–	0.113 (0.98)
AU	–	−0.002 (−1.28)
DISC	–	0.025 (0.93)
IAS	–	−0.501 (−1.52)
R^2 (Adjusted)	50.40%	52.51%
F	11.50*	4.18*
Wald test	0.01	0.01
Reset F-value	0.05	0.05
Hausman F-value	9.35*	4.06*

Note: Variables such as PCLF, CFMC, and DLE one defined in Table 1. Other variables are defined as follows: CL: Legal system with 1 for common law and 0 for civil law countries; RGDP: Ten year GDP growth; AU: Number of auditors per 100,000 inhabitants; DISC: Financial disclosure level; IAS: International accounting standards use.

*Significant at $\alpha = 0.01$.

**Significant at $\alpha = 0.05$.

(3) The impact of the degree of law enforcement is negative and significant ($t = -4.96$, $p = 0.01$). This is very much in line with the thesis that the higher degree of law enforcement and the implied penalties for failing to meet the legal requirements predispose to a lower level of earnings opacity.

5. SENSITIVITY ANALYSIS

The model is expanded to investigate the potential impact of accounting order. The accounting order is measured by the following three variables:

(a) The relative number of auditors as a proxy for the demand for auditing discipline. It is measured by the auditors per 100,000 population from Saudagaran and Diga (1997, Table 6, p. 51). The original source is the International Federation of Accountants (IFAC, 8/13/1996).
(b) The amount of financial disclosure in a country as a proxy for accounting transparency. It is measured by the disclosure level from the Center for

International Financial Analysis and Research (CIFAR, 1995). The higher the number more is the disclosure.

(c) The adoption of International Accounting Standards (IAS) as a proxy for demand for international accounting harmonization. It is measured by the IAS use (IASC, *Insight*, dated October 1997). Three dummy variables were used as follows:
   - 0: For completely independent standard setting and no use of IAS except for comparison with IAS.
   - 1: Separate accounting standards that are based on and similar to IAS in most cases.
   - 2: IAS are used as national standards with some modifications for local conditions. Standards not covered by IAS are added.

The model is also expanded by adding a dummy variable for the legal system (common law 1; civil law 0) and economic growth measured by the real growth of GDP for 10 years.

The results of the expanded model in column 2 of Table 4 show that all the new variables added were insignificant and did not contribute to the original model. It seems that the manifestation of opportunistic use of accounting techniques, resulting in the level of earnings opacity observed is independent of the quality of accounting order, the nature of the legal system and the economic growth rate.

The results of Table 4 rely on White's (1980) adjusted standard error estimates to deal with heteroscedasticity. The Wald test for joint significance is reported in the table. In addition, for the three regressions used, there is no evidence of serious multicollinearity among the independent variables. The RESET (regression specification error test) as suggested by Ramsey (1969) and Thursby (1981, 1985) and the Hausman test (1978), as suggested by Wu (1973) and Hausman (1978), were used as specification tests. The result of the RESET test, used to check for omitted variables, incorrect functional form, and non-independence of regressors, show that the models used in this study are not mispecified (see diagnostic check statistics in Table 4).

6. CONCLUSIONS

An investigation of the determinants of earnings opacity in 32 countries yielded unexpected results. First, elements of accounting order do not seem to affect earnings opacity. It is the political context rather than the technical that explicates better the level of accounting quality in general and the level of earnings opacity

in particular in a given country. Second, earnings opacity is higher as a result of political connectedness of firms and lower as a result of a high degree of law enforcement and market capitalization of connected firms. What appears from the second results is that creating a culture based on law enforcement and market discipline is conducive to demand for more accountability and high quality of accounting. However, the constraints created by political connectedness are more conducive to the supply of less accountability and lower quality of accounting. The answer to the problem of the quality of accounting internationally rests more with creating the "right" morals of a political society, than with toying with the limited technical discourse rituals offered by accounting.

NOTES

1. This view of earnings opacity is the opposite of earnings transparency, defined as the timely incorporation of (unobservable) economic income into accounting earnings (Ball, Kothari & Robin, 2000).
2. The core and traditional definition of rule of law in the U.S. still contains three basic values or concepts: (1) constitutionalism; (2) rule-based decision making; and (3) a commitment to neutral principles, such as federalism, separation of powers and textualism.
3. Teoh and Wong (2002) present some indirect evidence that scaled accruals affect earnings opacity by affecting analysts' forecast errors.
4. The law enforcement index used was found to be correlated with the "efficiency of the judicial system" score provided by La Porta et al. (1998), the law and order indicator provided by the International Country Risk Guide (ICRG), and the level of litigiousness in a country from Wingate (1997). The Pearson correlations of the law enforcement index used in the study with the three other legal enforcement indexes described earlier are high, ranging from 0.4632 to 0.6931.

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THE EFFECTS OF ACCOUNTING REGULATION ON TAX CREDIT UTILIZATION PROPENSITY

Thomas J. Linsmeier and Thomas J. Carroll

ABSTRACT

This research examines whether the anticipated imposition of the deferral method of accounting for the investment tax credit affected investors perceptions about the propensity of firms to invest in ITC qualifying assets. We find significant negative (positive) abnormal returns associated with events increasing (decreasing) the probability of the mandated accounting change. Additionally, we find a significant association between these returns and variables measuring potential changes in future investment and proximity to debt covenant constraints. These results have implications for policymakers because they indicate that investors expected the proposed accounting regulation to mitigate the stimulative effects of the tax credit.

1. INTRODUCTION

This research examines whether the anticipated imposition of the deferral method of accounting for the investment tax credit (ITC) affected investors perceptions of the propensity of firms to innovate through investment in ITC qualifying assets. Presently both the deferral (DF) and flow-through (FT) methods are acceptable for financial reporting purposes. However, this was not always the case. Three

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times during the period, 1962–1971, the Accounting Principles Board (APB) attempted to eliminate the FT method as an acceptable alternative. Each time the Board's actions were met with a firestorm of protest leading to reversal of the DF mandate.

In 1971, these lobbying efforts culminated in congressional legislation mandating that companies be free to select either method of accounting for the ITC. This is the only time Congress has passed binding legislation to intervene in the accounting standard setting process.[1] The executive branch of the federal government also consistently opposed the APB's actions on the grounds that imposing the DF method would counteract the intended economic benefits of the ITC. For example, in 1971, the Nixon administration feared that, as a result of the APB's actions, capital investment would be reduced and correspondingly fewer jobs would be created (*Wall Street Journal*, November 23, 1971). In addition, in 1963, the Treasury Department suggested that "... business investment in new equipment would actually be retarded" if DF was mandated (*Wall Street Journal*, November 9, 1963).

This research is important for two reasons. First, it provides evidence that accounting regulation was perceived by investors to adversely impact the propensity of firms to innovate through new investment in ITC qualifying assets. As a result, the mandated change to the DF method was perceived to stifle the intended benefits of federal tax policy.

Second, much accounting research has focused on the economic consequences of mandatory accounting changes.[2] This literature has examined, in part, whether significant refinancing and renegotiation costs are imposed on shareholders at the time of accounting changes that reduce the slack in accounting-denominated debt covenants. In this paper, we propose that adverse economic effects will arise for FT firms because the mandated change to the DF technique reduces slack in debt covenants that determine firms' abilities to pay dividends and issue additional debt. As a result, we examine whether mandating the DF method imposes potentially significant renegotiation costs for affected firms. In addition, we examine whether a mandatory accounting change can affect firms' financing and investment decisions by reducing firms' abilities to finance new investments with debt.

We investigate these potential economic effects of mandating the DF method in a two-step process. First, we examine the market reactions to public announcements of APB deliberations relating to the proposed accounting change.[3] Second, we examine the cross-sectional association between these changes in firm value and proxies for the costs arising from accounting-denominated debt covenants. We include measures of the potential renegotiation costs imposed on shareholders, as well as a measure of the costs arising from potential modifications in the firms financing and investment decisions.

Our results show that events increasing the likelihood of adoption of the DF method are associated with significant decreases in the equity prices of FT firms, and significant price increases are associated with events decreasing the likelihood of adoption. Our cross-sectional tests show a significant association between the stock price effects of the accounting deliberations and costs imposed by debt covenants. We find that proxies for expected changes in financing and investment decisions explain a significant portion of the variation in security returns not explained by the potential renegotiation costs associated with debt covenants. This evidence is consistent with the imposition of the DF method reducing the propensity of firms to innovate through new investment.

The remainder of the paper is organized as follows. Section 2 describes the theoretical links between the imposition of the DF method and changes in investing and financing decisions. This section also summarizes our major predictions. Section 3 describes the sample. Stock price responses to the accounting policy deliberations are reported in Section 4. Cross-sectional tests of the determinants of the stock price responses are described in Section 5. Section 6 presents conclusions.

2. THEORETICAL LINKS BETWEEN THE ITC, ACCOUNTING METHODS AND INVESTMENT

Congress adopted the ITC for the expressed purpose of stimulating the economy by encouraging investment in capital goods. The tax credit reduced the cost of qualifying investments by lowering a firm's tax liability. A 7% ITC was first introduced by the Revenue Act of 1962. Since then the credit has been suspended, reinstated and amended at various times, and finally repealed by the Tax Reform Act of 1986. Evidence using macroeconomic data indicated that the ITC stimulates new investment.[4] Two studies using firm level data also provide additional evidence that the ITC affects the level of investment. Specifically, Bathala and Carlson (1992) find that the repeal of the ITC in 1986 was associated with a significant decline in investment rates. Plummer (1993) provides preliminary evidence that the reinstatement of the ITC in 1971 was associated with planned increases in long-term capital expenditures.

As stated previously, both the DF and FT methods are presently acceptable methods of accounting for the ITC. However, if DF was mandated exclusively, significant economic effects may arise due to the financial statement effects of the accounting change. The two permissible methods allow the reporting of differing amounts of income, retained earnings, and assets or liabilities. Income differs because the FT method increases income in the year the property is acquired by the full amount of the credit, while the DF method defers the benefit and

amortizes it to income over the productive life of the asset. The balance sheet differs because the DF method reports the deferred benefit as a reduction of the carrying amount of the property or as a deferred credit. There is no separate line item reported on the balance sheet under the FT method.

The financial statement effects of the method choice can be substantial. At a 1962 Congressional hearing Arthur Andersen and Company estimated that in the year of purchase, the DF method would reduce reported income relative to the FT method by between 0 and 113% for a random sample of NYSE firms. The average reduction was 10.19%. Although, these differences would have disappeared by the end of the asset's productive life, retained earnings of DF firms would be lower in each year relative to FT firms by the deferred amount of the credit.

Since covenants in bond indentures are usually written in terms of generally accepted accounting principles (Leftwich, 1983), a mandated switch from the FT method can alter the proximity to accounting-denominated covenants.[5,6] The imposition of the DF method would likely cause a potential increase in renegotiation or refinancing costs for shareholders due to the increased likelihood of technical default. Beneish and Press (1993) estimate that the costs associated with technical violation range between 1.2 and 2% of the market value of equity, and between 4.4 and 7.3% of the debt in violation. These costs may arise for firms because of modifications to their contracting, investment or financing activities. In particular, reduction in the slack in debt covenants might alter a firm's ability to pay dividends and raise additional debt. These restrictions can arise because typical debt covenants: (1) define the maximum amount that retained earnings can be reduced upon payment of dividends; and (2) prohibit the issuance of additional debt if the firm does not meet specified debt-to-equity ratios. Thus, the DF method by deferring recognition of income over the asset's life could cause a delay in payment of dividends throughout the life of the asset.[7] In addition, by decreasing stockholders' equity, and in some instances increasing reported debt,[8] the DF method also creates a higher debt to equity ratio throughout the asset's life, thereby, restricting management's ability to raise additional debt.

The inability to raise additional debt also can impair new investment, imposing additional costs on shareholders. If firms cannot raise debt, then at the very least they may be forced to substitute more costly equity financing, reducing the net present value of the investment (Myers & Majluf, 1984). However, Brealey and Myers (1988, p. 313) show that new equity issues accounted for only 20% of new external financing during the period 1967–1971. Thus, a more extreme response would be to simply forgo the investment altogether. Whited (1992) provides evidence that borrowing constraints, measured in terms of debt-to-equity and interest coverage ratios, often force firms to reduce investment. In either case,

mandating the DF method may impose additional costs on shareholder by altering the firms financing and/or investing decisions.

Similar concerns were raised in comment letters to the APB during its deliberation process. For example, Oppenheimer and Company argued that imposing the DF method would cause the major airlines to forgo $3 billion of new investment over a ten-year period. They reasoned that the accounting change would eliminate $1.487 billion of combined equity, reducing the industry's borrowing capacity by 1.5 times that amount. The magnitude of this potential effect is large given the industry's gross investment at the time was $5 billion (Wilson, Shank & Frolin, 1979). In addition, another letter to the APB from an investment banking firm claimed that adoption of the deferral approach would impair the ability to borrow capital to finance expansion; and, as a result, more expensive equity capital would have to be used or firms would have to raise revenues to cover the extra costs (Hawkins, 1968, p. 38).

This analysis suggests that, unless management of FT firms took mitigating actions, stockholders could incur negative economic effects upon mandated adoption of the DF method. The objective of this study is to determine whether these negative economic effects were perceived to be significant enough to cause a measurable change in the stock prices of affected firms. Stock prices are used in this study to assess the economic effects of the accounting change because the APB's efforts to mandate the DF method were never successful. Thus, we cannot examine actual changes in planned investment, financing or contracting relationships that occurred during periods surrounding the mandated accounting change because management never had to respond to an actual change. Instead, we assess changes in market expectations about future investment in a two-step process that exploits the fact that security prices reflect changes in investor's expectations about future net inflows and, therefore, can provide one measure of the perceived impact of the proposed accounting change before it had been reversed.

In the first step, we assess the degree to which abnormal stock returns are associated with key events in the ITC accounting policy deliberation process.[9] Prior research indicates that security prices are sensitive to investment activity and the effect of the ITC on that activity. McConnell and Muscarella (1983) provide evidence that announcements of new investment plans are associated with positive security price reactions. Ayres (1987) finds a positive association between the stock price response to enactments of the ITC and the level of the tax credit received. Hence, if the APB's deliberations about the DF method affected market expectations about net cash inflows associated with current or future investments in ITC qualifying assets, this should be reflected in stock prices at the time of public announcements of decisions related to accounting for the ITC. This analysis leads to the first formal hypothesis to be tested in this paper.

Hypothesis 1 *(Alternative Form)*. Negative (positive) abnormal returns are predicted for FT firms at the time of the accounting policy deliberations related to the ITC because significant costs were expected to be incurred as a result of management's response to the increased probability of tighter (looser) debt covenants caused by the increased (decreased) probability of adopting the DF method.

In the second step, we examine the cross-sectional association between these abnormal returns and the potential changes in investment, financing and contracting costs caused by changes in slack in debt covenants of FT firms. This analysis determines if investors perceived that the cash flow effects of DF adoption are associated with debt covenant-related investment, financing or renegotiation costs. This leads to the second formal hypothesis to be tested in the paper.

Hypothesis 2 *(Alternative Form)*. The abnormal returns for FT firms examined in Hypothesis 1 are negatively associated with variables that measure the risk of technical default, costs of renegotiation, and costs due to changes in investments or financing decisions that may occur as a result of the DF mandate.

3. SAMPLE

3.1. Sample Selection

The 103 sample firms were selected using the following criteria. First, each firm was required to have an ITC income statement amount disclosed on the Compustat Industrial File for at least six of the following seven years, 1962–1964, 1966–1967 and 1970–1971. These are the only years in which an ITC could be taken by taxpayers during the sample period, 1962–1971. Second, the Compustat Industrial File was checked to ensure that none of these firms had a deferred ITC account balance for any of those seven years. Third, each firm was required to have complete daily returns available on the CRSP Tape for the period July 2, 1962 through March 3, 1972. Lastly, data needed to measure the independent variables for Hypothesis 2 must have been available in either the Compustat Industrial File or in one of the Moody's manuals dealing with industrial or transportation firms.

The first two sample selection criteria for the treatment group insured that each firm had both purchased a significant amount of ITC qualifying assets during the sample period and had used the FT method to account for these purchases. The last two criteria insured that data were available to: (1) test for market effects; and (2) calculate the independent variables used in the cross-sectional regression models described in Section 5.

The market value of equity for our sample firms in 1966 ranged from $11 million to $10.3 billion with a mean (median) of $729 million ($332). The sample is well diversified across industries encompassing 25 two-digit SIC codes. The heaviest industry concentration is in food and beverages (14%) and machinery and computing (11%).

3.2. Evidence on Debt Financing of ITC Investments

Implicit in the arguments provided in Section 2 is the assumption that firms primarily finance the purchase of ITC qualifying assets with debt. This assumption is required because only in the presence of additional debt financing will firms likely have significant incremental debt covenant-related costs that arise from the purchase of ITC qualifying assets. These costs arise because only with additional debt financing is it likely that material unexpected increases in debt-to-equity ratios and material unexpected reductions in retained earnings (due to additional interest expense) will occur upon the acquisition of ITC qualifying assets. In these situations, the FT method will provide the most slack in accounting-denominated covenants and, therefore, may be favored over the DF method.

Table 1 provides evidence on the degree to which our sample firms employed additional debt financing to purchase ITC qualifying assets during the years 1962–1978. Table 1 provides data on annual changes in long-term debt during years when sample firms purchased ITC qualifying assets and in firm-years when they did not. If the ITC stimulates new debt-financed investment (either previously unplanned or accelerated from later periods), then debt should increase more during ITC periods than during non-ITC periods. The evidence in Table 1

Table 1. Annual Changes in Long-term Debt Financing During ITC – Years 1962 Through 1978.

	Mean	Percentile				
		10%	25%	50%	75%	90%
Years with ITC[a]	$18.5[b]	$1.0	$3.5	$9.0[b]	$23.7	$57.1
Years without ITC[a]	$5.1[b]	−$5.0	−$1.1	$0.1[b]	$7.2	$18.0

[a] Determined using the ITC benefit reported in the income statement of sample firms. If an ITC benefit was reported, the firm-year observation was included in the "Years with ITC" category; otherwise, it was included in the "Years without ITC" category.
[b] Difference is significant at less than the 0.01 level using both a matched-pairs *t*-test (mean) and a Wilcoxon matched-pairs signed-rank test (median).

is consistent with this assertion. The average (median) increase in long-term debt during firm-years with an ITC was \$18.5 (\$9.0) million compared with \$5.1 (\$0.1) million during firm years without an ITC. A paired *t*-test (Wilcoxon matched-pairs signed-ranks test) reveals that the within-firm differences in means (medians) across years are (both) significant at less than the 0.01 level. In addition, the Pearson product-moment correlation between annual changes in long-term debt in ITC qualifying years and the magnitude of investment in ITC assets is 0.413 and is significant at less than the 0.01 level. This correlation statistic suggests that the magnitude of additional debt financing incurred in new investment years was related to the magnitude of purchases of ITC qualifying assets. Therefore, investors may have expected significant debt covenant-related costs to be associated with the mandated change in ITC accounting for our sample firms.

4. ACCOUNTING REGULATION AND STOCK PRICES

4.1. The Returns Generating Model

The stock price effects of the ITC accounting regulations are assessed using the following returns generating model for each firm.

$$R_{jt} = a_j + b_j R_{mt} + \sum_k c_{jk} I_{kt} + f_j P_t + e_{jt} \tag{1}$$

where,

R_{jt} = return on the stock of the *j*th firm for day *t*.
R_{mt} = return on the CRSP equally-weighted market portfolio for day *t*.
I_{kt} = dummy variable equaling one if the *k*th accounting event occurred during day *t* and zero otherwise. Each of the $k = 19$ accounting events consist of one seven-day (or longer) event period.
P_t = dummy variable equaling one if day *t* was in January, and zero otherwise.
e_{jt} = NID $(0,\sigma_j)$ disturbance of the *j*th firm for day *t*.
a_j = intercept of the *j*th firm.
c_{jk} = coefficient capturing the average effect (over seven days) of the *k*th accounting event on the *j*th firm. Each coefficient corresponds to one of the $k = 19$ accounting events outlined in Tables 2 through 4.
f_j = coefficient capturing the January effect for firm *j*.

The accounting event dates associated with the ITC deliberations during each of the three attempts by the APB to mandate the DF method were determined as

Table 2. Tests for a Market Reaction at Critical Accounting Dates for 103 FT Firms During Period I.

Event No.: Date(s)	Brief Description[a]	Expected Sign of Market Reaction	Average Abnormal Returns	F-Value for H1	F-Value for H2
1: 10/17/62	The *Wall Street Journal (WSJ)* reports the APB's position supporting the DF method of accounting for the ITC.	–	0.0009	1.33	0.87
2: 11/1/62	The Exposure Draft (ED) of APB Opinion No. 2 is issued mandating the use of the DF method.	–	0.0011	1.85	1.69***
3: 12/10–12/62	APB No. 2 is issued.	–	0.0007	1.08	0.65
4: 12/18/62	The *WSJ* reports that the "Big-Eight" public accounting firms split evenly on the APB No. 2 vote.[b]	+	0.0010	1.68	0.83
5: 1/10/63	Accounting Series Release No. 96 is issued. In it the SEC says it will allow use of either the FT or DF method.	+	–0.0005	0.33	1.23*
6: 1/23–25/63	A Business Week article discloses that several "Big-Eight" firms will allow use of the FT method.	+	0.0005	0.50	0.96
7: 3/17–18/64	APB Opinion No. 4 that allowed use of both the FT and DF methods is released.	+	0.0001	0.03	0.86
Reversal: Events 2 & 5	–	–	0.0009	2.18	1.35**

[a] For a more detailed description of these events, see Linsmeier (1985, Appendix B).
[b] The critical event period surrounding this event also includes the date of the meeting at which the SEC stated its reluctance to support the APB's Opinion.
* Significant at 0.10 level.
** Significant at 0.05 level.
*** Significant at 0.01 level.

follows. First, APB meeting minutes, and the articles from the *Wall Street Journal*, accounting journals, and the popular financial press were examined to identify relevant events during the deliberation process. Next, events likely to change the probability of the DF method's adoption were selected. These events included both public (nonpolicy) commentary and public announcements by policymakers

Table 3. Tests for a Market Reaction at Critical Accounting Dates for 103 FT Firms During Period II.

Event No.: Date(s)	Brief Description[a]	Expected Sign of Market Reaction	Average Abnormal Returns	*F*-Value for H1	*F*-Value for H2
1: 5/15/67	The SEC gives it support for the DF method.	–	−0.0026	7.40***	0.93
2: 8/16–18/67	The APB approves an Exposure Draft (ED) dealing with the accounting for income taxes which contains a section mandating the DF method.[b]	–	0.0003	0.18	0.73
3: 9/15–20/67	The APB releases the August ED.[b]	–	0.0003	0.15	0.84
4: 11/8–9/67	The *Wall Street Journal* reports that the Assistant Secretary for Tax Policy opposes the section of the ED dealing with accounting for the ITC.	+	0.0006	0.40	0.78
5: 11/15/67	The SEC withdraws its support.	+	0.0022	5.67**	0.82
6: 12/1–4/67	The APB unanimously withdraws the ITC portion of the proposed opinion.	+	−0.0005	0.28	1.06
Reversal: Events 1 & 5	–	–	−0.0025	14.37***	0.92

[a] For a more detailed description of these events, see Linsmeier (1985, Appendix B).
[b] The ED relates to what eventually became APB No. 11. The non-ITC portions of APB No. 11 could, therefore, have confounded our tests of the market section to the ITC accounting regulations. It should be noted, however, that because the significant ITC event dates in this table are at dates when only ITC information had been released, such confounding is unlikely.
** Significant at 0.05 level.
*** Significant at 0.01 level.

of their position on the ITC proposals. While care was taken to include in the analysis all significant dates in the accounting regulatory process, it is possible critical event dates were omitted. Thus, the market effects detected by this model may not represent the full impact of the ITC regulations on security prices.

Tables 2 through 4 contain a description of these critical accounting events and an indication as to whether each event was considered likely to increase or decrease the probability of adoption of the DF method. Events determined to

Table 4. Tests for a Market Reaction at Critical Accounting Dates for 103 FT Firms During Period III.

Event No.: Date(s)	Brief Description[a]	Expected Sign of Market Reaction	Average Abnormal Returns	*F*-Value for H1	*F*-Value for H2
1:10/8–12/71	The SEC supports the DF method of accounting for the ITC.	–	−0.0001	0.03	0.77
2:10/22/71	The APB releases an Exposure Draft (ED) mandating the use of the DF method.	–	−0.0019	4.15**	0.94
3:11/4/71	The *Wall Street Journal* issues an article discussing the ED.	–	−0.00003	0.001	0.88
4–11/9–15/71	The Senate Finance Committee report stating that companies should have a free choice when selecting ITC accounting procedures is approved by the Treasury and made part of the 1971 Revenue Act.	+	−0.0003	0.01	0.89
5:11/18–27/71[b]	Numerous articles in the business and popular press report the Congressional action.	+	0.0018	4.73**	1.07
6:12/9–10/71[b]	The Revenue Act passes without modification and the APB withdraws the ED.	+	0.0009	0.93	0.86
Reversal: Events 2 & 5	–	–	−0.0017	8.49***	1.04

[a] For a more detailed description of these events, see Linsmeier (1985, Appendix B).
[b] For these dates the critical event period defined in Section 4.1 overlaps with an ITC tax legislation event identified by Ayres (1987). On 11/22/71, the Senate passed a bill reinstating the ITC and on 12/9/71 the bill was signed into law.
** Significant at 0.05 level.
*** Significant at 0.01 level.

increase (decrease) the probability of adoption of the DF method are indicated using a "–" ("+") sign in the expected market reaction columns in Tables 2 through 4 because, in these instances, negative (positive) economic effects are predicted to be associated with the DF method's impact on debt covenants of affected firms. This distinction was made to isolate potential price reversals.

In this study, a seven-day event period was defined around each critical event. This period consisted of the three days before, the day(s) of, and the three days following the event.[10] This long event period was selected to capture information leakage before the identified date and to allow the market time to assimilate the potential impact of the event on debt covenants and investments in ITC qualifying assets subsequent to the announcement day. We are concerned about information leakage because in many cases private accounting policy deliberations occurred only two to three days before the public announcement of the policy decision. Additionally, recent evidence on market inefficiency causes one to question the wisdom of using very narrow windows when attempting to capture the subsequent market reaction to events such as these.[11]

The main purpose of model (1) is to isolate the abnormal return associated with each of the 19 accounting events for each of the N firms. The c_{jk} coefficients isolate the individual event k abnormal return for each of the sample firms. In this study, we chose to estimate abnormal returns at each event date rather than across dates within each deliberation period (see Tables 2 through 4) because we believe the market is likely to react at only a subset of dates in each deliberation period (e.g. at least, one good news date and one bad news date in each period). Thus, to increase the power of our tests we estimate abnormal returns at individual dates with the expectation that many dates will exhibit no significant market return.

Finally it should be noted, to enhance the ability of model (1) to isolate the accounting effects, two control variables are included in the model. First, as is the case in most event studies, the return on the market as a whole is isolated in order that an individual firm's market reaction could be better determined. The second control variable is introduced to isolate the January seasonality in the size effect in stock returns. Keim (1983) provides evidence that during our sample period large (small) firms experience abnormally large negative (positive) returns during the month of January. The existing sample of FT firms fall within the large firms size deciles indicated by Keim. Thus, to diminish the impact of this seasonality on the accounting coefficient estimates (especially the estimate for accounting event five during the 1/10/63 attempt by the APB to mandate use of DF method), we isolate the average excess return occurring in January by including P_t in the model.

4.2. The SUR Model and Test Statistics

A "seemingly unrelated regressions" model (SUR) is used to formulate hypotheses and estimate parameters for detecting market reactions in this study. The SUR model is obtained by grouping the equation given by (1) into a system of return

equations across the $N = 103$ stocks.

$$
\begin{aligned}
R_{1t} &= a_1 + b_{1t} R_{mt} + \sum_k c_{1k} I_{kt} + f_1 P_t + e_{1t} \\
&\cdot \\
&\cdot \\
&\cdot \\
&\cdot \\
R_{Nt} &= a_N + b_{Nt} R_{mt} + \sum_k c_{Nk} I_{kt} + f_N P_t + e_{Nt}
\end{aligned}
\qquad (2)
$$

The parameters for the SUR model are estimated over three different periods, each of which surround the event dates corresponding to one of the three attempts to mandate the DF method (see Tables 2 through 4).

Period I: 7/2/62 thru 9/10/65 (7 accounting events over 804 days).
Period II: 9/13/65 thru 12/27/68 (6 accounting events over 804 days).
Period III: 12/31/68 thru 3/3/72 (6 accounting events over 803 days).

Parameters were estimated over these three time periods and not over the entire 2411-day event period because of concern with parameter instability over the longer period of time.

The SUR approach permits the individual event date coefficients to differ across firms.[12] When the explanatory variables in the return generating process are identical for each of N equations, coefficient estimates can be obtained simultaneously using the generalized least squares procedure or individually using the ordinary least squares method. No gains in efficiency result from using the joint GLS estimation procedure within the SUR model. The advantage of the SUR approach lies in hypothesis testing, since nonconstant variances across equations and contemporaneous dependence of the disturbances are explicitly incorporated in the hypothesis tests. In addition, certain hypotheses (e.g. H2 below) are not easily formulated and tested in a non-SUR framework.

Two sets of hypotheses are of primary interest to this study. The first hypothesis set tests for non-zero price responses to individual standard setting events; in the null form, the hypothesis is

H1.

$$\mathrm{H}_0 : \sum_{j=1}^{N} c_{jk} = 0$$

The sum of the c_{jk} parameters reflects a total, sample-wide measure of the influence of each standard setting event.

The second SUR based hypothesis is that, for a particular standard setting event, k, all of the individual c_{jk} parameters across the sample of firms are equal to zero.

H2.

$$\mathrm{H}_0 : c_{jk} = 0 \quad \text{for all } j$$

Under certain circumstances, this hypothesis is stronger than H1. Burgstahler and Noreen (1984) provide evidence from simulations that H2 is a more powerful test for detecting a market reaction when there is substantial variation about the mean or when the mean market reaction is near zero. In all other cases H1 is more powerful. Thus, depending on the situation, it is possible to reject H2 and not H1, and vice versa. They also point out that the researcher need not pre-specify the direction of the market reaction when performing tests of H2, since the rejection of H2 says nothing about the sample-wide effects of the event of interest. Thus, if a regulatory change influenced only a few firms or influenced some firms positively and others negatively, its effects could be hidden by the aggregation process used for H1. In these instances, H1 may not be rejected. H2 therefore makes it possible to identify when a subset of firms were significantly affected by the regulatory process (e.g. when the market effects are dependent upon the magnitude of debt covenant problems for sample firms).

Under the null hypotheses, and assuming normality of the R_{jt} terms, both statistics used to test H1 and H2 are exactly distributed F. For H1, the F-test of the sum of the announcement coefficients has 1 and (T-k-3) degrees of freedom. For H2, the joint F-test of the vector of those coefficients has N and (T-N-k-2) degrees of freedom.[13]

4.3. Results

Tables 2 through 4 present the results of the SUR tests of H1 and H2 for the 103 FT firms for each of the 19 sets of accounting event coefficients. Results of tests on control variables are not reported in the tables. These results, however, indicate that both the general market index and the January effect control variables were highly associated with the return behavior in the predicted direction in each of the three estimation periods.

In the tables, significant security price effects are documented at six accounting event dates using a 0.10 significance level or less. In period I, accounting events two ($p < 0.001$) and five ($p < 0.07$) exhibit significant security price effects as measured by H2 (see Table 2). These events pertain to the dates the exposure draft to APB Opinion No. 2 was released (event two) and the dates when the SEC issued Accounting Series Release No. 96 reversing the DF mandate. In period II,

accounting events one ($p < 0.01$) and five ($p < 0.05$) exhibit significant abnormal returns as measured by H1 (see Table 3). Accounting events one and five relate to the SEC's provision and subsequent rescission of support for the DF method, respectively. Note, the negative average abnormal return at event one (−0.0026) is nearly offset by the positive average return at event five (+0.0022) indicating a price reversal may have occurred when the SEC withdrew its support of DF. Finally, events two and five in period III exhibit significant security price effects (at $p < 0.05$) as measured by H1 (see Table 4). These events correspond to the APB's release of an ED mandating the DF method of accounting for the ITC (event two) and to the discussion in the press of the Senate's action placing no restrictions on the methods used to account for the ITC (event five). Once again the magnitude of the offsetting mean average abnormal returns are nearly equal (−0.0019 vs. 0.0018), supporting a potential price reversal when the DF mandate was overruled.

This evidence provides support for research Hypothesis 1, which predicts significant abnormal returns for FT firms at the time of the accounting policy deliberations related to the ITC. It also should be noted that the signs of the average abnormal returns at each significant event date in Tables 3 and 4 are consistent with prior expectations. That is, for each significant event date that increases the likelihood of adoption of DF, a negative average security price reaction is documented, and for each significant event that decreases the probability of DF adoption, a positive security price reaction is found. Similar analyses are not provided for the significant events in Table 2 because the security price response documented therein are detected using H2. This indicates that a total sample-wide market reaction was not found at these dates, making the average coefficient uninterpretable. Tests assessing whether the magnitude of the market reaction across events two and five in Table 2 are related to each other are provided in the next section.

4.4. Internal Validity Checks

While the average abnormal returns at events one and five in period II and events two and five in period III were consistent with a price reversal, a further test of the internal validity of the individual event date results was formulated for each event period. These tests investigate whether individual firm's abnormal returns are related when the market's expectation about the rule change is reversed. Reversal tests have an advantage over the traditional single event date tests because the intrusion of confounding events is less likely to underlie significant results over multiple dates in time.

The reversal tests are formulated by using a different ITC accounting regulatory variable than in model (1). This variable took on values of one, zero, and minus one to identify time periods in which significant accounting events were announced

(ones), time periods when the accounting events were overruled (minus ones), and time periods when no significant regulatory change occurred (zeroes). Unlike the model (1) accounting event regulatory change parameters, which each test for a market effect during only one event period, this accounting parameter captures the *average* effect across the two significant events in each time period. Since the accounting events that had an expected negative security price effect were coded one while the accounting events with expected positive effects were coded minus one, the expected sign of these average coefficients is negative. Of course, as before, this average coefficient level is uninterpretable if the market reaction is detected by H2.

Results of these tests are consistent with predictions and are reported as the last "event" in Tables 2 through 4. In period I, the individual security price reaction across events two and five are related to each other because H2 is rejected at $p = 0.02$ using this new test formulation. In periods II and III, SUR tests of H1 were found to be significant at less than the 0.01 level with each average event coefficient being negative. These results provide additional evidence that economic consequences associated with ITC proposals occurred in a manner consistent with the debt covenant effects hypothesized in Section 2.

Finally, as noted in Table 4, ITC accounting events five and six in 1971 overlap with two of the ITC tax legislation event dates identified by Ayres (1987). Accounting event five (which exhibits significant security price effects) overlaps with the Senate passage of a bill reinstating the ITC and accounting event six (with insignificant security price effects) overlaps with the signing of the ITC tax bill. In order to address the possibility that our results may be confounded by these tax events, we constructed a control group of 45 DF firms with sufficient security price data available on CRSP to enable separate tests of market effects for the two events. These DF firms (which excluded utilities) were not affected by the APB deliberations; therefore, a significant market reaction at either event five or six for DF firms would be consistent with a tax event contaminating our results.[14] The control group results, however, were insignificant for both events indicating that our results are most likely due to the accounting deliberations alone.

5. CROSS-SECTIONAL TESTS

5.1. Model Specification

The following cross-sectional model is estimated in this study:

$$c_{jk} = a_0 + a_1\mathrm{DEBT}_j + a_2\mathrm{DIV}_j + a_3\mathrm{RSK}_j + a_4\mathrm{REN}_j + a_5\mathrm{PUB}_j + a_6\mathrm{INVST}_j + e_{jk} \tag{3}$$

where, c_{jk} is the abnormal return to equity holders of firm j at all six significant accounting events k documented in Tables 2 through 4, the a_i's ($i = 1, \ldots, 6$) are the regression coefficients, and c_{jk} is a random error term. In addition, the independent variables, described further below, are divided into three sets. The first set, DEBT, DIV and RSK, isolates the proximity to debt covenant violation for sample firms. The second set, REN and PUB, measures the potential renegotiation costs associated with technical violation of debt covenants. The last one – INVST – measures the potential costs of altered investment or financing decisions associated with the accounting change.[15]

In model (3) the abnormal returns for each date when the DF mandate was reversed (i.e. event five in periods I–III) are multiplied by minus one so that each c_{jk} coefficient reflects a uniformly larger negative reaction for firms most significantly affected by the accounting deliberations. This transformation allows us to make uniform predictions about the signs of the coefficients on the independent variables in model (3).

5.1.1. Variables Measuring Proximity to Debt Covenant Violation

Debt Limits (DEBT). DEBT measures the proximity to debt covenant restrictions and is defined as follows:

$$\text{DEBT} = \frac{\text{Long-term Debt}}{\text{Stockholders' Equity} + \text{Long-term Debt} - \text{Intangible Assets}}$$

Harrison and Grudnitski (1983) provide evidence that of the many ways in which additional debt restrictions can be written, this measure of DEBT depicts the most common form of debt-equity ratio in the sample time period.

The ideal means of measuring closeness to additional debt covenants would compare the existing value of the DEBT ratio to the contractual DEBT limit imposed by the debt covenant. This, however, is seldom feasible. Examination of the Moody's Industrial and Transportation Manuals for each of the 103 FT firms indicates that, although the DEBT variable was the most common way of specifying the additional debt constraint: (1) a great variety of constraints exists across the firms; and (2) the specific contractual DEBT limit was not available for many of the firms.

Fortunately, previous research provides evidence that proximity to a variety of additional debt constraints may be adequately represented in statistical analyses by using debt-to-equity ratios similar to the DEBT variable (Beneish & Press, 1993; Press & Weintrop, 1990). Thus, it is assumed that the higher the DEBT variable the less slack there is in existing debt covenants.[16]

Dividend Constraints (DIV). DIV measures proximity to dividend covenant violation. Smith and Warner (1979) provides evidence that dividend restrictions are

commonly used to determine the maximum available pool (unrestricted retained earnings) from which dividends can be paid. This variable is used to depict the slack in dividend covenants and is calculated as follows:[17]

$$\text{DIV} = \frac{\text{Cash Dividends Paid}}{\text{Unrestricted Retained Earnings} + \text{Cash Dividends Paid}}$$

The higher the DIV variable the greater the percentage of available funds being paid out in current dividends. Firms with higher DIV ratios will have less funds available for future dividends and thus have less slack in existing covenants.[18]

Risk of the Firm (RSK). Lys (1984) provides evidence that another important factor potentially relevant to the measurement of proximity to debt covenant violation is total firm risk. His analysis suggests that to adequately measure the potential for default on individual debt issues, it also is necessary to determine the risk of the firm. Lys suggests that these two factors are often negatively correlated. The DEBT variable is included in model (3) to measure the default risk of debt. An additional variable – RSK – is included in model (3) to measure total firm risk.

Following Lys, the variable RSK is defined as the standard deviation of the firm's return divided by one plus the debt-to-equity ratio. In this study, the standard deviation of firm returns is calculated using the residuals from model (1) for the appropriate period of time. That is, if the RSK variable is being measured for an accounting event occurring in period I, II or III, then the residuals from the returns generating model estimated during that period are used. In addition, the debt to equity ratio used to estimate RSK is the DEBT variable discussed previously.

Finally, it is expected that all three of these variables will be negatively related to the market reaction to the accounting proposals because the less the slack in covenants and the higher the risk of the firm, the more likely adverse economic effects will arise as a result of the accounting change.

5.1.2. Variables Proxying for Potential Renegotiation Costs

Interest-related Renegotiation Costs (REN). One set of costs can arise if, upon renegotiation of debt covenants, debtholders make their consent conditional on an adjustment in the coupon rate towards the current market rate of interest. These costs can be estimated by measuring the additional interest (plus call premium) that would be paid over the remaining life of the debt as a result of renegotiation of existing covenants. In this research, the additional interest charge was calculated by determining the present value of the ordinary annuity of extra yearly interest to be paid over the remaining life of the debt, discounted at the average yield rate that was being paid on bonds during the year of the accounting change.[19] The relative refinancing costs were obtained by deflating the total interest-related renegotiation costs by the market value of equity at the beginning of the period.

Public or Private Debt (PUB). Past research hypothesizes that the relative renegotiation costs differ between public and private debt issues (e.g. Leftwich, 1981). These costs are assumed to be higher for public debt because more people (typically two-thirds of the debtholders) have to approve any covenant renegotiation. The relative amount of these costs are computed by deflating the amount of public debt that had debt covenants potentially affected by the ITC accounting change by the market value of equity at the beginning of the period.

For both these variables, higher renegotiation costs are expected to be associated with more negative security market reactions to the proposed accounting change.

5.1.3. Variable Proxying for Potential Costs Related to Changes in Financing or Investment Decisions

Expected Investment/Refinancing Costs (INVST). If the imposition of the DF method reduces the slack in a firm's existing debt constraints, then the firm's borrowing capacity will be reduced. The firm could respond by reducing investment in ITC qualifying assets or switching to more costly equity financing. In either case, additional costs are imposed on shareholders. Because the APB's recommendations were never implemented, the ex-post effects on financing and investment decisions are not observable. Consequently, we use the level of investment in ITC qualifying assets reported in the next annual report, as a measure of the market expectations about future investment and financing needs. We scale that value by the market value equity at the end of the period to determine the following variable:

$$\text{INVST} = \frac{\text{Qualifying Investment}}{\text{Market Value of Equity}}$$

Ceteris paribus firms making larger investments in the next fiscal year might be expected to make larger reductions in future investments or have a higher demand for more costly future equity financing as a result of the accounting change. Consequently, higher levels of investment in the next fiscal year are expected to be associated with more negative security price reactions.

5.2. Summary Statistics for Independent Variables

Descriptive statistics for the independent variables across the three time periods are presented in Table 5. The average potential cash flow impact caused by renegotiation of interest rates (REN) is 2.1% of the market value of equity. This amount is slightly higher than the range (0.84–1.03%) documented by Beneish and Press (1993) for firms disclosing actual technical defaults over the period 1983–1987.

Table 5. Summary Statistics for the Independent Variables Across Three Event Periods.

Variable	Mean	Standard Error	Pearson Product Moment Correlation Coefficients					
			DEBT	DIV	RSK	REN	PUB	INVST
DEBT	0.224	0.135	1.000					
DIV	0.143	0.130	0.048	1.000				
RSK	0.013	0.004	−0.161***	−0.032	1.000			
REN	0.021	0.041	0.265***	0.089	−0.045	1.000		
PUB	0.062	0.158	0.324***	0.073	−0.022	0.453***	1.000	
INVST	0.044	0.053	0.185***	0.055	0.017	0.062	0.040	1.000

Note: DEBT = long-term debt/(stockholders' equity + long-term debt − intangible assets); DIV = cash dividends paid/(unrestricted retained earnings + cash dividends paid); RSK = standard deviation of returns/(1 + DEBT); REN = additional interest charge assuming renegotiation/market value of equity; PUB = public debt/market value of equity; INVST = qualifying investment/market value of equity.

*** Significant at 1% level, two-tail test.

Table 5 also indicates that the average amount of annual investment in ITC qualifying assets by sample firms was 4.4% of the market value of equity.

These values represent the maximum costs that might be expected to be incurred by sample firms if they were forced to incur renegotiation costs or change their investment or financing decisions as a result of the proposed accounting change. The average market reactions to the accounting events reported in Tables 3 and 4 ranged from −0.26 to 0.18% of the market value of equity. These values appear reasonable when compared to the upper bounds, suggested above, and indicate that investors may have reliably perceived that small but statistically significant costs would arise for FT firms if the DF method was ultimately mandated.

The Pearson product-moment correlation coefficients between the independent variables also are reported in Table 5. We observe that several of the independent variables are significantly correlated with each other. These significant correlations are concentrated in the DEBT variable, with all but one of the variables (DIV) being statistically correlated with DEBT at the 0.01 level. The only other significant correlation is between the two variables proxying for potential costs of renegotiation: REN and PUB. With this amount of pairwise correlation between variables it is possible that significant multicollinearity is present in the data. In the presence of multicollinearity it may be difficult to isolate the effects of particular independent variables at individual event dates. We, therefore, chose to estimate a combined cross-sectional model across all significant event dates to diminish the

Table 6. Cross-Sectional Regression Model Results for Significant ITC Accounting Events for Periods I–III (t-Values are in parentheses).

$$c_{jk} = a_0 + a_1\text{DEBT}_j + a_2\text{DIV}_j + a_3\text{RSK}_j + a_4\text{REN}_j + a_5\text{PUB}_j + a_6\text{INVEST}_j + e_{jk}$$

Predicted Sign of Non-intercept Coefficients	Intercept	Independent Variables Measuring						R^2 (%)
		Proximity to Violation			Cost of Violation		Expected Investment/ Financing Costs	
		DEBT	DIV	RSK	REN	PUB	INVST	
Minus	0.002 (1.80)	−0.005 (−2.14)**	0.001 (0.46)	−0.164 (−2.24)**	0.010 (1.35)	−0.0004 (−0.22)	−0.010 (−1.93)**	2.6

Note: c_{jk} is the abnormal stock return at all significant events k. DEBT = long-term debt/(stockholders' equity + long-term debt − intangible assets). DIV = cash dividends paid/(unrestricted retained earnings + cash dividends paid). RSK = standard deviation of returns/(1 + DEBT). REN = additional interest charge assuming renegotiation/market value of equity. PUB = public debt/market value of equity. INVST = qualifying investment/market value of equity.

** Significant at 2.5%, one-tail test.

effects of multicollinearity by maximizing the number of observations used to fit model (3).

5.3. Cross-Sectional Test Results

The results of estimating model (3) across the six significant accounting event dates are presented in Table 6. The regression results provide solid support for Hypothesis 2. The model is significant at the 0.018 level. In addition, individual coefficient results are consistent with the imposition of the DF method having debt covenant-related economic consequences. Two of the three proxies measuring the proximity to debt covenant constrains are significant. DEBT and RSK have negative coefficients, as predicted, and are significant at the 0.016 and 0.012 level, respectively. The DIV variable is insignificant; however, failure to reject the null hypothesis for this variable is not surprising because Kalay (1982) provides evidence that few, if any, firms are close to violating their dividend constraints.[20]

The results measuring the debt covenant-related costs associated with the mandated accounting change indicate that reducing the slack in debt covenants may impose restrictions on firms financing and investing decisions. INVST,

which proxies for the expected amount of future investment, is significant at the 0.025 level and has a negative coefficient. This result is consistent with investors perceiving that FT firms will have to reduce investment or substitute more costly equity financing in response to more binding debt constraints. The coefficients on the REN and PUB variables are not statistically different from zero. This result suggests that investors do not perceive that firms will incur significant renegotiation cost from the accounting change.[21] The combined results on the REN, PUB and INVST variables also suggest that investors perceive firms are more likely to alter their investment or financing decisions than be placed in technical default of their covenants as a result of the mandated accounting change. Such actions would hinder the propensity of FT firms to invest in ITC qualifying assets and, therefore, represent potential significant economic consequences to sample firms.[22]

6. SUMMARY AND CONCLUSIONS

The primary objective of this research was to determine whether mandating the DF method of accounting for the ITC had significant economic effects on FT firms. We examine whether this action imposed costs on shareholders due to the increased probability of technical default of accounting-denominated debt covenants. Two sets of costs are considered: (1) the cost of renegotiating existing debt contracts; and (2) the cost of foregoing new investment or of employing more costly equity financing. Evidence provided in the first stage of this analysis supports the notion that statistically significant negative security price effects were associated with ITC accounting proposals that increased the likelihood of adoption of the DF method. In addition, significant market price reversals occurred at events that decreased the probability of a DF method mandate. Thus, statistically significant economic consequences appear to exist for the proposed ITC accounting changes.

The second stage of this research was formulated to test whether the security price reactions could be associated with variables proxying for the debt covenant effects of the ITC proposals. Three sets of proxies were used. The first measured the proximity to debt covenant violation. The second measured the cost of renegotiating the debt and the third measured the cost of altering financing or investing decisions. The second-stage test results show a significant association between the security price effects related to the ITC proposals and proxies for debt covenant effects. Variables measuring the proximity to debt covenant are negatively associated with the security price effects, but renegotiation costs are not significant. Additionally, debt covenant constraints appear to impose potential

costs in the forms of reduced investment or increased financing costs. This is consistent with the hypothesis that imposing the DF method causes firms to reduce new investment because of restrictions on raising new debt.

Our results are important because they provide evidence to policymakers on the economic consequences of accounting regulation. In this case, the evidence indicates that mandating the DF may have had the unintended consequence of hindering the efforts of the government to stimulate economic activity. Our evidence is consistent with investors perceiving that FT firms would reduce investment in ITC qualifying assets as a result of the imposition of the DF method. And thus, governmental concerns that business investment in new equipment may actually be retarded upon mandate of the DF method appear to be supported by this research evidence.

NOTES

1. In recent times, Congress also has passed non-binding resolutions expressing their preferences relating to accounting standard setting matters. E.g. in 1994, the U.S. Senate passed a non-binding resolution condemning FASB's proposal to require immediate expensing of employee stock options by a vote of 88 to 9.
2. See Watts and Zimmerman (1986, 1990) and Fields et al. (2001) for a review of this literature.
3. The reasons why we use the market reaction to APB deliberations to assess the debt covenant-related effects of a DF mandate are discussed in Section 2.
4. See Hall (1967), Hall and Jorgenson (1971), Bischoff (1971), Coen (1968, 1971), Auerbach and Hassett (1992).
5. Leftwich (1983) provides evidence that many lending agreements in the 1960s and 1970s were commonly insulated to avoid the effects that certain generally accepted accounting practices (GAAP) would have on accounting numbers. In the instances where a certain accounting method is either not contained on the list of acceptable methods or is proscribed from use during the calculation of specific lending agreement ratios, a change in GAAP which would mandate or eliminate the use of that method would have no effect on lending agreement covenants. In the case of the ITC, analysis of the most common lending agreement covenants (as specified in American Bar Foundation, 1971) shows that the lending agreement numbers normally can be calculated using any GAAP method of accounting for the ITC. Thus, a mandated change in GAAP to the DF method may have a significant impact on lending agreement ratios of affected firms.
6. Proposed accounting changes are sometimes hypothesized to have potential economic consequences for reasons other than the debt covenant rationale espoused in this paper. These economic effects are often hypothesized to arise as a result of changes in: (1) managerial compensation; (2) regulated rates; and (3) political costs of affected firms. These hypotheses are not pursued in this paper for the following reasons. First: (1) managerial compensation plans directly tied to accounting numbers were not prevalent in the 1960s (Hite & Long, 1982); (2) the maximum contribution to the bonus pool is often defined in terms of income *before* taxes (Healy, 1985); (3) the direction of the security price

effect related to the mandated accounting change is likely to vary depending on where the future accounting earnings are expected to be relative to the bonus window specified in the compensation contract; and (4) the prior belief that outside the directors can circumvent the effects of an accounting change on bonus levels at low costs to the firm. Second, a mandatory change to the DF method would not have adverse effects on political costs or regulated rates because the DF method is the preferred income-decreasing accounting method for these purposes (Watts & Zimmerman, 1986).

7. For example, one letter received by the APB in objection to the mandated adoption of the DF method states, "It is conceivable that some marginal companies might even find that their freedom to declare dividends would be somewhat restricted if the proposed treatment were adopted" (Zeff & Keller, 1964).

8. Leftwich (1983) and American Bar Foundation (1971, p. 72, fn. 25) provide evidence that deferred tax credits may or may not be counted as debt within lending agreements during that time period.

9. The ITC accounting policy deliberation process is described in detail in Section 4.

10. If two events were within four calendar days of each other, the event period for one or both events was arbitrarily reduced to avoid event date overlap. However, in no instance, were the event intervals reduced by more than one day.

11. If the event window is either too short or to long, it likely will serve to bias the results against rejection of the null hypothesis of no market effects.

12. The SUR model assumes that the cross-sectional covariance matrix of disturbances for the system of equations is constant over time and that the disturbances are serially independent and normally distributed. It also assumes that across equations, the contemporaneous covariances of the disturbances $E(e_{it},e_{jt})$ are nonzero for some firms and the noncontemporaneous covariances $E(e_{it},e_{j,t+k})$ all equal zero. Diagnostic tests of these assumptions indicate that by: (1) observing the plots of individual firm regression residuals, little or no change in variance appeared to occur over time; (2) employing a Durbin-Watson test using lower bounds, serial dependency was not any greater than that expected by chance; and (3) employing a Q–Q plot correlation test for normality, the assumption of normality could not be supported. Thus, except for the nonnormality, the models appeared to be well specified. Note, however, that Brown and Warner (1985) provide evidence that nonnormality in returns generating models similar to model (1) may not severely bias test statistics similar to those employed in this study.

13. The nonnormality problems noted in footnote 12 may make the exact distribution significance levels for the test statistics more tenuous. However, for these statistics the asymptotic significance levels approach the exact distribution significance levels as T approaches infinity. So, this may not be much of a problem given that the individual regression models were estimated using at least 803 observations.

14. Note, however, we do not necessarily expect these tax event results for DF firms to be significant. While Ayres (1987) provides evidence of a statistically significant market reaction to the ITC *tax* proposals, her tests aggregate security returns over several event dates. Thus, security returns at any individual tax event date may be statistically indifferent from zero and still be consistent with her aggregate results. This result also would suggest that the market reacted to the tax proposals at dates other than those examined in this study.

15. It should be noted that, unless indicated otherwise, all independent variables discussed in this section are defined using financial statement numbers for the year before the proposed accounting change.

16. Of course this assumption may be more plausible for samples representing firms in one industry than samples representing firms from many industries. Smith and Watts (1992) suggest that different industries face different optimal leverage ratios due to differences in noncash deductions and investment opportunity sets. If optimal leverage ratios differ by industry, bondholders may take this into account and determine different leverage constraints for different industries. To account for potential industry differences in these constraints, the stage-two cross-sectional regression models also were run with the DEBT variable scaled by the median DEBT value for firms in the same 3-digit SIC Code industry. This modification did not change our inferences.

17. For firms that neither paid dividends in the previous year nor had a balance in unrestricted retained earnings, this variable was defined as being equal to 1.0. In this instance, the firms had no leeway to pay extra dividends so their dividend covenant was considered binding.

18. A problem arose when calculating the DIV variable. The value of unrestricted retained earnings is not always available in either the Compustat Industrial File or the Moody's Manuals because this value was not required to be disclosed until the mid-1970s. In this situation, total retained earnings is used as a proxy for unrestricted retained earnings because dividend restrictions also are imposed by state incorporation statutes. Typically these statutes restrict dividends to the amount of total retained earnings. This procedure assumes that if a firm did not report unrestricted retained earnings, no dividend restrictions existed other than those imposed by state charters.

19. A surrogate for the extra yearly interest to be paid is determined by multiplying the face value of all debt (with covenants potentially affected by the accounting change) by the difference between the average bond yield during the year of issuance of the debt and the average yield during the year of the accounting change. If the bond yield decreased from the date of issuance of the bonds to the date of the accounting change, zero interest-related renegotiation costs were assumed to occur. Since the yield on the existing debt was not always observable at the time of bond issuance or at the time of the accounting change, specific rules similar to those described in Lys (1984, fn. 20) were use to estimate these amounts.

20. Healy and Palepu (1985) also provide evidence that firms with near binding dividend constraints seldom change accounting procedures to introduce slack in these constraints. Rather, these firms choose to cut or omit dividends. This result suggests that elimination of the FT method also may not have severe economic consequences for firms close to their dividend constraints.

21. The finding on the REN and PUB variables are also consistent with prior research (e.g. Leftwich, 1981; Lys, 1984), which provide only limited evidence of significant renegotiation costs arising from mandated accounting changes.

22. Model (3) was also estimated with the dependent variable defined as the abnormal returns at the 13 nonsignificant accounting event dates (see Tables 2 through 4). This model was estimated to provide a benchmark for understanding the significance of the model (3) results reported in Section 5.3. In this model the independent variables were measured as specified in Section 5.1. The overall regression model estimated did not explain a significant portion of the cross-sectional variation in the dependent variable ($R^2 < 0.1\%$) suggesting that the results reported in Section 5.3 are not primarily attributable to severe biases in the model (3) specification. Finally, the model reported in Table 6 also was rerun employing White's heteroskedasticity-consistent covariance matrix estimator. Inferences remained unchanged.

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AN ANALYSIS OF RESTATEMENTS ON FINANCIAL REPORTING: IS THE LOSS OF INVESTOR CONFIDENCE JUSTIFIED?

James H. Thompson and Gregory M. Larson

ABSTRACT

Public confidence in financial statements may be at an all-time low. The bankruptcy of Enron, the largest bankruptcy in United States history, brings into question whether the accounting profession, and the auditing process in particular, protects the users of financial statements. The shower of scandals and earnings restatements make users skeptical of the financial reporting rules that are supposed to protect the public. In addition, a lack of transparency in reporting followed by restated financial restatements disclosing billions of dollars of omitted liabilities and losses exacerbate this problem.

This paper considers the frequency and nature of Form 8-K reports that are filed with the Securities and Exchange Commission (SEC) by Fortune 500 companies during 2001. This form is used to report the occurrence of any material events or corporate changes which are of importance to investors or security holders and previously have not been reported by the registrant. Information from Form 8-K is analyzed to identify which companies filed 8-K reports, the types of disclosures that are included, industry characteristics of companies that file 8-K reports, whether financial statements were restated as

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a result of those filings, the reasons that restatements, if any, were required, and the relationship between size of company and number of restatements.

Public confidence in financial statements may be at an all-time low. The shower of scandals and earnings restatements has made users skeptical of the financial reporting rules that are supposed to protect the public (Gibbs, 2002). The bankruptcies of Enron, WorldCom, and others bring into question whether the accounting profession, and the auditing process in particular, protects the users of financial statements. Although these companies are not the first big name corporations to fall because of questionable accounting practices, their shear size results in public shock waves.

The fallout from the Enron collapse is being felt on many levels. Perhaps more than any other, the accounting profession has felt these repercussions. James G. Castellano (2002), chairman of the AICPA Board of Directors, states that the AICPA shares the distress that all Americans feel concerning the tragic breakdowns. Further, he states that the AICPA takes seriously its public responsibility and is committed to doing everything possible to restore confidence in our profession. The accounting profession has more than 100 years of history based on public trust and integrity. In fact each year, more than 15,000 audits of publicly traded companies are completed successfully without restatement or allegations of impropriety. As an attempt to bolster public confidence, the Sarbanes-Oxley Act of 2002 is a major reform package that creates a public-company-accounting-oversight board, revises auditor independence rules, revises corporate governance standards, and significantly increases the criminal penalties for violating securities laws (Miller & Pashkoff, 2002).

Most successful businesses generate product or service value from personal and corporate credibility. When credibility is lost because of evidence or even claim questionable accounting practices, this value is diminished or lost. Although Enron is an extreme example, other public companies somewhat routinely test public credibility because of errors and other irregularities that result in reissued financial statements. Even though a company may employ the most technically competent accountants around, financial statements and the related audit opinion are useless if users do not believe what they read (Beck, 2002).

How can a company worth $80 billion like Enron go bankrupt in less than one year? Enron's eventual downfall resulted from many factors, but individual and collective greed born in an atmosphere of market euphoria and corporate arrogance are prominent (Thomas, 2002). Hardly anyone – the company, its employees, analysts, or individual investors – wanted to believe the company was too good to be true. So, for a long time, no one did. Meanwhile, Enron made many high-risk deals, some of which went sour in the early months of 2001 as its stock price and

debt rating imploded because of loss of investor and creditor trust. Methods that the company used to disclose its complicated financial dealings were erroneous and, to many, deceptive. The lack of transparency in reporting its financial affairs followed by financial restatements disclosing billions of dollars of omitted liabilities and losses contributed to Enron's demise.

Because of scandals like Enron and other anecdotal reports of restatements in the financial press, many argue that the investing public has experienced a loss of faith and credibility in financial statements. The purpose of this paper is to investigate the extent and nature of restatements in financial reporting. This assessment may assist the accounting profession in determining whether such a loss of faith and credibility is justified.

BACKGROUND

The loss of faith and credibility in financial statements involves a number of dimensions. In this paper, four dimensions are investigated. These include an analysis of prior studies of restatements, anecdotal evidence regarding the financial statement effects of restatements on selected companies, the impact of restatements and other factors on public confidence in financial statements, and actions intended to restore public confidence.

Prior Studies of Restatements

Several studies have analyzed financial statement restatements. Even before the recent bankruptcies, the frequency of restated financial statements had been increasing for many years (Greenberg, 1998). The Financial Executives Institute (FEI) and Wu (2001) reported that the number of restatements in the early and mid-1990s remained approximately the same, but in the late 1990s the number of restatements increased significantly. The Huron Consulting Group (2003) also reported an increase in the number of restatements. They reported that there were 330 restatements in 2002 compared to 158 restatements in 1998. One of the most comprehensive studies of restatements was conducted by the General Accounting Office (GAO). The GAO (2002) reported that the number and trend of announcements of financial statement restatements has increased significantly each year from 1997 through the first half of 2002. The projected increase from 1997 through the end of 2002 is more that 170%. Figure 1 illustrates the GAO's findings.

Although several very large companies like Xerox and WorldCom reported significant restatements, the majority of restatements have historically occurred in

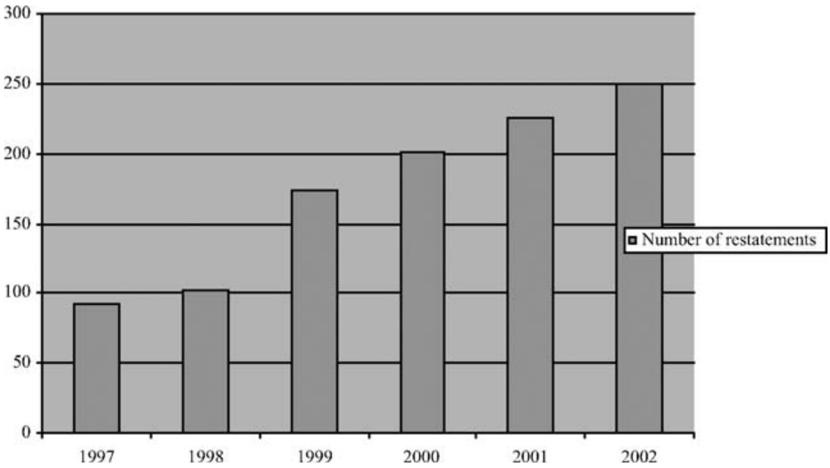

Fig. 1. Total Number of Restatement Announcements: 1997–2002. *Source:* GAO (2002).

small companies. In fact, more than two-thirds of the more than 1000 restatements from 1977 to 2000 occurred at companies with a market capitalization of less than $500 million (Countryman, 2002). However, the number of large companies restating their financial statements has increased significantly. Based on total assets, large companies as a percentage of the total restating companies have increased from about 25% in 1997 to over 30% in 2001. Between 2001 and 2003, the number of large and small companies restating has been equal (20X).

Not only has the number of restatements increased in recent years but also the magnitude of restatements has increased. For example, WorldCom reported the single largest restatement ever with a $3.8 billion reduction in previously reported pretax income. In addition, Xerox Corporation admitted to overstating operating earnings by $1.4 billion. These two restatements alone nearly match the combined total effect of $5.8 billion from all 463 restatements in 1998, 1999, and 2000 (Byrne, 2002). Also, Enron admitted errors that resulted in a $1.2 billion reduction in stockholders' equity.

Although there are many reasons for financial statement restatements, most restatements are routine and do not indicate accounting irregularities. Accounting irregularities include "aggressive" accounting practices, intentional and unintentional misuse of facts that applied to financial statements, oversight or misinterpretation of accounting rules, and fraud (GAO, 2002). In Nourayi's (1994) study, restatements involving accounting irregularities produced the largest market reactions.

Nourayi (1994) examined the effect of enforcement actions of the SEC against companies that are listed on the New York Stock Exchange and the American Stock Exchange. Using stock price changes as an indicator for the enforcement effect, Nourayi found a negative market reaction to the announcement of the investigations. Violations produced a larger negative price impact if the company or the financial press announced the violations prior to the announcements made by the SEC.

A search for additional papers using ProQuest[1] from peer reviewed publications reporting the impact of restatements on stock prices was largely unsuccessful. There were several papers that reported the impact of various factors on stock prices. These factors included the effect of incremental earnings, the effect of estimates of future earnings, economic effects of changes in loan loss provisions of banks, the use of debt as a method of acquisition, the effect of alternative financial disclosure strategies, the effect of misstatements on auditor materiality thresholds, and many others. Notably absent, the effect of restatements on stock prices was not addressed in any of the peer reviewed publications that were identified by the search.

Anecdotal Evidence of Effects of Restatements on Financial Statements

The Wall Street Journal contained anecdotal reports regarding restatements and the resulting stock price change for individual companies. In almost every instance, reductions in earnings due to restatements were followed by a decline in the stock price. That is, restatement of earnings is regarded as the primary culprit in causing decline in stock price. Discussed below are the effects of restatements on stock prices for Xerox, Cendant, Rite Aid, Bristol-Myers Squibb, and HealthSouth.

In June 2001, Xerox Corporation, after months of defending its accounting as sound, restated financial results for three years after an investigation by its board and an outside auditor concluded that the company had "misapplied" accounting rules in several ways (Maremont & Bandler, 2001). On July 1, 2002, Xerox admitted that it had improperly booked $6.4 billion in revenue and overstated pretax profit by $1.41 billion over five years. Xerox share prices had fallen from a high of $62 in 1999 to below $5 in late 2000 (Bandler, 2002).

Cendant Corporation, in another major stumble experienced a stock price decline of 17% when the company reported that accounting fraud was far deeper than originally thought. The fraud involved booking fictitious revenue totaling $300 million during a three-year period. With the deception, "there was never a service performed, never a customer," reported Cendant's chief financial officer.

"Somebody just took a pen and made a journal entry." Cendant's report of fictitious revenue sent its stock tumbling $3.1875 to $15.6875, a 52-week low (Nelson & Maremont, 1998).

Shares of Rite Aid Corporation fell 21% on the first trading day after the drug store chain disclosed that it overstated income by more than $1 billion for two prior fiscal years and reported it had a loss of $1.14 billion for the year ended in February 2000. Following an accounting scandal that cost the chief executive his job and pushed Rite Aid's stock down more that 85% in 18 months, new management released the company's financial restatements (*The Wall Street Journal*, 2000).

The Wall Street Journal reported on February 17, 2003, that Bristol-Myers Squibb had spent the past year embroiled in a wave of seemingly unending scandals, ranging from a dubious investment to an SEC investigation of earnings restatements. As a result, Bristol's stock plummeted to about $23 a share, down almost 50% from the previous year (Revell, 2003).

On April 4, 2003, HealthSouth's stock had been delisted from the New York Stock Exchange following the previous month's regulatory allegations of accounting fraud at the Birmingham, Alabama, provider of outpatient surgery and rehabilitation services. The stock then traded at 12 cents on the pink sheets (Brown & Frank, 2003). The SEC had filed charges accusing the company of overstating earnings by $1.4 billion since 1999 in a scheme in which the founder Richard Scrushy was alleged to have instructed employees to inflate earnings since the company went public in 1986 (Terhune, Mollenkamp & Carrns, 2003).

Consistent with Nourayi's finding, the anecdotal accounts of Xerox, Cendant, Rite Aid, Bristol-Myers Squibb, and HealthSouth all involve negative earnings reports that were followed by significant stock price decreases. Despite the anecdotal nature of these reports, there seems to be ample evidence that restatements due to error, accounting irregularity, and fraud produce measurable stock price declines. Hill (2002) writes, "worries about massive earnings restatements like Enron's, WorldCom's and Xerox's have cast a cloud over the market this year and were a major factor in driving down stock indexes." The more companies restate their earnings, the more money investors will lose. According to Wells (2002), "corporate earnings restatements related to accounting problems cost investors $100 billion in the last five years." Thus, the significance of this type of restatement has important implications for the investment community.

Table 1 summarizes the financial statement impact of restatements reported by Xerox, Cendant, Rite Aid, and Bristol-Myers Squibb.[2] Table 1 shows that earnings per share computed over all affected years decreased between 10 and 218% as a result of restatements.

Table 1. Summary of Financial Statement Impact of Restatements for Selected Fortune 500 Companies (Millions Omitted Except for per Share Amounts).

	Year	Pretax Profit Reported	Pretax Profit Restated	Difference	Number of Shares Issued & Outstanding	Pretax Profit per Share Reported	Pretax Profit per Share Restated	Difference	Percentage of Originally Reported Amount
Xerox	1997	$2,005.00	$1,287.00	$(718.00)	$653.40	$3.07	$1.97	$(1.10)	−35.81%
	1998	579.00	(13.00)	(592.00)	659.00	0.88	(0.02)	(0.90)	−102.25%
	1999	1,908.00	1,288.00	(620.00)	663.20	2.88	1.94	(0.93)	−32.49%
	2000	(384.00)	(367.00)	17.00	667.60	(0.58)	(0.55)	0.03	−4.43%
	2001	(137.00)	365.00	502.00	704.20	(0.19)	0.52	0.71	−366.42%
Total		$3,971.00	$2,560.00	$(1,411.00)	$669.48	$5.93	$3.82	$(2.11)	−35.53%
Cendant	1995	$503.00	$350.00	$(153.00)	$763.70	$0.66	$0.46	$(0.20)	−30.42%
	1996	714.00	534.00	(180.00)	821.60	0.87	0.65	(0.22)	−25.21%
	1997	247.00	257.00	10.00	851.70	0.29	0.30	0.01	4.05%
Total		$1,464.00	$1,141.00	$(323.00)	$812.33	$1.80	$1.40	$(0.40)	−22.06%
Rite aid	1998	$512.00	$(239.00)	$(751.00)	$250.70	$2.04	$(0.95)	$(3.00)	−146.68%
	1999	200.00	(605.00)	(805.00)	258.50	0.77	(2.34)	(3.11)	−402.50%
Total		$712.00	$(844.00)	$(1,556.00)	$254.60	$2.80	$(3.32)	$(6.11)	−218.54%
Bristol-Myers	1999	$5,158.00	$4,790.00	$(368.00)	$1,984.00	$2.60	$2.41	$(0.19)	−7.13%
Squibb	2000	5,478.00	5,247.00	(231.00)	1,965.00	2.79	2.67	(0.12)	−4.22%
	2001	2,986.00	2,218.00	(768.00)	1,940.00	1.54	1.14	(0.40)	−25.72%
Totals		$13,622.00	$12,255.00	$(1,367.00)	$1,963.00	$6.94	$6.24	$(0.70)	−10.04%

The Impact of Restatements and Other Factors on Public Confidence in Financial Statements

Not only do restatement announcements appear to affect company stock prices, but some evidence suggests that these announcements may negatively impact overall investor confidence. According to Joseph Berardino, former head of Andersen, Enron's auditor, "our financial reporting model is broken" ("Company Accounts: Badly in Need of Repair," 2002). Investors quickly picked up on this theme, and loss of confidence in the accounting profession has spiraled.

Investor confidence is difficult to quantify because it cannot be measured directly and because investors consider a variety of factors when making an investment decision. However, the GAO (2002) identified several survey-based indexes to measure investor optimism. A periodic UBS/Gallup survey-based index found that as of June 2002 investor confidence was at an all-time low due to concern over corporate accounting practices. Other than restatements, are there other factors that have contributed to a loss of investor confidence?

According to the GAO Report No. 03-138, industry officials and academics have speculated that several factors may have caused U.S. companies to use questionable accounting practices. These factors include corporate pressure to meet quarterly earnings projections, perverse executive compensation incentives, outdated accounting and rule-based standards, complex corporate financing arrangements, and compromising of independence by some public accounting firms (GAO, 2002).

Actions Intended to Restore Public Confidence

Regardless of the reason, can the accounting profession restore faith and credibility in financial statements? The growing number of accounting problems, particular among larger companies, illustrates weaknesses in the current corporate governance and financial reporting system at virtually every level. In many restatements, corporate management, boards of directors, auditors, securities analysts, and credit rating agencies failed to identify problems before investors and creditors lost billions of dollars. Thus, current corporate governance and accounting oversight structures have limitations and need to be improved. The Sarbanes-Oxley Act of 2002 addresses many of these concerns. One of the major cornerstones of the Act is the creation of a new oversight body, the Public Company Accounting Oversight Board, to oversee the audit of public companies. To insure independence of this board, its structure is established as a nonprofit corporation funded by registration and annual fees from registered public

accounting firms and support fees assessed to issuers. A majority of its members will be nonaccountants. Unlike the previous oversight structure (the now disbanded Public Oversight Board), this new board will have sweeping powers to inspect accounting firms, set rules and standards for auditing, and impose meaningful sanctions on violators. Further, the Act addresses auditor independence by prohibiting auditors from providing certain nonaudit services to their clients and strengthening the oversight role of the board of directors (GAO, 2002).

In addition to changes in the financial reporting structure, there must be an increase in corporate accountability. Corporate boards of directors' audit committee members must be independent and are responsible for selecting and overseeing outside auditors. Also, pursuant to Securities and Exchange Commission (SEC) Rules required by the Act, top corporate officials must personally attest to the accuracy of their firm's accounting or face civil and criminal penalties. The Act also addresses other issues aimed at strengthening investor confidence, such as implementing rules, addressing analysts' conflicts of interest, creating new disclosure requirements, increasing criminal sanctions, and requiring the SEC issue rules that address standards of professional conduct for attorneys (GAO, 2002).

METHODOLOGY

All 2001 8-K filings for each Fortune 500 Company were obtained from the SEC website and summarized in a spreadsheet. The spreadsheet shows the name of the company, the date of each 8-K filing, the North American Industry Classification System (NAICS) sector of the company, the items of disclosure, the number of restatements, and the reason for restatements.

An 8-K is the current form used to report the occurrence of any material events or corporate changes that are important to investors or security holders that previously have not been reported by the registrant (U.S. Securities and Exchange Commission, 2003). It provides more current information on certain specified events than would Forms 10-Q (quarterly) or 10-K (annual reporting).

The nine disclosure items under form 8-K reporting during 2001 are as follows:

(1) Change in control of the company.
(2) Acquisition or disposition of a significant amount of assets.
(3) Bankruptcy or receivership.
(4) Change in the company's certifying accountant.
(5) Disclosure of events deemed to be of importance to shareholders.
(6) Resignation of a company director.

(7) Exhibits, financial statements, and pro forma financial information included as part of Form 8-K in connection with a business acquisition.
(8) Change in the company's fiscal year.
(9) Public disclosure requirements under Regulation FD.

Items 1, 2, 3, 4, 6, 7 and 8 define specific events that trigger a requirement to file form 8-K. Items 5 and 9 are optional methods of providing relevant information to investors. Although the SEC is currently proposing an overhaul of 8-K reporting, including the addition of 11 new items that would trigger filing of an 8-K, this analysis focuses on the requirements that were in place during 2001.

The 2001 8-K data for the Fortune 500 companies are grouped by NAICS sector in order to perform industry comparisons.[3] The NAICS has replaced the 1987 U.S. Standard Industrial Classification (SIC) system. The NAICS was developed jointly by the U.S., Canada, and Mexico to provide new comparability in statistics

Table 2. Industry Classification System (NAICS) Relation to SIC North American Divisions.

NAICS Sectors	SIC Divisions
Agriculture, Forestry, Fishing, and Hunting	Agriculture, Forestry, and Fishing
Mining	Mining
Construction	Construction
Manufacturing	Manufacturing
Utilities	Transportation, Communications and Public Utilities
Transportation and Warehousing	Transportation, Communications and Public Utilities
Wholesale Trade	Wholesale Trade
Retail Trade	Retail Trade
Accommodation and Food Services	Retail Trade
Finance and Insurance	Finance, Insurance, and Real Estate
Real Estate and Rental and Leasing	Finance, Insurance, and Real Estate
Information	Services
Professional, Scientific, and Technical Services	Services
Administrative Support; Waste Management and Remediation Services	Services
Educational Services	Services
Health Care and Social Assistance	Services
Arts, Entertainment, and Recreation	Services
Other Services (except Public Administration)	Services
Public Administration	Public Administration
Management of Companies and Enterprises	(Parts of all divisions)

about business activity across North America. On April 9, 1997, the Office of Management and Budget (OMB) announced its decision to adopt NAICS as the industry classification system used by the statistical agencies of the United States (U.S. Census Bureau, 2002).

The NAICS consists of 20 major sectors under which hundreds of subdivisions further dissect the major sectors. Similarly, the SIC system consists of 10 major divisions with hundreds of subdivisions. Table 2 shows how the 20 NAICS sectors relate to the 10 SIC Divisions.[4]

RESULTS

Fortune 500 companies filed a total of 3,120 8-K reports in 2001, an average of 6.24. The number of 8-K forms filed by any one company ranged from one to 48. These data indicate that the number of 8-K reports filed varies greatly. Form 8-K reports filed during 2001 contained a total of 150 restatements. The following five sections analyze these restatements.

Where Are Restatements Found?

Most of the 8-K forms filed during 2001 reported more than one item of disclosure. The 3,120 8-Ks included a total of 5,315 items of disclosure. This total represents an average of 1.7 disclosure items per 8-K form filed. Item 5 (disclosure of events deemed to be of importance to shareholders) was the most frequently disclosed item (43.9%), and Item 7 (exhibits, financial statements, and pro forma financial information) was a close second (41.9%). Far less frequent, Item 9 (public disclosure requirements under Regulation FD) and Item 2 (acquisition or disposition of a significant amount of assets) were reported 623 and 102 times, respectively. Of the 29 remaining items, item 4 disclosures appeared 12 times for a change in a company's certifying accountant, and item 3 disclosures appeared 10 times for bankruptcy or receivership. Finally, only a very few filings were found for change in control of a company, the resignation of a company director, or a change in a company's fiscal year. Figure 2 illustrates the frequency of items reported.

The fact that items 5 and 7 are the most frequently disclosed is important to this study because items 5 and 7 are the very disclosure items that contain most of the information about restatements. In fact, disclosure items 5, 7 and 9 were involved in all 150 restatements. More than 70% of the restatements were reported in disclosures involving only item 5, item 7, or a combination of items

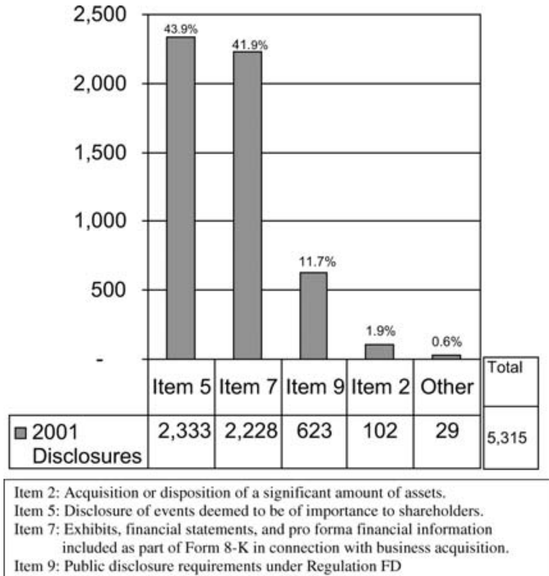

Fig. 2. Frequency of Items Disclosed in 2001 8-K Reports. *Note:* Item 2: Acquisition or disposition of a significant amount of assets. Item 5: Disclosure of events deemed to be of importance to shareholders. Item 7: Exhibits, financial statements, and pro forma financial information included as part of Form 8-K in connection with business acquisition. Item 9: Public disclosure requirements under Regulation FD.

5 and 7. A few restatements were reported in disclosures involving items 2, 3, 4 and 9.

Why Are Restatements Necessary?

Although 150 restatements were reported during 2001, only 82 companies issued those 8-K forms. Thus, more than one restatement often arose from a single 8-K filing. Of the 82 companies that reported restatements, 76 reported a single reason for the restatement. Only Phillip Morris (2), Walt Disney (2), Lucent Technologies (3), Xerox (2), Cendant (2), and Becton Dickenson (2) reported more than one reason. Thus, these 82 companies disclosed a total of 89 reasons for restatements. These reasons can be classified into seven categories. Mergers and acquisitions (24.7%), changes in segment reporting (23.6%), changes in accounting method (20.2%), and discontinued operations and divestitures (18.0%) accounted for

Table 3. Reasons for 2001 Restatements.

Category	Number of Reasons	Percentage
Merger/Acquisition	22	24.7
Change in segments	21	23.6
Change in accounting method	18	20.2
Discontinued operations/Divestiture	16	18.0
Error	7	7.9
Change in presentation	3	3.4
Change in accounting estimate	2	2.2
Total	89	100.0

86.5% of all restatements. Unlike errors, most of these restatements relate to business expansion and should not be perceived as negative. Errors, however, accounted for only 7.9% of restatements in 2001. Notably, all of these errors resulted in a decrease in pretax profits.[5] Table 3 shows the number and percentage of 8-Ks according to the reason for the restatement.

How can errors account for such a small percentage of restatements given the current pounding in the financial press regarding repeated evidence of restatements? One, the shear magnitude of restatements by companies like Enron, Xerox, Worldcom, HealthSouth, and others have had a dramatic impact. In these cases, Enron went bankrupt, Xerox experienced a significant decrease in its stock price, Worldcom's shares have fallen to pennies, and trading of HealthSouth shares was halted. Furthermore, investor portfolios, especially retirement accounts, shrank to a mere fraction of their former value.

In addition to the magnitude of restatements, not all errors that might ultimately produce restatements have surfaced. That is, restatements are often announced that affect not only the current period but also a number of previous reporting periods. For example, Xerox's restatement in 2002 affected financial reporting over a five-year period (Bandler, 2002). Likewise, Cendant's restatement in 1998 affected financial reporting over a three-year period (Nelson & Maremont, 1998). Finally, HealthSouth in 2003 was alleged to have inflated earnings since the company went public in 1986 (Terhune, Mollenkamp & Carrns, 2003).

Which Financial Statements and Years Are Most Affected by Restatements?

Of the 150 restatements, the type of restatement and the number of years affected varied greatly. Some restatements involved all financial statement types for many

Table 4. Financial Statements by Type and Year that were Restated in 2001.

Range of Years	Income Statement	Balance Sheet	Statement of Stockholders Equity	Statement of Cash Flows	Total
Panel A: Type of financial statement affected					
Number of Times	111	65	43	44	263
Panel B: Years that financial statements were restated					
1995	3	2	1	1	7
1996	5	5	1	2	13
1997	13	7	6	7	33
1998	50	15	38	38	141
1999	58	46	38	39	181
2000	94	48	35	35	212
Totals	223	123	119	122	587

years, while others affected only one type for a certain quarter. Most restatements involved more than one financial statement for more than one year. Table 4 shows the number of restated financial statements by type and year. Panel A shows the number of times each financial statement type was affected. Of the 150 restatements, 111 (or 74.0%) affected the income statement. By comparison, only 65 (43.3%) affected the balance sheet. Fewer restatements affected the statement of stockholders equity and the statement of cash flows. The 150 restatements affected a total of 263 financial statements. Panel B of Table 4 shows that of the 111 times the income statement was affected, there were a total of 223 income statements affected over the six-year period from 1995 to 2000. Similarly, of the 65 times the balance sheet was affected, there were a total of 123 balance sheets affected over the same period. The statement of stockholders equity and the statement of cash flows were less often affected by restatements, but those restatements also affected the financial statement for more than one year.

Based on the data in Table 4, the income statement is the financial statement most often affected by restatements. A high percentage of restatements affecting the income statement is not surprising based on numerous articles in *The Wall Street Journal*, which focus on stock price declines that followed restatements involving a reduction in reported earnings (Bandler, 2002; Brown & Frank, 2003; Maremont & Bandler, 2001; Nelson & Maremont, 1998; Revell, 2003; Terhune, Mollenkamp & Carrns, 2003).

Table 4 also shows the trend of financial statement years that were affected by restatements during 2001. Most restated financial statements involved the year

2000 with a decreasing pattern back to 1995 (see panel B, "totals"). This finding is logical since restatements from earlier years may have already been reported prior to 2001. In addition, this trend may continue into future years particularly since an increased level of scrutiny by management teams and auditors is justified.

Which Industries Are Most Affected by Restatements?

Of the 20 major NAICS sectors, Fortune 500 companies represented all but three sectors: Educational Services, Public Administration, and Management of Companies and Enterprises. Table 5 shows the number of restatements by sector, including the number of 8-Ks filed, the number of 8-Ks with restatements, and the percentage of 8-K with restatements. As shown, the average percentage of 8-K forms that included a restatement was 4.8% for all 2001 filings by Fortune 500 companies. The industry reporting the greatest number of restatements was manufacturing (5.9%). This finding is consistent with the findings of the Huron Consulting Group (2003). They reported that the manufacturing industry has generated the largest number of restatements during the five-year period between 1998 an 2002. The finance and insurance (5.1%), and retail trade (5.5%) sectors reported the second and third highest percentages, respectively, of 8-Ks with restatements. An understanding of industry restatement patterns is important from an audit perspective. When comparing a client in an industry in which the restatement rate is low to a client in an industry in which the restatement rate is high, an auditor should be more alert for the need for restatement for the latter client.

Table 5. Number of 2001 8-K Filings and Restatements by Sector.

NAICS Sector	Number of Companies	Number of 8-Ks Filed	Number of 8-Ks with Restatements	Percentage of 8-Ks with Restatements
Manufacturing	179	1,005	59	5.9
Finance and Insurance	94	627	32	5.1
Retail Trade	50	183	10	5.5
Utilities	49	441	14	3.2
Information	27	221	8	3.6
Wholesale Trade	28	124	5	4.0
All others	73	519	22	4.2
Total	500	3,120	150	4.8

Table 6. 2001 8-K Data Stratified by Size.

Strata	Number of 8-Ks Filed	Number of Restatements
1–100 Total	872	48
101–200 Total	716	23
201–300 Total	629	45
301–400 Total	448	18
401–500 Total	455	16
Total	3,120	150

Do Restatements Vary According to Size of Company?

Table 6 stratifies the 8-K data of Fortune 500 companies into five groups for additional insight. Each stratum consists of 100 companies. The data indicate that larger companies generally filed more 8-Ks with restatements than smaller companies. Companies in the middle stratum had, however, a comparably higher number of restatements than companies in the other strata. Larger companies should be expected to file more 8-Ks with restatements than smaller companies since the larger companies are more often in the public eye and are involved in events that require restatements. The GAO (2002) reported that the number of large company restatements had grown rapidly in recent years. The Huron Consulting Group (2003) reported similar findings. They reported that the number of public registrants with revenues under $100 million represented 58% of the number of all registrants; yet that group only reported 48% of the total number of restatements. On the other hand, the number of public registrants with revenues of $100 million or greater reported 52% of the total number of restatements.

CONCLUSION

This paper presents an analysis of restatements reported by Fortune 500 companies during 2001. The data in this study indicated that the number of restatements was increasing. However, most restatements were due to mergers and acquisitions, change in segments, and changes in accounting method. Although these activities may require restatement of financial reports, they represent expanding business activity and are not negative in nature. Thus, investors should view these restatements as "normal" rather than unexpected. Accounting errors, on the other hand, only accounted for 7.9% of the restatements by Fortune 500 companies in 2001. Certainly, the occurrence and magnitude of restatements in several high profile

companies have created an image that the accounting process has failed more often than it really has. Indeed, these restatements reflect negatively on the accounting process within these companies. However, there are far more financial statements that did not require restatement due to irregularity in the accounting process.

Is the relatively small number of errors so important that the affected financial statements overshadow the vast majority of financial statements that are free of errors? Based on the numbers reported in this study, a wholesale loss of faith and credibility in financial statements because of restatements does not seem to be justified. Yet, there is evidence that loss of confidence in financial statements has occurred.

Studies and anecdotal cases involving restatements have indicated that corporations themselves are also accountable for loss of faith and credibility. Corporate pressure to meet earnings estimates, misguided incentive programs, and lack of transparency in reporting complex transactions have led to financial statements that require restatement.

The Sarbanes-Oxley Act is probably the profession's most effective response to declining investor confidence. This Act not only establishes safeguards for the accounting and reporting process but also increases criminal sanctions for corporate misbehavior. Thus, the Act may actually increase corporate accountability as well as make the accounting process more reliable. In theory, American companies should police themselves in preventing and detecting errors in financial reports because of their ethical responsibility to the public as well as exposure to criminal penalties for failure to report accurately. However, corporations have not always exercised this responsibility nor have previously established penalties been sufficient to deter negligent or even fraudulent activity. New laws and regulations such as the Sarbanes-Oxley Act and new oversight bodies such as the Public Companies Accounting Oversight Board should assist in this process.

Other findings also emerge from this study. First, disclosure items 5 (disclosure of events deemed to be of importance to shareholders) and 7 (exhibits, financial statements, and pro forma financial information) were the most frequent; however, the other disclosure items were not frequently disclosed. This finding is important because information about restatements is generally found in these two disclosure items. Second, most restatements affect the income statement and affect more than one year. The impact of restatements on the other financial statements was substantially less important. Third, the highest percentages of restatements were found in the Manufacturing, Retail Trade, and Finance and Insurance sectors. This finding is potentially important to auditors because it may create a heightened awareness for the need for restatements in audits of companies in these sectors. Finally, larger companies tended to report more restatements than smaller

companies. This finding might be expected since the largest companies are more often in the public eye and are involved in events that require restatements.

NOTES

1. A search for articles reporting the impact of restatements on stock prices was conducted using the ProQuest database on March 27, 2003. The phrase "stock price changes and financial statements" identified 69 articles in peer reviewed periodicals.
2. Restatement amounts for HealthSouth have not yet been determined.
3. The NAICS categories provide a greater level of granularity compared to the SIC categories. The data in Table 2 would be very similar if SIC codes were used rather than the NAICS categories. Several of the NAICS categories would simply "roll up" into a broader SIC category.
4. A conversion table from the U.S. Census Bureau was used to convert each company's SIC code to its corresponding NAICS sector classification.
5. In the case of ConAgra, pretax profits decreased in 1998 and 1999 but increased in 2000.

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BANKING INDUSTRY FINANCIAL STATEMENT FRAUD AND THE EFFECTS OF REGULATION ENFORCEMENT AND INCREASED PUBLIC SCRUTINY

Brian Patrick Green and Alan Reinstein

ABSTRACT

In October 1987, the chairman of the SEC released his committee's Report of the National Commission on Fraudulent Financial Reporting*, stating that "regulations and standards for auditing public companies must be adequate to safeguard . . . public trust" (CFFR, p. 5). Using publicly owned banks and savings and loan institutions as a backdrop, we study the effects of regulation and increased public scrutiny on financial statement fraud. Specifically, we examine how the characteristics of bank fraud have changed over the past two decades. We hypothesize that increased public scrutiny through changes in regulation on banks and savings and loans, as well as general financial statement fraud detection standards have altered fraud strategies. The study further explores key characteristics of management fraud that occur in bank and savings and loan organizations. Results indicate that bank frauds have changed over time, and are now more likely to involve withholding real information than create fictitious information. While the frequency of frauds*

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did not significantly change over time, the magnitude of each fraud event has declined. This may imply that public regulation and scrutiny may have little effect on the frequency of fraud, but does affect fraud strategies.

INTRODUCTION

The *Report of the National Commission on Fraudulent Financial Reporting* (CFFR) (*Treadway Commission*, 1987) noted that "when the independent public accountant opines on a public company's financial statements, he assumes a public responsibility. The regulations and standards for auditing public companies must be adequate to safeguard that public trust" (p. 5). This study uses publicly owned banks and savings and loan institutions as a backdrop to study changes in financial fraud strategies under conditions of increased regulation and increased public scrutiny. Understanding how fraud strategies have changed over time under existing public regulation and scrutiny is one step towards developing future public regulation and private guidance. Prior studies have examined financial statement fraud largely as a static issue, and academic research has not yet considered changes in the business environment and the potentially significant confounding effects of the passage of time. This study extends prior research by examining how fraud changes over time.

As a secondary focus, this exploratory study also examines key management fraud characteristics in the banking profession, including publicly owned banks and savings and loan (S&L) institutions. This is important since over 20 years ago, Ramage, Kreiger and Spero (1979) noted that financial institutions have different error characteristics than other industries. Key to improving financial reporting effectiveness is understanding where and how frauds occur (Nieschwietz et al., 2000), which in turn should help private guidance within the public accounting profession. Appropriate industry regulation, whether public or private, can reduce the incidence of financial statement misstatement. For example, Maletta and Wright (1996) found that companies in publicly regulated industries had fewer routine errors, a lower rate of misstatement, and more audit-detected errors than unregulated companies. In contrast, savings and loan institutions have fallen under close public regulation. However, Thompson (1993) reported that the use of public regulatory accounting principles (RAP) over the private sectors generally accepted accounting principles produced higher reported income and fewer assets supporting regulatory capital. While Johnson and Khurana's (1995) study offers evidence that private guidance through Statement on Auditing Standards (SAS) have effectively increased the proportion of appropriately modified auditor's reports. Nichols, Bishop and Street (2001) also reported that recent private (SFAS)

accounting guidance has improved financial reporting, through increased disclosure, in the banking industry. Besides reporting areas of bank-specific fraud risk, this paper also identifies fraud strategies, which, in turn, can help auditors examine and assess fraud risks more effectively and guide future authoritative standards.

While those developing both public regulation and private guidance may rely on anecdotal evidence to assess risk, the severity and location of risk may have changed. Most error- and fraud-characteristic research was developed from early 1980s data, before the public attention focused on fraud that occurred during the 1980s banking crisis. Data in our sample extends this research by allowing us to compare changes in frauds between periods T1 (1979–1987) and T2 (1988–1996). The former period witnessed increased public awareness and increased SEC-mandated disclosures to help avert potential fraud, according to the Treadway Commission (1987). Examining changes in characteristics between frauds primarily motivated by the economically troubled 1980s and its competitive/merger period in the 1990s should provide public policy data.

Information on bank and S&L-specific irregularities should help the public accounting profession to revise guidance to more effectively address risk, despite Mock and Wright's (1999) finding of no significant association between changes in operationalizing private guidance through audit programs and changes in client risk. Increased understanding of bank fraud may also reduce future litigation and its cost to investors, creditors, auditors and the public, especially since the cost of litigation when fraud exists increases when management knowingly withholds critical information (Bonner, Palmrose & Young, 1998). Our study may be especially relevant given Palmrose's (1988) and St. Pierre and Anderson's (1984) findings that about 30% of auditor lawsuits involve commercial banks or S&Ls, thereby damaging public confidence.

The first section of this paper discusses relevant public regulation and private auditing guidance, as well as prior misstatement characteristic research. Section two describes the research method and questions. Section three presents the results and analysis of misstatement frequency and magnitude, method and aftermath. The final section presents conclusions, theoretical and practical concerns, study limitations and suggestions for future research.

Public Policy and Authoritative Standards

Over a decade ago, the General Accounting Office (GAO, 1989) noted that economic and political factors led to many financial institution failures in the 1980s. The GAO also found that adherence to sound internal controls, effective management practices and solid financial reporting are essential to ensuring

the banking system's safety and soundness. However, bank management often failed to implement adequate internal controls to ensure safe and sound bank operations or compliance with laws and regulations. Recognizing the increased risk of fraud and misstatement in financial reporting should affect public policy and regulation decisions, including the issuance of authoritative accounting and auditing pronouncements. Historically, lending has provided the single largest source of bank earnings and accounted for the largest category of assets. Of the banks that failed in 1987, 79% had not implemented adequate and prudent general procedures to guide loan department personnel in the loan underwriting and approval process. Poor loan documentation was cited in 41% of 1987 bank failures, a period in which banks often failed to obtain such documentation as current statements of cash flows, business plans, building inspections, appraisals and Uniform Commercial Code filings. The Tax Reform Act of 1986 contributed greatly to the collapse of many S&L institutions that had invested heavily in real estate and mortgages (Cordato, 1991). As the market value of real property decreased due to the Tax Reform Act, so did the value of the S&Ls' major assets, leaving some institutions with negative capital balances.

In 1987, the Treadway Commission stated that "regulatory and law enforcement agencies provide the deterrence that is critical to reducing the incidence of fraudulent financial reporting." The SEC's financial fraud enforcement program already has raised corporate and public accounting's awareness of the problem and potential for detection and punishment, demanding that management and the public accounting profession reduce intentional misstatements in financial statements. For public accountants, punishment has mostly led to CPA resignations from practice, and other sanctions and censures (Kunitake, 1987). The SEC has taken similar action against key corporate executives. More recently, the popular press has followed management fraud cases such as Enron and WorldCom that should lead to executive jail time. However, further improvements can and should be made at both the state and federal levels.

Recent changes in public policy have increased corporate responsibility for internal controls. Effective in July 2002, the Sarbanes-Oxley Act (SOA), requires that the CEO, CFO or other designated executive certify in the financial report: (1) the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management's assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Individuals knowingly certifying false reports face criminal fines and imprisonment.

In response to public demand for more reliable financial information, the SOA Act contains many provisions that greatly affect auditor responsibilities, including

stricter independence guidelines, increased financial statement disclosures and greater corporate responsibility (e.g. CEOs and CFOs also "signing off" on financial statements). Such large-scale debacles at public companies as Enron and WorldCom also raised the question of whether greater government regulation of accounting rules should exist. In an apparent step in that direction, the Public Company Accounting Oversight Board (PCAOB), an organization deriving its power from the SOA, establishes rules relating to the preparation of audit reports for issuers. Subject to SEC oversight, the PCAOB conducts inspections, investigations, and disciplinary proceedings with accounting firms who audit public companies.

SAS No. 53 (AICPA, 1998), through using the term "irregularities," offered guidance on an auditor's responsibility to plan audits to search for financial statement fraud. A decade later, SAS No. 82 (AICPA, 1997) required auditors to identify the presence of risk factors, primarily by assessing the risk of fraudulent material misstatement in each audit. Crucial to the risk assessment is a bank's move towards an increasingly risky asset/investment mix. In 1988, the SEC also issued Financial Reporting Release (FRR) No. 28, containing industry-specific disclosure guidance for loan losses to help determine allowances for loan losses for registrants engaged in lending activities. The issuance of the Treadway Commission's Report, SAS No. 53 and FRR No. 28 all illustrate increased public attention to bank fraud. Moreover, SAS No. 99, effective in 2003, builds upon SAS No. 82 to expand auditor guidance for detecting material fraud in financial statements. While not technically changing auditors' responsibilities, SAS No. 99 encourages increased *professional* skepticism (an objective, questioning mindset) in all audits and requires "brain-storming" among engagement team members to identify potential fraud risk areas before and during the audit.

The Committee of Sponsoring Organizations of the Treadway Commission (1999) noted that between 1987 and 1997, about half of the firms that committed financial statement fraud recorded revenues prematurely or created fictitious revenue transactions. One-half that recorded fictitious assets should have expensed. Auditors should understand that audit procedures designed to address an increased risk in errors could respond ineffectively to increased risks of fraud (Bloomfield, 1995). Management can alter existing information, withhold data or use other methods to avoid detection from auditors who use common error detection methods in performing their duties. For example, Erickson et al. (2000) reviewed the CPAs' working papers in the Lincoln S&L fraud found that: (1) while following the dictates of SAS No. 82 would have detected some fraud issues, still more guidance is needed; and (2) increasing traditional audit procedures would not have cast doubt or suspicion on Lincoln S&L's questionable revenue recognition procedures. Adapting audit plans to accommodate changing

levels of fraud risk allows auditors to improve their ability to detect financial statement fraud.

Misstatement Research

Several studies have examined the general characteristics of financial statement errors and fraud. Hylas and Ashton's (1982) premier misstatement characteristic study, for example, examined 281 errors in 152 audits of clients from one Big Eight firm that required audit adjustments, most of which were made in three of 17 audit areas: sales, accounts receivables and inventory. Other studies found similar results (Ham et al., 1985; Johnson et al., 1981; Kreutzfeldt & Wallace, 1986). Loebbecke, Eining and Willingham's (1989) first fraud characteristic study examined 77 fraud cases. They also found that 45.7% of fraud involved the audit areas of sales, accounts receivable and inventory. Citing characteristic studies' results, detection research conducted during the 1980s and 1990s examined quantitative methods to assess risk (e.g. Anderson & Koonce, 1998; Kaplan et al., 1992; Koonce et al., 1993; Mastracchio & Schmee, 1992; Scott & Wallace, 1994; Wilson & Colbert, 1989). While Loebbecke and Steinbart (1987) focused on general misstatement more recent studies examined fraud detection (e.g. Bell & Knechel, 1994; Green & Choi, 1997).

However, Ramage, Kreiger and Spero (1979) noted that financial institutions have different error characteristics than other business sectors. More recently, Eilifsen and Messier (2000) also reported that varying business sectors have significant differences in error rates and misstated accounts. While extending misstatement research to specific sectors should help to develop more effective regulation and guidance. Several projects have examined misstatements in specific business sectors. Kreutzfeldt and Wallace (1986, 1990) noted that misstatement characteristics varied across sectors, in both error rates and accounts misstated. For example, banks have a significantly greater incidence of cash errors than other areas. Bell and Knechel (1994) also found significant errors and irregularities differences for property and casualty insurers, where misstatements occurred most often in loss reserves. While Maletta and Wright (1996), examining 36 banks, 14 S&Ls, found that S&Ls had the largest percentage of errors that overstated net income (68.8%).

Bonner, Palmrose and Young (1998), investigating whether litigation rates differ based on varying characteristics of management fraud, developed a fraud sample of 261 companies from 1982 to 1985. Two of their findings may have implications for our study. First, more litigation and more severe penalties arose when a "common" fraud occurs (e.g. increasing period sales by leaving the books

open after year-end). Second, litigation frequency and severity of penalties were also greater for "knowledge" (e.g. fair market value of investments) compared to "judgment" (e.g. estimation of loss reserves) based frauds.

Research Questions

The above discussions highlight the need to better understand bank frauds by examining profession-relevant information. This study extends prior characteristic studies by asking the following research questions:

(1) Are there differences in magnitudes between the most frequently misstated accounts in banks and saving and loans?
(2) Which accounts are most frequently misstated when financial statement frauds occur in banks and saving and loans?
(3) Has the frequency of the most commonly occurring bank and saving and loan frauds changed over time?
(4) What are common methods that bank and saving and loan management use to commit fraud?
(5) Have the methods used to fraudulently misstate banks and saving and loans financial statements changed over time?
(6) What are the common outcomes of a bank or saving and loan fraud after discovery?

RESEARCH METHODS

We examine specific characteristics of management fraud for financial service organizations by focusing on Standard Industrial Classification (SIC) Codes 6000–7000, including federally- and non-federally-chartered savings institutions and S&L associations (including branches of foreign banks) and other establishments primarily engaged in accepting time, demand and other deposits and making commercial, industrial, and consumer loans or other investments in high-grade securities (We did not include credit unions since they not subject to SEC scrutiny). Management fraud commonly entails management's intentional actions to deceive investors and creditors by releasing false financial information. We use Palmrose's (1987) definition of fraud as indicated by SEC enforcement actions. Our sample includes incidents where enforcement actions were taken against the company, its management or its external auditors.

Our sample consists of publicly held banks and S&Ls that have released fraudulently misstated financial statements, based on drawing AAER data. Bonner,

Palmrose and Young (1998), Green and Choi (1997) and others (e.g. Beasley, 1996; Beasley et al., 2000; Nieschwietz et al., 2000; Stice, 1991) have also relied on samples drawn from AAERs. As in prior studies, we use AAER releases citing action against the company, its management or the auditors (e.g. Palmrose, 1987) as a surrogate for fraud. SEC enforcement actions offer an objective and legal indication of financial statement fraud, providing a high level of probability that management fraud has occurred. AAERs usually present sufficient detail on the fraud in a manner useful to exploratory characteristic studies.

AAERs samples may be subject to various sources of selection bias. First, the sample includes only detected frauds, or where SEC allegations of fraud arose. Allegation of fraud without court findings is evident as some AAER releases indicate SEC action without trial. For example, a defendant may accept a settlement without admitting or denying guilt of the "alleged" fraud activity. In these cases, the alleged fraud may not have occurred. Second, AAERs only describe detected or "unsuccessful" frauds since they failed to deceive. The sample does not include undetected or "successful" frauds (see for example, Pourciau, 1993). We rely on the AAERs to provide the time period in which the fraud was committed. However, the misstatement activity may have begun before the "reported" fraud date, and was merely undetected until that date. Some fraudulent financial data was also possibly internally corrected before the information was issued to the public. Finally, in the past AAERs have discussed some frauds involving smaller companies, there may still be a tendency for a sample developed from SEC/AAERs to focus on larger companies. Each of these factors can produce various degree of selection bias, producing unknown limitations for the study's results.

We initially screened all AAERs Nos. 1 through 1231 that were issued between April 15th, 1982 and February 18th, 2000. The process identified 89 bank or S&L frauds (see Table 1). The first sub-sample (T1) of 31 frauds occurred during the time period 1979 to 1987, and the second sub-sample (T2) of 33 frauds occurred during 1988 to 1996. Primarily, the time split was based on the above described increase public attention, changes in the industry, and authoritative releases.

Since a several year lag usually arises between the dates the fraud occurred and when the SEC issued an enforcement release, the 1982–2000 releases related to frauds occurring between 1979 and 1996. Thus, period T2 ended with frauds occurring up to 1996 (AAERs released through 2000). Ending T2 in 1996 (2000) produced several advantages for the sub-samples. The 1996 fraud cutoff considered nine years in both compared time periods, and the T2 cutoff placed a relatively even numbers of observations in each sub-sample (T1 & T2).

Table 1. Description of Research Sample Composition of Initial Sample.

	Fraud Sample
Total number of AAERs issued from 1982 to 2000	1231
Less: AAERs not involving banks or saving and loan	*1142*
AAERs describing bank or savings and loan occurring between 1979 and 1996	*89*
Less: AAERs describing prior released fraud[a] AAERs describing prior released fraud[b]	24
Less: AAERs lacking adequate data	1
Study's final sample size	64[c]

[a] AAER No.1 was released in April 15, 1982, and AAER No. 1231 was released on February 18, 2000. Since a several year lag usually exists between the date the fraud occurred and when the SEC issued an enforcement release, the 1982–2000 Releases related to frauds occurring between 1979 and 1996. The frauds were classified based on the actual dates when the frauds occurred, and not the SEC/AAER issue date.

[b] Several AAERs described additional actions or developments for a single fraud case. For example, a single fraud case may have additional SEC actions as new evidence emerges.

[c] The final sample contains 47 banks and 17 savings and loans.

Finally, fraudulent financial statements in T2 were audited under SAS No. 53 (AICPA, 1998), before SAS No. 82 (AICPA, 1997) became effective. Potential confounding effects may have occurred if the T2 sample had been extended beyond 1996, including financial statements audited under SAS No. 82's new procedures and higher level of professional skepticism. We read the SEC text to summarize the characteristics of bank and S&L misstatements. AAERs generally report fraud methods, affected accounts, dollar amounts of misstatement, officers and positions involved, motivations, dates of annual and quarterly reports and other information. To improve our overall reliability, two coders categorized bank fraud characteristics. We summarized the data by frequency and magnitude for each affected account, fraud method and aftermath of the SEC action.

Frauds were classified into time periods T1 and T2 based on the actual dates when the frauds occurred (not the SEC/AAER issue date), thereby limiting potential lags and increasing the legitimacy of time-period analysis. We eliminated 24 AAERs in the initial sample since they discussed previously identified frauds, and removed one additional AAER from the sample since it lacked detail supporting all dimensions required for this study. The final sample of 64 included 47 bank and 17 S&L frauds. After collecting, classification, and summarizing data, a test of proportional difference was used to compare frequencies and mean differences for aggregate fraud characteristics. We also examined how frequencies and magnitudes evolved over time, using the T1 and T2 two sub-samples.

RESULTS AND ANALYSIS

Frequencies of Bank and Savings and Loan Frauds

Table 2 summarizes the frequency of institution frauds by audit area – Accounts Receivable, Cash, Investments, Loans Receivable, Reserves for Loan Loss, and Revenues, Gains and Losses. All three Accounts Receivable frauds occurred in period T1. Accounts Receivable frauds commonly involved simple overstatement of amounts owed to the institution. Cash frauds, which grew from three during T1 to four during T2, involved overstating actual cash balances, as when CapitalBanc (AAER, p. 458) misrepresented to its auditors that vault cash on hand was $2,700,000. Investment frauds report carrying values on an institution's financial statements that exceed the investment's realizable value.

In some cases, banks and S&Ls held investments at higher book values per share even when they had knowledge that the companies they had invested in were insolvent. Loans Receivable fraud, which fell from 12 to 7 from periods T1 to T2, maintains known uncollectible loans on an institution's books. For example, between 1983 and 1986, American Pioneer (AAER, p. 524) knowingly maintained on their books and continued to accrue interest on a $25,000,000 loan to a Texas developer who was both delinquent in loan payments and insolvent. However, typical Reserves for Loan Loss frauds entail an institution failing to maintain allowances sufficient to cover the estimated probable loss, as when Savings Security Bank (AAER, p. 679) under-reported management's 1990 estimated allowance for loan loss by $971,337. The category of Revenue, Gains and Losses contain several recognition challenges and misclassifications.

Table 2 also summarizes the most prevalent bank frauds, showing that Investments (31), Reserve for Loan Loss (29) and Loans Receivable (19) were the three most frequently misstated accounts, while Revenue, Gains and Losses (17), Cash (7) and Accounts Receivable (3) were misstated the least. This result is not unexpected, given the industry's asset make-up. Thirty-nine of the 64 misstatements involved more than one audit area or account, a finding consistent with prior research (e.g. Green & Choi, 1997). Hence, once fraud is detected in one area risk also increase for related account groups. Sixty of the 64 sampled frauds involved overvaluing the net asset values of accounts receivable, cash, investments, and loans receivable. This result was consistent with Bonner, Palmrose and Young's (1998) results, who also found that overvalued assets were more likely to result in litigation and increased severity in penalties against auditors.

Columns six and seven of Table 2 compare the frequency differences between T1 (frauds that actually occurred from 1979 to 1987) and T2 (frauds that actually occurred from 1988 to 1996); 31 frauds were reported during T1, compared to 33

Table 2. Bank Misstatement Summary (000) Nominal Frequency Demographics by Misstatement Account Bank Fraud Frequency by Time Period.

Misstated Accounts	*n* (31) 1979–1987	Percent[a] 1979–1987	*N* (33) 1988–1996	Percent[b] 1988–1996	Percent[c] 1979–1987	Percent[c] 1988–1996	*N* (64) 1979–1996	*p*-Value[d]
Accounts receivable	3	0.0968	0	0.0000	1.000	0.0000	3	
Cash	3	0.0968	4	0.1212	0.4286	0.5714	7	
Investments	13	0.4194	18	0.5456	0.4193	0.5807	31	0.0910
Loans receivable	12	0.3871	7	0.2121	0.6316	0.4684	19	0.0286
Reserve for loan loss	13	0.4194	16	0.4848	0.4483	0.5517	29	0.2114
Revenues, gains and losses	12	0.3871	5	0.1515	0.7058	0.2942	17	
Total sample	31	1.000	33	1.000	0.4844	0.5156	64[e]	NA

[a] Percent is calculated by $n/31$ (1979–1987 sub-sample).
[b] Percent is calculated by $n/33$ (1988–1996 sub-sample).
[c] Percent is calculated by n/N (1979–1996 aggregate-sample).
[d] *p*-Values were calculated for the account classifications most frequently misstated using a two-tailed test of proportional differences.
[e] Thirty-nine financial statements had two or more accounts misstated, and 25 statements had only one account misstated. There were 106 misstated accounts in the 64 sampled financial statements. Thus, the sample total in column 5 equals our sample *N* and not the total number of misstatements found in the 64 financial statements. The mean number of accounts misstated per financial statement = 1.70.

in T2. Increased public and regulatory attention, a period reporting 33 institutional frauds, marks T2. While the aggregate number of frauds remains relatively unchanged between periods, frequencies within specific areas have changed. Making statistical comparisons between periods T1 and T2 for the three most frequent fraud areas shows greater Loans Receivable frauds during T1 (12/19) than T2 (7/19). While Investment frauds increased from T1 (13/31) to T2 (18/31) ($p < 0.05$), the proportion of Loan Loss Reserve frauds increased in period T2, though not significantly. This is important since investments and, to a lesser extent, loan loss reserves may be becoming more risky areas, while loans receivable are less likely to be misstated. This change can be seen as either good or bad news. While successful audit methods and SEC reporting requirements may have lowered the frequency of loans receivable frauds, the same pressures may not have affected the related loss reserve frequency during period T2. However, modifying audit guidance and industry regulation to curb future problems is normally based on past crises. This creates friction within the regulatory process, since SEC-reported fraudulent activity (AAER, issue date) usually lags the actual fraud occurrence date (T1/T2 sample classification date) by two years. Thus, preventive guidance and regulations follow the trail of misstatement activity. The economic conditions motivating new specific regulations may no longer exist. For example, frauds relating to valuation of loan portfolios may increase during periods of economic recession. The related discovering and subsequent reporting of such fraud activity may lag into periods of strong economic growth. However, this does supports a proactive regulatory stance to protect the public during the next economic downturn cycle.

Magnitude of Bank and Savings and Loan Frauds

With relatively equal frequencies, both the mean and maximum investment misstatements initially seem larger than that for loans receivable or their related reserves. Misstatements in the sample range from \$1.34 billion for investments to \$125,000 for cash. The largest loans receivable fraud is \$390 million smaller (\$950 million) than the largest investment account misstatement. The investment account mean fraud of about \$143 million is significantly greater ($p < 0.05$) than the next largest means for both loans receivable (\$114 million) and loan loss reserves (\$96 million). This sample's magnitudes of means also exceed those of earlier studies. For example, Green and Choi (1997) reported a considerably smaller, largest fraud of \$180 million and a sample mean of only \$12.6 million for inventory-based industries.

Despite a high frequency of investment misstatement, the reported means could overstate their true magnitudes. The \$11 million median misstatement for

investments is the second lowest of all six reported audit areas. The equally misstated area of reserve for loan loss (29 misstatements versus 31 for investments) has a much larger median of $26.7 million. However, the two largest frauds in the aggregate sample are investment fraud of $1.34 and $1.00 billion that occurred during period T1. After removing these two outliers, the investment mean drops to $34.8 million.

Comparing means for frauds occurring in periods T1 and T2 finds the aggregate mean for period T1 of $164 million significantly greater ($p < 0.05$) than the $33 million for T2. This decline in fraud magnitudes occurred in five of the six account areas. Significant decreases in means were also found for the three most frequently occurring frauds in investments ($p < 0.05$), loans receivable ($p < 0.10$) and loss reserves ($p < 0.05$). The level of significance might have been even greater if nominal dollar amounts were adjusted for inflation (Table 3).

Bank Misstatement Methods

Table 4 summarizes 88 fraud methods used in the 64 financial statement frauds; 24 of the 64 sampled institutions used two methods to commit their frauds. Panel A of this Table summarizes fraud methods that produced misstatements in the three most frequently misstated audit areas. Inaccurate accounting estimates (13) and making inadequate or misleading disclosures (46) are the most common methods (over 50%) used to materially misstate financial institution's financial statements. Disclosure deficiencies in reserves for loan loss primarily occur when management knowingly understates reserve balances, or retain non-producing loans on the books at their face value. Inaccurate disclosures for investments, a common disclosure fraud, may entail management reporting an investment in a regional company using a book-value-per-share, even when the last trade price was significantly lower. The frequency of this method exceeds all other methods combined for investment misstatements.

During period T2, financial institutions committed financial fraud less often in such areas as fictitious documents, unsupported journal entries, and classification of accounts, and more often in such areas as estimates and disclosures. Thus, during T2, such institutions more likely committed fewer (but more significant) acts of "commission" than "omission," which could lead to more severe civil and criminal penalties. Kiernan (1997) indicates that defendants of knowledge-based frauds (e.g. management knowingly fails to discloses decreases in investment fair values) face more severe penalties than judgment-based frauds (e.g. misapplication of GAAP). Bonner, Palmrose and Young (1998) also speculate that auditor's

Table 3. Bank Misstatement Summary (000) Magnitude Demographics by Misstatement Account.

Misstated Accounts	Maximum	Minimum	Mean	Median	*N*	Mean 1979–1987	Mean 1988–1996	*p*-Value[b]
Panel A: Bank fraud magnitudes by time period								
Accounts receivable	\$35,600	\$20,300	\$30,500	\$35,000	3	\$30,500	NA	
Cash	\$340,000	\$125	\$67,295	\$5,700	7	\$206,900	338	
Investments	\$1,340,000	\$590	\$142,729	\$11,050	31	\$225,592	\$33,304	0.0380
Loans receivable	\$950,000	\$1839	\$114,498	\$19,131	19	\$165,853	\$22,178	0.0912
Reserve for loan loss	\$950,000	\$1376	\$95,863	\$26,710	29	\$156,052	\$14,768	0.0226
Revenues, gains and losses[a]	\$275,000	\$125	\$43,942	\$18,000	17	\$37,032	\$51,531	
Total sample	\$1,340,000	\$125	\$113,151	\$19,000	64	\$164,001	\$33,003	0.0443

[a] This category includes ten overstatements if revenue due to classification and early recognition schemes, five understatements of loss, and 2 overstatements of gain.
[b] *p*-Values were calculated for the account classifications most frequently misstated using a two-tailed test of mean differences.

Table 4. Frequency of Method Misstatement Aggregated and Disaggregated Samples.

Panel A: Aggregate Sample, 1979 Through 1996

Method	Early Recognition	Fictitious Documents	Unsupported Entries	Detailed Books	Classify	Estimates	Disclosure
Investments	2	3	3	5	4	4	25
Loans receivable	2	1	2	3	3	8	16
Reserve for loan loss	1	1	1	2	3	12	24
Total sample	4	5	5	7	8	13	46

Panel B: Disaggregated Sample, 1979 through 1987; 1988 through 1996

Method	Early Recognition		Fictitious Documents		Unsupported Entries		Detailed Books		Classify		Estimates		Disclosures	
Years	1979–1987	1988–1996	1979–1987	1988–1996	1979–1987	1988–1996	1979–1987	1988–1996	1979–1987	1988–1996	1979–1987	1988–1996	1979–1987	1988–1996
Frequency	2	2	4	1	3	2	4	3	7	1	6	7	22	24
Sample proportion[a]	0.0606	0.0571	0.1290	0.0303	0.0968	0.0571	0.1290	0.0968	0.2258	0.0303	0.1935	0.2121	0.7097	0.7273
Sample	4		5		5		7		8		13		46	

[a] Percent of Sub-Sample is based on *frequency/number of fraud cases in sub-sample*. There were 31 cases for 1979–1987 and 33 cases for 1988–1996.

failure to detect false information reduces their defense of complying with auditing standards. Fewer investment misstatements are due to classification schemes (8). The remaining misstatements are evenly distributed among the five other misstatement method categories. While methods used to commit fraud appear to differ between the account areas of investments (disclosure and classification) and loans receivables (disclosure and estimation), a significant parallel emerges. Most misstatements fail to recognize decreases an assets fair value (investments and loans receivable) or increased risk of a loss (reserve for loan loss). Frequency of methods (Table 4, Panel B) for while false documentation, unsupported entries, lack of detailed books and classification all slightly decreased during period T2. Both estimation and disclosure slightly increased during period T2; however, none of these frequency changes were significant.

Further analysis was performed to compare management actively supplying inaccurate information (early revenue recognition, false documents, recording unsupported entries, misclassifying transactions and creating inaccurate estimates), to management passively withholding accurate information (full disclosure and detailed books). During T1, passive (26) methods were nearly equal to active (22) methods. However, during T2 passive (27) methods were significantly ($p < 0.001$) more frequent than active (13) methods. With increased public attention and SEC reporting requirements, management is perhaps more likely to withhold potentially adverse information from investors and creditors. At a minimum, auditors should improve procedures used to test management's assertions for required disclosure in the investment and loss reserve areas, as Erickson et al.'s (2000) study documents.

Long-Term Impact

Table 5, panel A reports the long-term impact when bank misstatements occur in three of the most common audit areas. Bankruptcy, the most severe outcome, arose in 26.56% of the cases in our sample. In Bonner, Palmrose and Young's (1998) cross-industry sample, bankruptcy also occurred in about 26% of the cases. However, banks and S&Ls generally continued operations (46.88%) after receiving SEC penalties or sanctions. Mergers (10.94%) and changes resulting in new management (29.69%) were a less likely outcome after a reported fraud. Investment misstatements constituted 48.44% of reported fraud cases and account for 58.82% of the bankruptcy outcomes. Bankruptcy appears slightly less likely an outcome for either loans receivable or the related reserves for loan loss. Less favorable results for investors and institutional customers seem to occur when the misstatement involves only investments.

Table 5. Company Results.

Panel A: Aggregate Sample, 1979 Through 1996

	Bankruptcy	Merger	New Management	Continued	Total
Investments	10	2	7	13	32
Loans receivable	6	2	4	8	20
Reserve for loan loss	9	3	4	12	26
Total sample[a]	17	7	19	30	

Panel B: Disaggregate Sample for the Three Most Misstated Accounts, 1979 Through 1987; 1988 Through 1996.

	Bankruptcy		Merger		New Management		Continued	
Year	1979–1987	1988–1996	1979–1987	1988–1996	1979–1987	1988–1996	1979–1987	1988–1996
Investments	3	7	2	0	2	5	8	5
Loans receivable	1	5	2	0	2	2	4	4
Reserve for loan loss	2	7	2	1	1	3	5	7

[a] Since several banks had more than one misstatement, the results by account do not equal the total sample. Moreover, this table only summarizes three of the six reported accounts.

Panel B further examines changes in outcomes over time, focusing on the three most commonly misstated accounts, which represent two of the major assets (investments and net loan receivables) affected by pre-1988 regulation. For each account area, bankruptcy appears to be a more common outcome from 1988 to 1996. Overall, bankruptcy tends to move with a change in management. Mergers appear more prevalent from 1979 to 1987. The Tax Reform Act of 1986, which greatly affected S&Ls that had invested heavily in real estate and mortgages (Cordato, 1991), may have plausibly moved more institutions into bankruptcy. Changes in public regulation no longer allowed insolvent financial institutions and their related management to continue. Bankruptcy and change in management seems to have occurred when the value of the institutions' major assets decreased, resulting in negative capital balances.

IMPLICATIONS AND CONCLUSIONS

This exploratory study extends prior misstatement characteristic research to banks and saving and loans, focusing on the related issues of misstatement magnitude, frequency, method and their change over time (T1–T2). Our study

shows no significant changes in the frequency by type of bank fraud, but major changes in both method and magnitude. Fraudsters in T1 committed frauds in equal proportions by either creating fictitious information or withholding information. Fraudsters in T2 move towards committing more passive frauds by withholding information. Concurrently, the magnitudes of bank frauds decreased, which could have arisen from increased public and regulatory attention created by the Treadway Commission's (1987) report, industry guidance through SAS No. 53 (AICPA, 1998), and other industry-specific disclosure requirements. However, changes in fraud characteristics could be reactions to past discovery efforts. Smaller frauds and frauds without a starting point in a bank's information system may simply be harder to detect. Those in the banking profession who are motivated to commit fraud may have learned from past failures, cultivating their techniques and adapting to changing regulation. Future public regulation should focus on these changes in bank fraud strategies, including revisiting regulations limiting liberal asset valuation and enhancing disclosure of key information. This change should be teamed with increased penalties for SEC enforcement action when management either withholds relevant information or over-values assets. Changes in future private regulation, e.g. industry auditing standards, should also offer guidance on auditing both disclosures and asset valuation.

This paper examined bank and savings and loan frauds that occurred from 1979 to1996. It was hypothesized that increased public scrutiny through changes in regulation on banks and savings and loans, as well as general financial statement fraud detection standards have altered fraud strategies. Time period T2 ended with the issue of the fraud standard SAS No. 82. Future research could be extended to study the effects of further changes occurring after 1996. The extension could examine fraud strategy changes due to new public regulation (i.e. Sarbanes-Oxley) and audit standards. Two fraud standards have occurred post T2, including SAS No. 82 (AICPA, 1997) and SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, 2003). Further studies could be designed to compare the effects on fraud strategies due to new public regulation "or" changes in audit standards. Changes in audit standards have focused on detection through required audit procedures and increasing levels of professional skepticism. Public regulation has focused on fraud prevention through increasing management responsibility, information disclosure, and penalties. While we move towards increased public regulation, prior research has given pointed towards the effectiveness of private guidance, through accounting and auditing standards, to improve the credibility of financial reporting for banks and savings and loan institutions. Extending the current study could compare the effectiveness of changes in public regulation versus private guidance (Johnson & Khurana's, 1995; Nichols, Bishop & Street, 2001). Future results could be used to guide public policy,

by focusing fraud prevention on the most effective combination of private and public resources.

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CORPORATE GOVERNANCE ROLE IN FINANCIAL REPORTING

Zabihollah Rezaee

ABSTRACT

Reported financial scandals have galvanized considerable interest in and discussion on the role of corporate governance in the financial reporting process. Many factors, including high-profile financial scandals, well-publicized restatements of financial reports, and concerns over auditors' independence have resulted in loss of investor confidence in financial reports. The Sarbanes-Oxley Act of 2002 (the Act) was passed in response to these financial scandals to reinforce corporate accountability and professional responsibilities, and to rebuild investor confidence. The SEC has issued more than 20 rules to implement provisions of the Act. Other professional organizations (AICPA, AMEX, Conference Board, NASDAQ, NYSE) have issued standards and corporate governance guiding principles to restore public trust in corporations, the capital markets, and the financial reporting process. Mere compliance with these measures may not be adequate in rebuilding investor confidence and thus public companies should improve their corporate governance structure. This paper introduces a corporate governance structure consisting of seven interrelated mechanisms of oversight, managerial, compliance, audit, advisory, assurance, and monitoring functions. A well-balanced functioning of these seven interrelated functions can produce responsible corporate governance, reliable financial reports, and credible audit services.

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INTRODUCTION

Reported financial scandals at high-profile companies (e.g. Adelphia, Enron, Global Crossing, Qwest, Tyco,WorldCom) have reinvigorated considerable interest in corporate governance and accountability. Ineffective corporate governance and unreliable financial reports are widely cited as reasons for the loss of investor confidence and the stock market slump that followed these scandals (Browning & Weil, 2002). These scandals have also widened the gap between what investors expect in the areas of corporate governance and financial reporting, and what they have traditionally been provided. Several measures have been taken by regulators to close this gap. For example, the Sarbanes-Oxley Act (hereafter, the Act) was passed in July 2002 to reinforce corporate accountability and professional responsibility, and to restore investor confidence in the capital markets. The Securities and Exchange Commission (SEC) has issued more than 20 rules implementing provisions of the Act pertaining to corporate governance, financial reporting, and audit functions. National stock exchanges have issued a set of corporate governance rules, which have become part of listing requirements for public companies.

Measures like these are expected to be catalysts for more effective corporate governance and more reliable financial reporting. This paper: (1) examines the relevance of measures intended to improve corporate governance and financial reports; (2) demonstrates that mere compliance with these measures may not be adequate in restoring public trust in corporate governance and financial reports; and (3) suggests a proactive involvement and firm commitment by all corporate governance participants in the financial reporting process (as depicted in Fig. 1). These objectives will be achieved by: (1) defining corporate governance and its aspects; (2) describing corporate governance guidelines; (3) presenting a holistic approach to corporate governance structure; and (4) discussing the role of corporate governance in financial reporting.

DEFINITION AND ASPECTS OF CORPORATE GOVERNANCE

Corporations in the United States have traditionally adopted voluntary corporate governance by establishing their own codes of business conduct. The corporate governance concept has advanced from debates on its relevance to how best to protect investors' interests while considering the interests of other stakeholders (e.g. employees, suppliers, customers, creditors). Corporate governance addresses the agency issues raised by the separation of ownership and control of corporations.

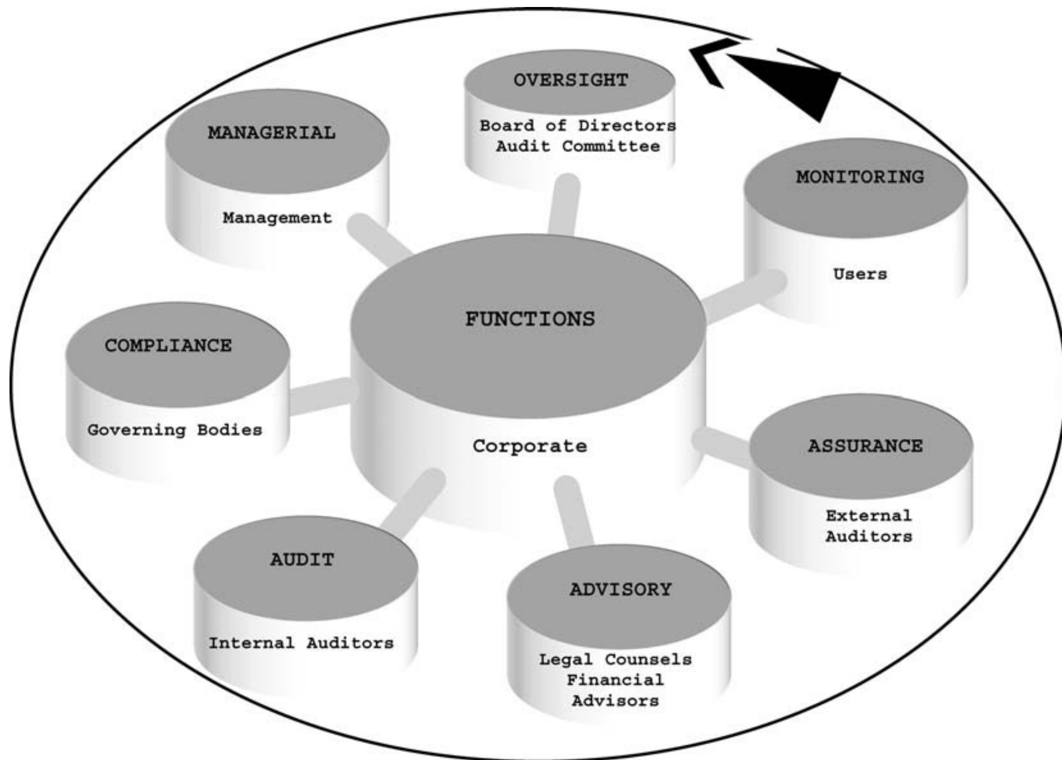

Fig. 1. Corporate Governance Role in Financial Reporting.

Corporate governance is the mechanism by which a corporation is managed and monitored. It determines a power-sharing relationship between corporation executives and investors by providing structure through which: (1) the objectives are defined; (2) policies and procedures are established to ensure achievement of these objectives; and (3) activities, affairs, and performance are monitored. Corporate governance specifies the division of authorities and responsibilities of different participants in the corporation. Corporate governance is based on the underlying concept of accountability and responsibility rather than the notion of who has the power and who is in charge. Under effective corporate governance, management is accountable to the board of directors and the board of directors is accountable to the shareholders with the purpose of creating shareholder value.

Standard and Poor's (S&P, 2002, p. 1) defines corporate governance as "encompassing the interactions between a company's management, its board of directors, and its financial stakeholders (e.g. shareholders and creditors)."[1] Academic literature focuses on outside investors' view of corporate governance. For example, Shleifer and Vishny (1997, p. 737) state, "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." Corporate governance should facilitate the alignment of interests among managers, directors, and investors. Three important aspects of corporate governance are fiduciary, shareholder, and stakeholder, as discussed in the following paragraphs.

Fiduciary Aspect

Corporate governance has traditionally focused on the fiduciary aspect of governance in ensuring that the company's assets are safeguarded. Jensen and Meckling (1976), in applying agency theory to corporations, argue that separation of ownership and control creates conflicts of interest between owners and controllers. The role of corporate governance is to minimize the loss of value that may result from the separation of ownership and control. Thus, the corporate governance structure is centered on the establishment and maintenance of adequate and effective internal control systems to protect assets from loss or theft. In this context, corporate governance is viewed as a mechanism of monitoring the actions, policies, and decisions made by management to achieve corporate objectives.

Shareholder Aspect

The shareholder aspect of corporate governance is based on the emerging concept that the primary objective of corporations is to create and enhance shareholder

value. Corporate governance is viewed as a set of mechanisms designed to induce management to make decisions that maximize shareholder value and ensure that shareholders receive a desired return on their investment (Shleifer & Vishny, 1997). The substantial boom in the capital markets and economy during the 1990s encouraged the creation and maximization of shareholder value as a primary goal of corporate governance. Thus, the corporate governance structure should focus on the process of directing and managing the business and affairs of the corporation to achieve its objective of creating shareholder value. This aspect of corporate governance concentrates on the roles of the board of directors, the audit committee, and management in managing business risk and protecting investors' interests.

Stakeholder Aspect

The stakeholder aspect of corporate governance is gaining tremendous support in the wake of recent corporate misconduct and financial scandals. This aspect of corporate governance defines the balance of power among directors, executives, auditors, investors, and other stakeholders (e.g. creditors, employees, customers, regulating agencies). The board of directors is charged with representing stakeholders' interests (Hermalin & Weisbach, 2003). It requires: (1) identification of all stakeholders who are affected by the corporation's business and affairs; (2) definition of responsibilities and authorities of each stakeholder; (3) development of a system of checks and balances to ensure proper accountability for the stewardship of the corporation's resources; and (4) establishment of a fair system of rewards and penalties. Under the stakeholder aspect of corporate governance, the corporate primary objective is to create shareholder value while protecting the interests of other stakeholders. The Conference Board (2003) advocates the stakeholder aspect of corporate governance to serve the best interests of shareholders as well as other constituencies including employees, customers, suppliers, and communities.

CORPORATE GOVERNANCE GUIDELINES

Corporate governance guidelines provide benchmarks for establishing internal mechanisms (the roles of the board of directors and management) and external mechanisms (the market-based monitoring and the legal/regulatory system). Corporate guiding principles and recommendations are provided by legislators and professional organizations to protect investors by improving accountability and the reliability of financial disclosures. Several provisions of the Act address

corporate governance. Professional organizations such as the National Association of Corporate Directors (NACD), the Business Roundtable (BRT), the Financial Executive International (FEI), New York Stock Exchange (NYSE), and the Conference Board have also made recommendations for improving corporate governance (summarized in Table 1). These measures are based on the five fundamental principles of: (1) reinforcing corporate accountability; (2) establishing professional responsibilities; (3) improving quality, reliability, and transparency of financial reports; (4) enhancing the effectiveness and credibility of audit functions; and (5) restoring investor confidence and public trust in public financial information.

Table 2 summarizes the provisions of the Act, which is intended to improve corporate governance, the quality of financial reports, and effectiveness of audit functions. The Act is intended to: (1) establish independent regulatory structure for the accounting profession; (2) set high standards and new guiding principles for corporate governance; (3) improve the quality and transparency of financial reporting; (4) improve the objectivity and credibility of audit functions; (5) create more severe civil and criminal remedies for violations of the federal securities laws; and (6) increase independence of securities analysts. The Act has received a mixed response from the financial community and the accounting profession. It is viewed by many as the most sweeping measures taken by legislators addressing corporate governance, financial reports, and audit functions.[2] Others consider the Act as patchworks and codification responses by Congress to widely publicized business and accounting scandals, with no direct impacts on improving corporate governance and financial disclosures, at least beyond those of market-based mechanisms.[3] The potential effects of the Act, therefore, range from "sweeping measures" that will eventually reform corporate governance and the financial reporting of public companies to "patchworks and codifications" of the existing corporate governance and financial disclosures regulations and requirements. In the short term, the Act seems to have some impacts on affected companies' internal controls and compliance practices as well as restoring investor confidence in the capital markets (Whitman, 2003). The long-term impacts of provisions of the Act on corporate governance (board of directors and audit committee oversight function), the financial reporting process (management reporting conservatism), and audit functions (audit quality, credibility, independence) is too early to assess. Nevertheless, the Act created news that was considered by investors as good news in addressing business and accounting scandals. Rezaee and Jain (2003) investigate the capital market reaction to several events (such as Congressional bills) leading up to the passage of the Act and find positive market reactions to these events, indicating that investors considered the Act beneficial and relevant in restoring their confidence in securities markets.

Table 1. Guiding Principles, Requirements, and Recommendations for Improving Corporate Governance.

New York Stock Exchange Recommendations	Business Roundtable	Financial Executives International	National Association of Corporate Directors	Conference Board
1. Require corporate boards to have a majority of independent directors.	1. Require stockholder approval of stock options.	1. All financial executives should adhere to a specialized code of ethical conduct.	1. Boards should be comprised of a substantial majority of "independent" directors.	1. The board should establish a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.
2. Tighten the definition of independent director.	2. Create and publish corporate governance principles.	2. Companies should actively promote ethical behavior.	2. Audit, compensation, and governance/nominating committees should be composed entirely of independent directors, and are free to hire independent advisors as necessary.	2. Each board of directors should adopt processes to ensure that the ability of the independent directors in fulfilling their oversight function is not compromised.
3. Require listed companies to have audit, compensation and nominating committees composed entirely of independent directors.	3. Provide employees with a way to alert management and the board to potential misconduct without fear of retribution.	3. Establish qualifications of the principal financial officer and principal accounting officer.	3. Each key committee should have a board approved written charter detailing its duties.	3. Every board should be composed of a substantial majority of independent directors.
4. Empower non-management directors to serve as a more effective check on management by meeting at regularly scheduled executive sessions without management.	4. Require that only independent directors serve on audit, corporate governance and compensation committees.	4. Create a new oversight body for the accounting profession staffed with finance and accounting professionals.	4. An independent director should be designated as chairman or lead director.	4. Every board should tailor the mix of directors' qualifications for its particular requirements.

Table 1. (*Continued*)

New York Stock Exchange Recommendations	Business Roundtable	Financial Executives International	National Association of Corporate Directors	Conference Board
5. The board must affirmatively determine that the director has no material relationship with the listed company.	5. Ensure that a substantial majority of the board of directors comprises independent directors both in fact and in appearance.	5. Place restrictions on certain non-audit services supplied by the independent auditor.	5. The performance of the CEO, other senior managers, the board as a whole, and individual directors should be evaluated.	5. Each board should develop a three-tier director evaluation mechanism.
6. Former employees or the independent auditor of the company – and their family members – may not be considered independent until five years after their employment ends.	6. Ensure prompt disclosure of significant developments.	6. Restrict the hiring of senior personnel from the external auditor.	6. Boards should review the adequacy of their companies' compliance and reporting systems at least annually.	6. Boards should be responsible for overseeing corporate ethics.
7. Director's compensation must be the sole remuneration from the listed company for audit-committee members.	7. Establish an appropriate management compensation structure that directly links the interests of management to the long-term interests of stockholders.	7. Reform the Financial Accounting Standards Board (FASB).	7. Boards should adopt a policy of holding periodic sessions of independent directors only.	7. The board and not management should retain special counsel for the necessary executives' investigation.
8. Increase the authority and responsibility of the audit committee, including the authority to hire and fire independent auditors, and to approve any significant non-audit services.	8. Require the audit committee to recommend the selection and tenure of the outside auditor.	8. Modernize financial reporting.	8. Audit committees should meet independently with both the internal and independent auditors.	8. Companies should formulate and communicate a strategy specifically designed to attract investors known to pursue long-term holding investment strategies.

9. Require listed companies to have an internal audit function.		9. Require continuous professional education for audit committee members.	9. Boards participate in companies' strategies.	9. Shareowners, particularly long-term shareowners, should act more like owners of the corporation.
10. Increase shareholder control over equity-compensation plans.		10. Periodic consideration of audit committee chair rotation.	10. Boards should provide new directors with a director orientation program.	10. Audit Committees should be vigorous in complying with applicable requirements and standards.
11. Require companies to adopt and disclose governance guidelines, codes of business conduct, and charters for their audit, compensation, and nominating committees.		11. Disclosure of corporate governance practices.		11. There should be an orientation program for each member of the Audit Committee.
12. Require foreign private issuers to disclose significant ways in which their governance practices differ from NYSE rules.				12. All companies should have an internal audit function.
13. Require CEO certification of the accuracy and completeness of financial information.				13. Audit Committees should consider rotating audit firms when there is a combination of circumstances that could call into question the audit firm's independence from management.

Table 1. *(Continued)*

New York Stock Exchange Recommendations	Business Roundtable	Financial Executives International	National Association of Corporate Directors	Conference Board
14. Allow the NYSE to issue a public reprimand letter to listed companies in violation of a corporate-governance standard.				14. The Audit Committee should, if necessary, retain professional advisors to assist it in carrying out its functions. 15. Public accounting firms should limit their services to their clients to performing audits. 16. The leadership of the Big Four accounting firms should each examine their business model to ensure that the model is consistent with the idea that quality audits is their number one priority.

Note: Sources from left to right:

(1) New York Stock Exchange (NYSE). 2003. NYSE Approves Measures to Strengthen Corporate Accountability. (April 13). Available at http://www.nyse.com/content/articles/1043269646468.html.

(2) Business Roundtable (BRT). 2002. Principles of Corporate Governance (May). Available at http://www.brtable.org/pdf/704.pdf.

(3) Financial Executives International (FEI). 2002. FEI Observations and Recommendations: Improving Financial Management, Financial Reporting, and Corporate Governance. Available at http://www.fei.org.

(4) National Association of Corporate Directors (NACD). 1999. 1999–2000 Public Company Governance Survey. Washington, D.C. NACD.

(5) The Conference Board Commission on Public Trust and Private Enterprise. 2003. Findings and Recommendations Part 2: Corporate Governance: Principles, Recommendations and Specific Best Practice Suggestions. (January 9). Available at http://www.conference-board.org/knowledge/governCommission.cfm.

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Table 2. Some Provisions of the Sarbanes-Oxley Act of 2002.

Sect.	Provisions	Effective Date
101	*Establishment of Public Company Accounting Oversight Board (PCAOB)* The PCAOB is an independent, non-governmental accounting oversight board to oversee the audit of publicly traded companies.	October 28, 2002
102	*The Registration with the PCAOB* Register public accounting firms (foreign and domestic) that prepare audit reports for issuers	April 26, 2003
103	*Functions of the PACOB –* The board shall establish, or adopt, by rule, auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers; Conduct inspections of registered public accounting firms; Conduct investigations and disciplinary proceedings and impose appropriate sections; Enforce compliance with the Act; and Establish budget and manage the operations of the Board and its staff.	October 28, 2002
107	*Commission Oversight of the Board:* The SEC shall have oversight and enforcement authority over the PCAOB.	July 30, 2002
108	*Accounting Standards:* 1. The SEC may recognized as "generally accepted" any accounting principles that are established by a standard setting body that meets the Act's criteria. 2. The SEC shall conduct a study on the adoption of a principles-based accounting system.	July 30, 2002
201	*Auditor Independence: Services Outside the Scope of Practice of Auditors:* Registered public accounting firms are prohibited from providing any non-audit services to an issuer contemporaneously with the audit including but not limited to: (a) bookkeeping or other services related to the accounting record or financial statement of the audit client; (b) financial information systems design and implementation; (c) appraisal or valuation services; (d) actuarial services; (e) internal audit outsourcing services; (f) management functions or human resources; (g) broker or dealer, investment advisor, or investment banking; (h) legal services and expert services unrelated to the audit; and (i) any other services that the PCAOB determines, by regulation, is impermissible.	January 26, 2003
203	*Audit Partner Rotation:* The lead audit or coordinating partner and reviewing partner of the registered accounting firm must rotate off of the audit every five years.	January 26, 2003
204	*Auditor Reports to Audit Committees:* The registered accounting firm must report to the Audit Committee all critical accounting policies and practices to be used; all alternative treatments of financial information within generally accepted	January 26, 2003

Table 2. (*Continued*)

Sect.	Provisions	Effective Date
	accounting principles, ramifications of the use of such alternative disclosures and treatments, and the preferred treatment; other material written communication between the auditor and management.	
206	*Conflicts of Interest:* The registered accounting firm is prohibited to perform audit for an issuer who is CEO, CFO, controller, chief accounting officer or person in an equivalent employed by the accounting firm during the 1-year period preceding the audit.	January 26, 2003
207	*Study of Mandatory Rotation of Registered Public Accounting Firms:* The Comptroller General of the United States will conduct a study on the potential effects of requiring the mandatory rotation of public accounting firms.	July 30, 2003
301	*Public Company Audit Committees:* Each member of the audit committee shall be an independent member of the board of directors. The audit committee shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm associated by the issuer. The audit committee shall establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters and the confidential, anonymous submission by employees of the issuer or concerns regarding questionable accounting or auditing matters.	July 30, 2002
302	*Corporate Responsibility for Financial Reports:* The signing officers (e.g. CEO, CFO) shall certify in each annual or quarterly report filed with the SEC that: (a) the report does not contain any untrue statement of a material fact or omitted material facts that cause the report to be misleading; and (b) financial statements and disclosures fairly present, in all material respects, the financial condition and results of operations of the issuer. The signing officers are responsible for establishing and maintaining adequate and effective controls to ensure reliability of financial statements and disclosures. The signing officers are responsible for proper design, periodic assessment of the effectiveness and disclosure of material deficiencies in internal controls to external auditors and the audit committee.	August 28, 2002
303	*Improper Influence on Conduct of Audits:* It shall be unlawful for any officer or director of an issuer to take any action to fraudulently influence, coerce, manipulate, or mislead auditors in the performance of financial audit of the financial statements.	April 26, 2003
304	*Forfeiture of Certain Bonuses and Profits:* CEOs and CFOs who revise company's financial statements for the material noncompliance with any financial reporting requirements	July 30, 2002

Table 2. (*Continued*)

Sect.	Provisions	Effective Date
	must pay back any bonuses or stock options awarded because of the misstatements.	
306	*Insider Trades During Pension Fund Blackout Periods:* It shall be unlawful for any directors or executive officers directly or indirectly to purchase, sell, or otherwise acquire or transfer any equity security of the issuer during any blackout periods. Any profits resulting from sales in violation of this section shall inure to and be recoverable by the issuer.	January 26, 2003
307	*Rules of Professional Responsibility for Attorneys:* Require attorneys who appear or practice before the SEC to report violations of securities laws to the CEO or chief legal counsel and if no action is taken, to the audit committee.	January 26, 2003
308	*Fair Funds for Investors:* Allows the SEC to impose civil penalties on disgorged executives for the compensation of victims.	July 30, 2002
401	*Disclosures in Periodic Reports:* Each financial report that is required to be prepared in accordance with GAAP shall reflect all material correcting adjustments that have been identified by the auditors. Each financial report (annual and quarterly) shall disclose all material off-balance sheet transactions and other relationships with unconsolidated entities that may have a material current or future effect on the financial conditions of the issuer.	January 26, 2003
402	*Extended Conflict of Interest Provisions:* It is unlawful for the issuer to extend credit or personal loans to any directors or executive officers.	July 30, 2003
404	*Management Assessments of Internal Controls:* 1. Each annual report filed with the SEC shall contain an internal control report, which shall: (a) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (b) contain an assessment of the effectiveness of the internal control structure and procedures as of the end of the issuer's fiscal year. 2. Auditors shall attest to, and report on, the assessment of the adequacy and effectiveness of the issuer internal control structure and procedures as part of audit of financial reports in accordance with standards for attestation engagements.	Upon the SEC rules
406	*Code of Ethics for Senior Financial Officers:* The SEC shall issue rules to require each issuer to disclose whether it has adopted a code of ethics for its senior financial officers and the nature and content of such code.	January 26, 2003
407	*Disclosure of Audit Committee Financial Expert:* The SEC shall issue rules to require each issuer to disclose whether at least one member of its audit committee is a "financial" expert as defined by the Commission.	January 26, 2003

Table 2. (*Continued*)

Sect.	Provisions	Effective Date
408	Requires the SEC to review disclosures made to the SEC on a regular and systemic basis for the protection of investors including the review of the issuer's financial statements.	July 30, 2002
409	*Real Time Issuer Disclosures:* Each issuer shall disclose information on material changes in the financial condition or operations of the issuer on a rapid and current basis.	July 30, 2003
501	*Treatment of Securities Analysts:* Registered securities associations and national securities exchanges shall adopt rules designed to address conflicts of interest for research analysts who recommend equities in research reports.	July 30, 2003
601	*SEC Resource and Authority* SEC appropriations for 2003 are increased to $776,000,000 from which $98 million shall be used to hire an additional 200 employees to provide enhanced oversight of audit services.	Fiscal year 2003
602	*Practice before the Commission* 1. The SEC may censure any person, or temporarily bar or deny any person the right to appear or practice before the SEC if the person does not possess the requisite qualifications to represent others, has willfully violated Federal Securities Laws, or lacks character or integrity. 2. The SEC shall conduct a study of "Securities of Professionals (e.g. accountants, investment bankers, brokers, dealers, attorneys, investment advisors) who have been found to have aided and abetted a violation of Federal Securities Laws. 3. The SEC shall establish rules setting minimum standards for professional conduct for attorneys practicing before the commission.	July 30, 2002
701	*GAO Study and Report Regarding Consolidation of Public Accounting Firms:* The GAO shall conduct a study regarding consolidation of public accounting firms since 1989 and determine the consequences of the consolidation, including the present and future impact and solutions to any problems that may result from the consolidation.	July 30, 2003
702	*Credit Rating Study and Report:* Directs the SEC to conduct a study and report its findings to congress regarding the role, importance, and impact of rating agencies in the market place.	January 26, 2003
703	*Study and Report on Violators and Violations:* Directs the SEC to conduct a study and report its findings to congress regarding the proliferation of violations of securities laws and associated penalties.	January 26, 2003
704	*Study of Enforcement Actions:* Direct the SEC to analyze all enforcement actions over prior 5-year period involving violations of reporting requirements and	January 26, 2003

Table 2. (*Continued*)

Sect.	Provisions	Effective Date
	restatements of financial statements to identify areas of reporting that are most susceptible to fraud.	
705	*Study on Investment Banks:* Directs the Comptroller General to conduct a study and report the findings to congress regarding the role of investment bankers and financial advisors assisted public companies in manipulating their earnings and obfuscating their true financial condition	January 26, 2003
802	*Criminal Penalties for Altering Documents:* Criminal penalties for document destruction, alternation, or concealment with the intent to impede federal investigations or in a federal bankruptcy case include fines and maximum imprisonment of 20 years.	July 30, 2002
803	*No Discharge of Debts in a Bankruptcy Proceeding:* Liability for securities law or fraud violations may not be discharged under the U.S. Bankruptcy Code.	July 30, 2002
804	*Statute of Limitations for Securities Fraud:* Statute of limitations to recover for a private action for securities fraud lengthened to the earlier of two years after the date of discovery or five years after the fraudulent activities.	July 30, 2002
806	*Whistleblower Protection:* Provides whistleblower protections for employees of any issuer who willingly provides evidence of fraud or violations of securities by that issuer.	July 30, 2002
903 904 906	*White Collar Crime Penalty Enhancements* 1. Maximum penalty for mail and wire fraud is 10 years 2. The SEC may prohibit anyone convicted of securities fraud from being a director or officer of any public company. 3. Financial reports filed with the SEC (annual, quarterly) must be certified by the CEO and CFO of the issuer. The certification must state that the financial statements and disclosures fully comply with provisions of Securities Acts and they fairly present, in all material respects, financial results and conditions of the issuer. Maximum penalties for willful and knowing violations of these provisions of the Act are a fine of not more than $500,000 and/or imprisonment of up to five years.	July 30, 2002
1001	*Corporate Tax Returns* The federal income tax return of public corporations should be signed by the CEO of the issuer.	July 30, 2002
905 1104	*Review of Sentencing Guidelines:* Authorizes the U.S. Sentencing Commission to review the sentencing guidelines for fraud, obstruction of justice and other white-collar crimes and propose changes to existing guidelines.	January 26, 2003

Table 2. (*Continued*)

Sect.	Provisions	Effective Date
1105	*Authority of the SEC* The Commission may prohibit a person from serving as a director or officer of a publicly traded company if the person has committed securities fraud.	July 30, 2002
1106	*Criminal Penalties for Violations of the 1934 Act:* Increases criminal penalties for violations of the 1934 Act from $1 million to $5 million for individuals; from 10 years to 20 years imprisonment for each violation; and from $2.5 million to $25 million for each entity.	July 30, 2002

Source: Sarbanes-Oxley Act of 2002. Public Company Accounting Reform and Investor Protection Act of 2002. Available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_bills&docid=f:h3763enr.txt.pdf.

The Corporate Accountability and Listing Standards (CALS) Committee of NYSE suggested a set of recommendations to improve the corporate governance of the Exchange's listed companies. The NYSE board, on August 1, 2002, adopted the final recommendations of its CALS committee, which were subsequently submitted to the SEC for review. The adopted recommendations are designed to improve investor confidence by ensuring the independence of directors and enhancing corporate governance practices. These recommendations are also intended to allow investors to more easily and effectively monitor the performance of companies (see Table 1). Other organizations and associations in the financial community have proposed similar corporate governance guidelines. The Business Roundtable (BRT, 2002), an association of chief executive officers (CEOs) of leading corporations, has proposed guiding principles as summarized in Table 1. The Conference Board (2003) issued a report that summarizes corporate governance principles, recommendations, and best practice suggestions. The Conference Board report states that the role of the corporation is to serve the best interests of stakeholders, and defines 16 corporate governance principles (summarized in Table 1).

CORPORATE GOVERNANCE STRUCTURE

Corporate governance structure consists of both internal and external mechanisms for managing and monitoring corporate activities to increase shareholder value. Corporate governance is viewed as interactions among participants in the oversight function (the board of directors and audit committee), the managerial

function (management), the audit function (internal auditors), the assurance function (external auditors), the compliance function (the SEC, standard setters, regulators, organized stock exchanges), the advisory function (legal counsels, financial advisors), and the monitoring function (investors, creditors, financial analysts, and other stakeholders) in the governance system of corporations. Figure 1 shows interactions among corporate governance participants in ensuring responsible corporate governance, reliable financial reporting process, adequate and effective internal control structure, and credible audit functions.

Oversight Function

The emerging interest in corporate governance underscores the importance of the board of directors and the audit committee as crucial elements of corporate governance mechanisms (as depicted in Fig. 1). The Conference Board (2003, p. 6) states, "The ultimate responsibility of good corporate governance rests with the board of directors." A vigilant board of directors that proactively participates in strategic decisions, asks management tough questions and oversees their plans, decisions and actions, and monitors management's ethical and legal compliance, can be very effective in achieving good governance and protecting stakeholders' interests. The success of the board in fulfilling its oversight responsibility depends on the structure, resources, and authority of the entire board as well as its working relationships with other participants of corporate governance (including management, external auditors, internal auditors, legal counsel, professional advisors, regulators, and standard-setting bodies).

Board of Directors

The board of directors, as an important internal component of corporate governance, receives its authority from shareholders who utilize their voting rights to elect board members. The board of directors, while retaining its oversight function, delegates its decision-making authority to management, who makes decisions on behalf of shareholders. The role of the board of directors is described by Rezaee (2002a) as a mechanism of: (1) overseeing managerial plans, decisions, and actions; (2) safeguarding invested capital; (3) preventing the concentration of power in the hands of a small group of top executives; and (4) creating a system of checks and balances. In fulfilling its legal responsibility, the board of directors should: (1) perform vigilant oversight to be a fiduciary for all stakeholders in the corporation; (2) monitor management plans, decisions, and activities; (3) act

as an independent leader that takes initiatives that create shareholder value; (4) establish guidelines or operational procedures for its own functioning; (5) meet periodically without management presence to assess company and management performance and strategy; (6) evaluate its own performance to ensure that the board is independent, professional and active; and (7) establish an audit committee that oversees the financial reporting process, internal control structure, and audit functions.

The board of directors is typically composed of both internal and external members. Internal members of the board of directors, due to their full-time status, often have knowledge of inside information that may improve the effectiveness of their oversight performance. Outside members of the board, on the other hand, can be more independent in exercising their authority and decision control to monitor management decisions and actions. Hermalin and Weisbach (2003) summarize the board characteristics: (1) higher proportions of outside directors are associated with better decisions regarding issues such as acquisitions, executive compensation, and CEO turnover, but not associated with superior firm performance; (2) board size is negatively correlated to both the quality of decision-making and the firm performance; and (3) changes in board members are often associated with poor firm performance, CEO turnover, and changes in ownership structure. Aligning the interests of managers and shareholders requires vigilant, objective, and effective boards of directors.

Reported corporate scandals have encouraged investors to raise an important question – “where were the directors?” Investors do not know what goes on behind the closed doors of the boardroom. Thus, they rely on directors to represent their interests, making directors accountable to shareholders. In the wake of these scandals, several initiatives were taken to ensure directors’ accountability. The Act (see Table 2) prohibits any directors or executive officers directly or indirectly to purchase, sell, or otherwise acquire or transfer any equity, security, or issue during any blackout periods. This ban on stock purchases and sales by directors should encourage them to keep a watchful eye on management without fear of the short-term price declines that may follow. The Act, however, stops short of requiring: (1) term limits for directors to resign after 10 years or at age 70, whichever comes first to prevent directors from becoming entrenched; and (2) annual self-evaluation of directors’ performance and public reporting of the assessment of directors’ performance. The Act authorizes the SEC to issue an order to prohibit any person who has violated section 10(b) of the 1934 Act from acting as an officer or director of any publicly traded companies. The SEC issued its final rule on “Improper Influence on Conduct of Audits” as directed by Section 303 of the Act. This rule prohibits officers and directors of public companies and persons acting under their direction from taking any action to coerce, manipulate, mislead,

or fraudulently influence auditors, causing the issuance of misleading audited financial statements.

Current initiatives on corporate governance (see Tables 1 and 2) provide the following recommendations for improving the effectiveness of the board of directors in fulfilling its oversight functions:

(1) Appoint a lead, independent director who can convene the board without the CEO.
(2) Require the majority of directors be independent.
(3) Develop the knowledge and expertise to ensure effective board oversight.
(4) Compensate independent directors with a combination of stock and stock options to align director incentives with shareholder interests.
(5) Limit the independent director's length of service to several years.
(6) Limit total board membership to less than 15 directors with no more than one third of members drawn from the company's management team.
(7) Assign directors to four board committees, namely: (1) corporate governance (nominating committee); (2) corporate operation (executive committee); (3) audit committee; and (4) compensation and human resource committee.
(8) Each of the nominating committee, the audit committee, and the compensation committee should be comprised of minimum three entirely independent directors.
(9) Require outside directors to hold meetings away from management where non-management directors meet without management in executive sessions.
(10) Restrict the number of boards that directors can serve on to no more than three boards.
(11) Reduce or eliminate any business relationships between board members and the company by requiring a five year "cooling-off" period for former corporate associates (e.g. employees, auditors) to be eligible to serve on the board of directors.
(12) Adopt a code of business conduct and ethics for directors and executive officers.
(13) Establish an orientation program for new board members.
(14) Conduct a thorough annual self-evaluation of the overall performance of the board, the performance of each committee, and the activities of individual directors and make this performance assessment report public.
(15) Separate the chairman of the board and CEO position.
(16) Provide adequate resources to the board to hire advisors and independent staff support.
(17) Hire special investigative counsel to perform investigations of the company activities, including directors and executives conducts.

(18) Make the board of directors responsible for overseeing corporate ethics by setting the tone at the top to ensure adherence to the applicable laws and regulations.

Audit Committees

Audit committees are standing committees composed of non-executive and independent board of directors. Audit committees have oversight responsibility over corporate governance and the financial reporting process, internal control structure, and audit functions. The effectiveness of the oversight function of the audit committee depends on the attitude, philosophy, and practices of the entire board of directors. The audit committee's responsibility is to oversee and monitor the integrity, quality, and reliability of the financial reporting process without stepping into the managerial functions and decisions relating to the preparation of financial statements. Members of the audit committee must be financially literate, professionally qualified, operationally knowledgeable, and functionally independent to effectively fulfill their vigilant oversight responsibility. The audit committee should meet regularly and as needed with the board of directors, CEO, CFO, treasurer, controller, director of the internal audit function, and external auditors as a group, and also in private with each individual to review and assess the integrity, and reliability of financial reports.

Rezaee et al. (2003) state that the evolution of audit committees shows many companies voluntarily establishing audit committees in the mid-twentieth century to provide more effective communication between the board of directors and external auditors. Publicly traded companies are required to establish audit committees consisting of non-executive and independent directors in order to strengthen their corporate governance. Prior research (e.g. Beasley, 1996; Dechow et al., 1996; McMullen, 1996) suggests that firms that engage in financial statement fraud are more likely to have no audit committee or ineffective audit committees that meet infrequently. The audit committee can assist in improving the integrity and transparency of financial statements by: (1) serving as a conduit for financial information flow to the board of directors; and (2) reducing information asymmetries between management and the board of directors.

The success of audit committees in fulfilling their oversight function depends on their working relationships with other corporate governance participants. The new audit committee rules of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) set forth requirements for independent directors, charter, structure, membership, and compliance. Arthur Levitt, former Chairman of the SEC, rightfully stated that "effective oversight of the financial

reporting process depends, to a very large extent, on strong audit committees, qualified, committed, independent, and tough-minded audit committees represent the most reliable guardians of the public interest-this time for bold action" (Levitt, 1999). The Conference Board (2003) recommends two guiding principles of the enhanced role of the audit committee and audit committee education. It also describes the following best practice suggestions: (1) the board of directors should implement provisions of the Act and requirements of NYSE pertaining to audit committees; (2) the board should evaluate the independence and qualifications of the audit committee; (3) audit committees should conduct an annual evaluation of the performance of the committee and its members; and (4) members of the audit committee should participate in an initial orientation and continuous educational programs.

The SEC requires that a report by the audit committee be included annually in each proxy statement of publicly traded companies. The audit committee report should state whether the audit committee has : (1) reviewed and discussed the audited financial statements with management; (2) discussed with the external auditors those matters required to be communicated to the audit committee in accordance with generally accepted accounting principles (GAAP); (3) received from the external auditors a letter revealing matters that, in the auditors' judgment, may reasonably be thought to bear on the auditors' independence; and (4) recommended to the board of directors that the company's audited financial statements be included in the Annual Report on Forms 10-K or 10-KSB based on discussions with management and external auditors. The report by audit committee is expected to ensure that financial statements are legitimate, the audit was thorough, and the auditors have no flagrant conflicts of interest that may jeopardize their objectivity, integrity, and independence. Rezaee et al. (2003) review a sample of audit committee reports, which indicate that the focus has been on the role and structure of the audit committee rather than the substance of the audit committee report. Many of these reports contain a disclaimer that the audit committee does not guarantee that the financial statements adhere to GAAP and based their recommendations solely on the word of management and auditors.

The Act (see Table 2) requires the audit committee to: (1) be independent from the company's management; (2) be directly responsible for the appointment, compensation, and oversight of the work of the external auditors; (3) be composed of independent members of the board of directors; (4) have the authority to engage advisors; (5) be properly funded to effectively carry out its duties; (6) develop procedures for addressing complaints concerning auditing issues; (7) pre-approve audit and any permitted non-audit services provided by the external auditors; (8) establish procedures for employee whistleblowers to submit their concerns regarding accounting or auditing issues; and (9) disclose that at least one member

of the audit committee is a financial expert. The SEC has adopted a rule providing standards relating to listed company audit committees. This rule directs the national securities exchanges (AMEX, NYSE) and national security associations (NASD) to prohibit the listing of any public company that is not in compliance with the audit committee requirements of the Act. The Act and the SEC related implementation rules have shifted some of management's financial reporting and audit involvement responsibilities to the audit committee. Table 3 compares and contrasts the composition, attributes, structure, and functions of the audit committee as required by the Act and SEC related rules with those of suggested best practices (benchmarks of the Conference Board). The most noticeable differences are: (1) the Act and SEC rules require an audit committee to have a minimum of three independent members, whereas the benchmark suggests five independent members; (2) the Act requires at least one member of the audit committee be designated as a "financial expert," while the benchmark suggests all members of the audit committee be financial experts; and (3) the benchmark suggests more extensive functions for the audit committee. The Act requirements, SEC related rules and suggested benchmarks are expected to improve the audit committee function as described in this paper.

Managerial Function

Management plays an important role in ensuring effective and responsible corporate governance by managing the business of the corporation in achieving the goal of creating shareholder value. Management, through the delegated authority from the board of directors, is responsible for developing and executing corporate strategies, safeguarding financial resources, complying with applicable laws and regulations, achieving operational efficiency and effectiveness, establishing and maintaining adequate and effective internal control system, and designing and implementing a sound accounting system that provides reliable and high quality financial reports. Management is primarily responsible for the quality, integrity, reliability, and transparency of the financial reporting process. Management may be motivated to engage in producing misleading financial statements when: (1) lack of an effective and vigilant oversight function by the board of directors and its representative audit committee creates the opportunity to manipulate financial information; (2) its personal wealth is closely associated with the well-being of the company through profit-sharing, stock-based compensation plans, and other bonuses; and (3) management is willing to take personal risks for corporate benefit.

Quality, reliability, and transparency of financial statements can be improved when a company's financial reporting process is subject to thorough scrutiny by

Table 3. Audit Committees: Composition, Attributes, Structure, and Functions.

Provisions	Required by the Sarbanes-Oxley Act of 2002 and the SEC Rules of 2003	Specific Best Practice Suggestions
I. Composition	1. The audit committee consists of at least three members. 2. Each member of the audit committee is independent as determined by the following two criteria: a. Members are barred from accepting any consulting, advisory, or other compensatory fee other than as a member of the board. b. Members are not affiliated persons.	1. The audit committee consists of five members. 2. All members of the audit committee are independent as defined by the applicable rules and regulations. 3. The performance of the audit committee and all of its members should be evaluated at least annually.
II. Functions	1. Enhance the independence of audit functions. 2. Hire, evaluate, and fire external auditors. 3. Responsible for the appointment, compensation, retention, and oversight of the work of auditors. 4. Approve all audit engagement fees and terms and significant non-audit engagements of the independent auditor. 5. Review of financial statements. 6. Assessment of risks and vulnerabilities. 7. Oversight of external and internal audits.	1. Approve all audit and non-audit services. 2. Hire, fire, and retain independent auditors. 3. Review and approve budget for the internal audit function and have authority to hire and fire chief executive auditor. 4. Promote sound hiring policies for audit firm employees. 5. Assess risk management. 6. Arrange meetings with management, internal auditors, and independent auditors. 7. Discuss annual and quarterly financial reports including financial statements and management's discussion and analysis (MD&A) with management and independent auditors. 8. Review the independent auditor's report. 9. Receive required information regarding auditor independence. 10. Have private meetings with external auditors. 11. Have private meetings with internal auditors. 12. Provide unrestricted access to external auditors.

Table 3. (*Continued*)

Provisions	Required by the Sarbanes-Oxley Act of 2002 and the SEC Rules of 2003	Specific Best Practice Suggestions
		13. Provide unrestricted access to internal auditors. 14. Review external auditors' audit plan, procedures, scope, and results. 15. Review internal auditors' audit plan, procedures, scope, and results. 16. Have unrestricted access to all company records. 17. Review management strategic plans and business risk. 18. Review corporate governance principles and monitors compliance with these principles. 19. Review internal control structure disclosures and reporting controls and procedures. 20. Review management assessment of the adequacy and effectiveness of internal controls. 21. Review independent auditors' attestation on management assessment of internal controls. 22. Review management's certification of the accuracy, completeness, and fair presentation of financial statements in conformity with generally accepted accounting principles.
III. Handling Complaints	Establish procedures for: 1. The receipt, retention, and treatment of complaints received by the company regarding accounting, internal controls, or auditing matters. 2. The confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.	Establish procedures for the receipt, retention, and treatment of complaints received.

Table 3. (*Continued*)

Provisions	Required by the Sarbanes-Oxley Act of 2002 and the SEC Rules of 2003	Specific Best Practice Suggestions
IV. Advisors	The audit committee must have the authority to engage outside advisors including counsel, as it determines necessary to carry out its duties.	The audit committee should retain professional outside advisors who have no independent from management and internal and external auditors to assist the committee with various financial, audit, and corporate governance issues.
V. Funding	The audit committee must have appropriate funding for payment of compensation to any:	1. Adequately compensated in cash and stock.
	1. Registered public accounting firm engaged for the purpose of rendering or issuing an audit report or performing other review or attest services.	2. Legally protected from potential liabilities.
	2. Advisor employed by the audit committee.	3. Have sufficient funds to compensate external auditors for audit and non-audit services and advisors for their legal, financial consulting.
VI. Knowledge	1. All members should have knowledge and experience in financial reporting and auditing matters.	1. All members of the audit committee must be financial experts.
	2. At least one member of the committee is a financial expert who:	2. There should be an orientation for each member of the audit committee.
	a. understands financial statements and accounting standards.	3. Members of the audit committee should participate regularly in continuing education programs.
	b. has experience with application of accounting standards as related to accounting estimates, accruals and reserves as well as preparing and auditing financial statements.	4. Members should retain outside advisors or educational consultants as they deem appropriate.
	c. has experience with internal accounting controls.	
	d. understands audit committee functions.	

the board of directors, audit committees, internal auditors, external auditors, and governing bodies (as depicted in Fig. 1). However, the presence of a "gamesmanship" environment enables management to use its discretion in choosing accounting practices that portray rosy earnings projections, in order to meet analyst forecasts to sustain or boost stock prices. Rezaee (2002b) discusses the "3 Cs model" (conditions, corporate structure, and choice), which represents broad reasons for management's manipulation of earnings and possible engagement in financial statement fraud. The 3 Cs model explains how management is provided with the opportunity and the incentives to stretch applicable rules and regulations to manipulate earnings, operating in its own self-interests rather than the interests of stakeholders. Lack of effective corporate governance may create opportunities for management to appoint the board of directors, auditors, and the audit committee, and offer the monetary incentive for their continued employment. This potential for moral hazard causes a fiduciary conflict of interest in the sense that management can bend the board of directors, audit committee, and auditors to its will. This type of corporate governance structure can result in an inappropriate transfer of resources from stakeholders to management (as depicted in Fig. 2). Management may act honestly but incompetently in managing corporate affairs. This causes management to be ineffective in creating shareholder value. In this case, the board of directors should exercise its oversight authority to replace the current management team.

The Act establishes the following requirements for management of public companies, including CEOs, CFOs, chief accounting officers, in an attempt to improve corporate accountability: (1) management should certify the accuracy and completeness of the company's financial reports (e.g. quarterly, annual reports); (2) management is responsible for establishing and maintaining effective internal controls; (3) management is responsible for the proper design and periodic assessment of the effectiveness and disclosure of material deficiencies in internal controls; (4) management should not take any action to fraudulently influence, coerce, manipulate, or mislead auditors in the performance of their audits of financial statements; (5) management should reimburse the company for any bonus or other incentive or equity based compensation received if the company is required to prepare a restatement due to material noncompliance with financial reporting requirements; (6) senior executives who violate SEC rules should be barred from acting as an officer or director of any public companies; (7) management should reconcile pro forma statements with the financial statements; (8) management should observe the company's code of ethics; (9) senior executives found guilty of committing mail and wire fraud could be sentenced up to 20 years of jail time; (10) Management's Discussion and Analysis (MD&A) sections should discuss and fully disclose critical accounting estimates and critical accounting policies; and (11) the federal

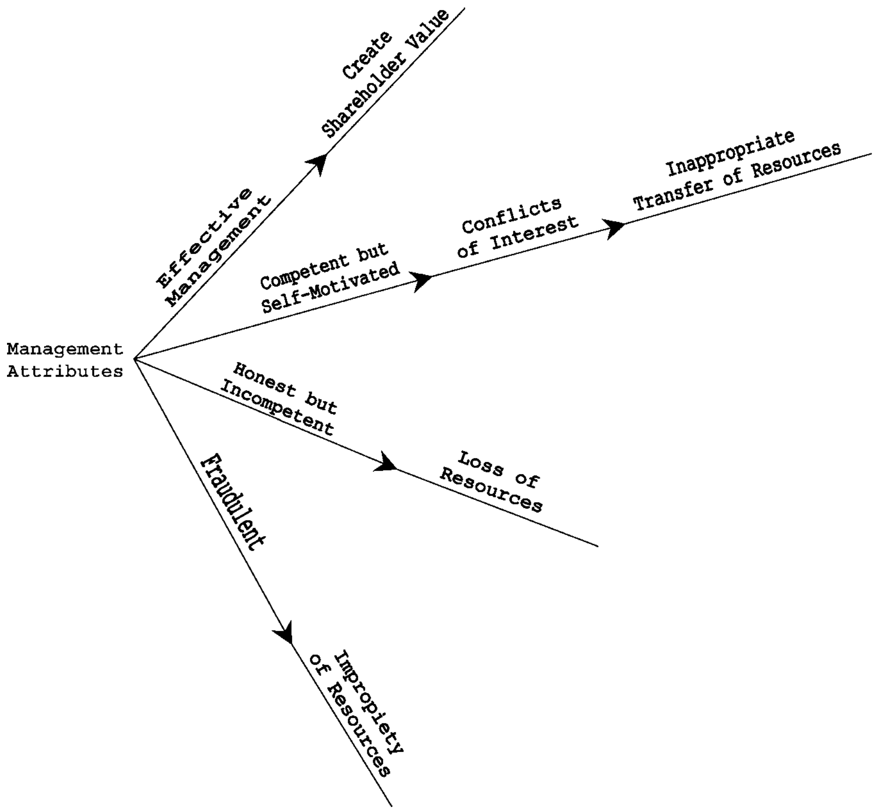

Fig. 2. Management Attributes.

income tax return of public companies should be signed by CEOs. Provisions of the Act and related SEC implementation rules have already changed and will continue to change the balance of powers between management, the board of directors, and auditors. These emerging changes are expected to improve corporate governance, the quality of financial reports and effectiveness of audit functions.

Compliance Function

Market-based correction mechanisms have failed to penalize and in some instances rewarded corporate wrongdoers in the sense that while investors were suffering great losses, senior executives seemingly responsible for those losses had enriched themselves as their corporations collapsed. This is evidenced by the fact that executives of 25 companies whose stock price fell by more than 75%

due to financial scandals walked away with $23 billion between January 1999 and May 2002 (Dash et al., 2002). Thus, rules and regulations established by governing bodies are important mechanisms of corporate governance in creating an environment that promotes and enforces responsible corporate governance (LaPorta et al., 2000). Prior studies (Jensen, 1993; LaPorta et al., 1998) document that the legal system is an essential corporate governance mechanism. Jensen (1993), while considering the legal system as a corporate governance mechanism, views it as being far too blunt an instrument to deal with the agency problems between owners and managers. LaPorta et al. (1998) argue that the extent to which a country's laws protect investor rights and the extent to which these laws are complied with and enforced are determinants of the ways in which corporate governance evolves in that country. LaPorta et al. (1997) document that better legal protection leads investors to demand lower rates of return. Legislators, regulators, and standard-setting bodies affect corporate governance in several ways: (1) through regulation of the capital markets; (2) through regulation of listed public companies and their financial reporting; and (3) through regulation of registered public accounting firms. Regulation can be levied by legislators (the Act), regulators (SEC rules), or organized stock exchanges (NASD, NYSE). Regulation monitors compliance with applicable rules, laws, and standards, which improves corporate governance.

Applicable laws and regulations designed to protect investors' interests and the compliance with these regulations by corporations are essential to the efficiency and integrity of the capital markets and the structure of corporate governance within companies. Concern over highly publicized business collapses has prompted several governing organizations to address the problem of financial statement misstatements and auditors' failure to detect them. The governing organizations that can influence the financial reporting process and corporate governance of public companies are the SEC, the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), and organized stock exchanges (NASDAQ, NYSE). The SEC requires public companies to file financial statements prepared in accordance with GAAP. In the wake of the reported financial scandals, the SEC has been criticized for: (1) not being sufficiently aggressive in addressing conflicts of interest across the financial and auditing professions; and (2) not providing adequate rules to improve corporate governance, quality, integrity, and transparency of financial reports, and effectiveness of audit functions.

Recently, the SEC has taken several initiatives to improve the quality of financial reports disclosed by publicly traded companies. These initiatives are: (1) strategies to promote high quality financial reports and punish companies engaged in financial statement fraud; (2) Regulation FD (fair disclosure), which

reduces inside trading of securities and creates a level playing field for all market participants regardless of size and sophistications in trading securities; (3) rules on audit committees to promote their independence, qualifications, compositions, and effectiveness; (4) rules on auditor's independence to reduce the potential conflicts of interest with their clients and to improve the auditor's ability to detect financial statement fraud; (5) rules to improve the financial reporting and disclosure system by expediting the filing of annual reports from 90 to 60 calendar days after fiscal year and filing of quarterly reports from 45 to 35 calendar days after the reporting period end; (6) the requirement that CEOs and CFOs certify the accuracy and completeness of financial statements and effectiveness of internal controls; (7) cooperation with the FASB in retaining its independence and considering important accounting issues and practices on a more timely basis; (8) the requirement that public companies discuss the effects of their critical accounting policies and disclose off-balance sheet financing arrangements; (9) Regulation AC (analyst certificate), which requires that brokers and dealers include certifications by research analysts in a research report; and (10) rules requiring attorneys who are involved with the financial reports of public companies to respond appropriately to evidence of material corporate misconducts. As of this writing, the SEC has issued more than 20 rules and several proposals pertaining to the implementation of provisions of the Act.

The Financial Accounting Standards Board (FASB) has been the designated private sector organization for establishing standards of financial accounting and reporting since 1973. The SEC has delegated its accounting standard-setting authority to the FASB to issue authoritative Statements of Financial Accounting Standards (SFAS) for the measurement, recognition, and reporting of business transactions and economic events as well as the preparation of financial statements. SFAS are generally accepted as authoritative guidelines in the financial reporting process primarily because the SEC, the accounting profession, and the investing public rely on SFAS in facilitating credible, reliable, comparable, and transparent financial information. The FASB has been criticized for being too slow to respond to emerging changes in the business environment on the grounds that existing SFAS are too complicated and too easy to circumvent. Standard-setting bodies such as the FASB and the International Accounting Standards Board (IASB) can improve corporate governance and the transparency of financial information by establishing principles-based standards that encourage companies to portray economic reality in their accounts and transactions and reflect the underlying economic performance rather than issuing accounting rules that can be easily circumvented (FASB, 2002).

The Act mandates several requirements for governing bodies (such as the SEC, AICPA, and FASB). First, the newly established Public Company Accounting

Oversight Board (PCAOB) will set auditing standards to be observed by auditors in conducting financial audits of public companies. Second, the Act authorizes the SEC to recognize any accounting principles that are established by a private standard-setting body (e.g. the FASB), governed by a board of trustees. The Act basically permits the FASB to continue its role in establishing accounting standards (e.g. GAAP) and provides public funding for the FASB to effectively fulfill this role. Third, the Act increases SEC appropriations for 2003 to $776,000,000 from which $98 million shall be used to hire an additional 200 employees to provide enhanced oversight of auditors and audit services required by the Federal Securities laws. Finally, the Act directs the SEC to: (1) require public companies to disclose whether they have adopted a code of ethics for their senior financial officers and the contents of such a code; (2) revise its regulations concerning prompt disclosure on Form 8-K to require immediate disclosure "of any change in, or waiver of" the company's code of ethics; (3) censure, temporarily bar, or deny any person the right to appear or practice before the SEC if the person does not possess the requisite qualifications to represent others, lacks character or integrity, or has willfully violated Federal Securities laws; (4) conduct a study of securities professionals (e.g. public accountants, investment bankers, brokers, dealers, attorneys, investment advisors, public accounting firms) who have been found to have aided and abetted a violation of Federal Securities laws; (5) establish rules setting minimum standards for professional conduct for attorneys practicing before the Commission; and (6) prohibit a person from serving as an officer or director of a public company if the person has committed securities fraud.

The AICPA has taken several steps in response to the provisions of the Act in an attempt to restore public confidence in financial reports and related audit functions. First, the AICPA has informed its members of plans for a transition from the current self-regulatory environment to a new regulatory framework established by the Act. The AICPA will work with the SEC to establish an orderly transition of its activities (e.g. standard-setting activities, peer reviewed monitoring) to the new PCAOB. Second, the AICPA supports modernization of the financial reporting model, which suggests moving from rules-based to principles-based accounting. Third, the AICPA coordinates its activities with state societies to determine the "cascade effect" of further regulatory actions that may be built on the Act. Finally, the auditing standards board (ASB) of the AICPA has issued a new exposure draft (ED) of a proposed statement on auditing standards (SAS), titled Sarbanes-Oxley Omnibus, which addresses many provisions of the Act including the requirement that the SEC engagements be reviewed by a reviewing (concurring) partner and that auditors retain certain audit and review documents for a period of seven years pursuant to the audit (AICPA, 2003a). This ED would amend several existing SASs regarding consideration of fraud in a financial statement audit, management

representations, related parties, audit documentation, communication with audit committees, and interim financial information. The ASB has also issued an ED on proposed SASs to provide guidance for auditors reporting on the effectiveness of internal control over financial reporting, as required by Section 404 of the Act (AICPA, 2003b). These proposed SASs and other SEC implementation rules pertaining to provisions of the Act are intended to enhance audit efficacy and effectiveness in detecting and reporting financial statement fraud, which in turn improves corporate governance.

Audit Function

Internal auditors are integral parts of corporate governance, and their expertise in internal control is on the front line in ensuring the integrity and reliability of financial statements. The internal auditor has been viewed as an important contributory factor in achieving operational efficiency and effectiveness in their organization. The revised definition of internal auditing specifies that internal auditors' activities are extended to evaluating and improving the effectiveness of a company's governance process. Internal auditing is defined by the Institute of Internal Auditors (IIA, 1999) as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations . . . bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

Internal auditing has evolved from a function that was mainly concerned with financial and accounting issues to a function that focuses on a broad range of operating activities and is an integral part of corporate governance structure. An internal audit function assists all individuals, and functions within the company to discharge their responsibilities by providing them with analyses, appraisals, recommendations, counsel, and information to perform their activities. Internal auditors' activities are summarized in the following functions: (1) assessing the efficiency and effectiveness of operational performance; (2) ensuring the adequacy and effectiveness of the internal control system in achieving its objectives; (3) reviewing the financial reporting process to ensure its quality and integrity in producing reliable, relevant, useful, and transparent financial information for decision making; (4) ensuring responsible corporate governance; and (5) preventing, detecting, and correcting fraud that may occur within the organization, particularly financial statement fraud, which threatens the integrity and quality of financial reports. Internal auditors should continuously monitor the financial reporting process and look for red-flag indicators suggesting the possibility of wrongdoing and illegal acts. These indicators, such as excessive related parties'

transactions and off-balance-sheet financial transactions, must be reviewed to detect any opportunistic behavior by the board and management.

The internal audit function is an important element of corporate governance, and is often an overlooked function in the financial reporting process. The Treadway Commission report (1987) suggests that the SEC require all public companies to maintain an internal audit function that is organizationally independent (NCFFR, 1987). The independence of the internal audit function is important to ensure that internal audit staff can effectively monitor the preparation of financial statements. To achieve this independence, the chief internal auditor should be appointed by the audit committee, and also be accountable and report to the audit committee, the CEO, or a superior financial officer who is not directly involved in the preparation of financial statements. External auditors are increasingly relying on the work of internal auditors in conducting financial statement audits. Thus, the extent of internal auditors' working relationships with external auditors and the effectiveness of internal auditors in preventing and detecting financial statement fraud can considerably improve their enhanced organizational status and professionalism. However, when outside auditors are hired to conduct both financial and internal audits, conflicts of interest can be created that may jeopardize outside auditors' independence and objectivity, as was the case with Andersen (Enron's auditor). The Act prohibits the registered accounting firms to perform internal audit outsourcing services for public companies contemporaneously with the audit.

The IIA, in its position paper presented to the U.S. Congress, states "Internal auditors, the board of directors, senior management, and external auditors are the cornerstones of the foundation on which effective corporate governance must be built" (IIA, 2002). The IIA also recognizes that internal auditors are an active participant in corporate governance, yet an independent observer of that process. The IIA has made the following recommendations for improving corporate governance: (1) the organized stock exchanges should issue a uniform set of corporate governance principles for publicly traded companies and require compliance with the established principles; (2) the boards of directors should publicly disclose the adequacy and effectiveness of their organization's system of internal controls; and (3) publicly traded companies should establish and maintain an independent, adequately resourced and competently staffed internal audit function to assist in ensuring a responsible corporate governance, a reliable financial reporting process and an effective system of internal controls.

Two provisions of the Act address the role of internal auditing and internal controls in improving corporate governance and the quality of financial reports. First, Section 302 of the Act requires senior executives to certify that they have designed disclosure controls and procedures. Second, Section 404 of the Act as well as SEC related implementation rules require that public companies include a report

by management on internal controls for financial reporting and an assessment of these controls in their annual report. Furthermore, external auditors should attest to and report on management's assessment and assertions on internal controls as an integral part of financial statement audits. Effective compliance with provisions of the Act and SEC implementation rules on internal controls requires internal auditors to work closely with other corporate governance participants to facilitate required certification and reporting processes.

Advisory Function

Professional advisors, such as legal counsels and financial advisors, assist public companies in the determination and execution of business transactions, and in the assessment of their legal, and financial consequences. Professional advisors, by virtue of their associations with public companies, can influence corporate governance and financial reports. The advisory function of corporate legal counsels and financial advisors is discussed in this section.

Corporate Legal Counsel

The function of corporate legal counsel as part of corporate governance has recently received a great deal of attention. Elliot and Willingham (1980) argued two aspects of lawyers' contributions to corporate governance as their obligation to disclose fraud and their relationships to management and boards of directors. Corporate legal counsels often provide advice to their clients in the preparation of documentation pertaining to business transactions, particularly information presented in the proxy statements and the footnotes to the financial statements. Management, the board of directors, and audit committees typically rely on: (1) the approval of legal counsel for the structure and disclosures of business transactions; and (2) the assurance that corporate public disclosures are legally sufficient. Thus, corporate legal counsels play an important monitoring role in corporate governance mechanisms. The Act directs the SEC to: (1) establish rules setting minimum standards for professional conduct for attorneys appearing and practicing before the Commission; and (2) conduct a study of securities professionals including attorneys who have been found to have aided and abetted a violation of Federal Securities laws.

The SEC has adopted a rule entitled, "Implementation of Standards of Professional Conduct for Attorneys." This rule is intended to protect investors and improve their confidence in public companies by requiring corporate attorneys to

respond appropriately to evidence of material misconduct. Attorneys who work for public companies must: (1) report evidence of a material violation of securities laws or breach of fiduciary duty to the chief legal counsel (CLC) or the CEO of the company; and (2) report the evidence to the audit committee or the board of directors upon the failure of the CLC or the CEO to respond appropriately to the evidence.

Financial Advisors

Financial advisors, including investment advisors registered by the SEC, play an important role in corporate governance through their discretionary authority to manage investments on behalf of their clients. Investors often give these advisors the authority to vote proxies relating to equity securities, which empower them to participate and affect corporate governance by influencing the outcome of shareholder votes. In accordance with the federal securities laws, investment advisors should exercise due diligence and service their clients to the best of their ability regarding all services rendered (including proxy voting), and should not subrogate client interests to their own. However, there may be a potential conflict of interest between investment advisors and their clients (investors) in the sense that advisors may have business or personal relationships with the company and/or participants in proxy contents and corporate directors. Thus, failure to vote in favor of management or directors may harm the advisor's relationship with the company or its directors. To address this potential conflict of interest, the SEC has adopted a rule that requires investment advisors to exercise voting authorities to act in the best interest of their clients and provide appropriate information to their clients. The rule also requires investment advisors to: (1) establish appropriate policies and procedures to ensure that their vote proxies are in the best interests of their clients; (2) disclose information about those policies and procedures to their clients; (3) disclose information regarding how they have voted their proxies; and (4) maintain certain records pertaining to proxy voting.

Assurance Function

The role of external auditors in corporate governance is to lend credibility to published financial statements by auditing those statements and providing reasonable assurance that investors are receiving relevant, useful, transparent, and reliable financial information in making sound business decisions. Public trust in auditor judgment and reputation plays an important role in substantiating

audit functions as value-added services. The recent business failures caused by reported financial statement fraud have encouraged auditors to place special and well-deserved attention to fraud prevention and detection. Users of audited financial statements typically expect external auditors to detect all financial statement fraud and illegal acts performed by employees, which would affect the quality and integrity of financial reports. External auditors, however, in recognizing the importance of discovering fraudulent financial activities, and in complying with their professional standards, are more concerned with material misstatements in audited financial reports (Rezaee, 2002a).

Reported financial scandals and related audit failures have eroded the public confidence in audit functions. Congress, regulators, and the accounting profession have taken several important initiatives to restore public confidence in the financial reporting process and related audit functions. The ASB of the AICPA, by issuing SAS No. 99, attempts to clarify the auditor's responsibility to detect and report financial statement fraud. SAS No. 99 states, "The auditor has a responsibility to plan and perform the audit to obtain *reasonable assurance* about whether the financial statements are *free of material misstatement*, whether caused by *error or fraud* (emphasis added)" (AICPA, 2002). SAS No. 99 makes it clear that the auditor's responsibility for detecting fraud is framed by the concepts of reasonable, but not absolute, assurance and materiality, and is subject to cost/benefit decisions inherent in the audit process. While SAS No. 99 is not suggesting any changes to the auditor's current responsibilities for detecting fraud in a financial statement, it does provide new guidelines, concepts, and requirements to aid auditors in fulfilling those responsibilities.

Several provisions of the Act are aimed at improving audit quality, effectiveness, and integrity. First, one of the most fundamental changes for the accounting profession is the creation of an independent Public Company Accounting Oversight Board (PCAOB), consisting of five financially-literate members who are appointed to five-year terms in order to establish standards (auditing, quality control, ethics, independence, and others) pertaining to the preparation of audit reports. The PCAOB is a nonprofit corporation, subject to SEC oversight, that: (1) annually reviews each of the registered accounting firms that conduct more than 100 audits a year; (2) investigates potential violations of rules; and (3) imposes sanctions on rule-breakers. Second, the Act prohibits registered accounting firms from providing non-audit services to their clients contemporaneously with the audit (see Table 2). The Act does however: (1) give the PCAOB authority to grant case-by-case exceptions; (2) allow auditors to engage in any non-prohibited audit services (such as tax service) that are pre-approved by the audit committee; and (3) permit accounting firms to provide non-audit services to private companies as well as any public companies that they are not concurrently auditing. Third, registered

public accounting firms will have to rotate their lead auditor or coordinating partner and the reviewing partner off of the audit every five years. Fourth, registered public accounting firms must report to the audit committee all critical accounting policies and practices used by the client, all alternative treatments of financial information within GAAP that have to be discussed with management, ramifications of the use of such alternative treatments and disclosures, as well as the treatment preferred by the accounting firm. Fifth, registered auditors must attest to and report on assessments made by management of the effectiveness of internal control structures and procedures as part of the audit of financial statements. Sixth, registered public accounting firms are required to retain work papers for at least five years in sufficient detail to support conclusions made in the audit report. Finally, the SEC, as directed by the Act, in January 2003, adopted amendments to strengthen requirements regarding auditor independence and enhance disclosures pertaining to fees paid to auditors.

The PCAOB has decided to take over the responsibility of setting audit standards. This decision practically ends more than six decades of self-regulation by the auditing profession. Table 4 summarizes the PCAOB's composition, responsibilities, and operating procedures. Pursuant to section 101(d) of the Act, the SEC on April 25, 2003 announced that the PCAOB is determined to be appropriately organized, and has the capacity to carry out the requirements of the Act and to enforce registered accounting firms' compliance with the provisions of the Act. This determination is an essential step in operationalizing the PCAOB to register public accounting firms and monitor their activities to ensure audit effectiveness and to rebuild public trust in the financial reporting process and audit functions. The PCAOB release No. 2003-006, dated April 18, 2003, describes the establishment of "Interim Professional Auditing Standards" pursuant to Section 103(a) of the Act, which enable the PCAOB to issue auditing and related attestation, quality control, and ethics standards to be used by registered public accounting firms. These interim professional auditing standards were originally issued by the AICPA, and are adopted by the PCAOB on a transitional basis to assure continuity and certainty in the standards that govern the audits of public companies. Upon further review of these standards, the PCAOB may modify, repeal, replace, or adopt these interim standards permanently. These professional auditing standards are owned by the AICPA and the permanent adoption of these standards by the PCAOB may result in payment of royalty to the AICPA. As of this writing, June 2004, the PCAOB has adopted three auditing standards for registered auditors. Provisions of the Act, along with SEC related implementation rules and PCAOB auditing standards and enforcement procedures, are expected to change the balance of power between management and auditors, which traditionally favors management's domination of financial reports and related audit functions. The

Table 4. Public Company Accounting Oversight Board Structure.

Composition	Responsibilities	Operating Procedures
1. A nonprofit organization funded by the SEC registrants and registered public accounting firms. 2. Consists of five members, two of which are CPAs. 3. Members serve full-time for a five-year staggered term, with a two-term limit. 4. The chair may be held by a CPA who has not been in practice for at least five years prior to the appointment. 5. The first group of members consists of: a. William J. McDonough (chair) b. Charles D. Niemeier c. Kayla J. Gillan d. Daniel L. Goelzer e. Willis D. Gradison, Jr. 6. Douglas R. Carmichael (Chief Auditor and Director of Professional Standards) 7. Thomas Ray (Deputy Chief Auditor)	1. Prepare its budget and manage its operations. 2. Register and inspect public accounting firms that audit public companies (registered firms). 3. Establish, adopt, and modify auditing, independence, quality control, ethics, and other standards for registered firms. 4. Enforce compliance with applicable laws and regulations including Securities Laws, professional standards, SEC rules, PCAOB standards by registered firms. 5. Investigate registered firms for potential violations of applicable laws, regulations, and rules. 6. Impose sanctions for violations. 7. Perform other duties or functions as deemed necessary.	1. Operate under the SEC oversight function. 2. File an annual report with the SEC. 3. Register public accounting firms that intend to audit publicly traded companies. 4. Issue auditing standards for registered firms. 5. Establish audit work paper retention rules. 6. Establish procedures to investigate and discipline registered firms and their personnel for violations of applicable rules and regulations. 7. Form one or more Standing Advisory Group to assist the PCAOB in its auditing standard-setting process.

Source: The PCAOB, available at http://www.pcaobus.org.

emerging well-balanced relationships between management, the audit committee, and external auditors are expected to improve the effectiveness of corporate governance, the quality of financial reports, and the credibility of audit services.

Monitoring Function

The monitoring function of corporate governance can be achieved through the direct participation of investors (or through intermediaries such as security analysts, institutional investors, and investment bankers) in the business and financial affairs of corporations.

Ownership Structure

Ownership and control are not completely separated in any company, in the sense that executives often own equity and shareholders have some degree of control through their equity positions. In this context, ownership structure can be viewed as an important element of corporate governance. However, in large corporations, individual shareholders own very small fractions of the company's share, which do not provide them with adequate opportunities and incentives to monitor managerial decisions and actions. Nevertheless, shareholders with significant ownership positions have greater motivations to monitor management or try to influence decision-making within the firm. In the wake of recent financial scandals, shareholders have been criticized for not being attentive and not acting like responsible owners of a corporation. Figure 1 shows that shareholders should assume monitoring functions of corporate governance by participating in the corporation's election process (such as the nomination of directors) and in proposals regarding the corporate governance, issues and activities specified in the proxy statement. The Conference Board (2003) recommends that shareowners, particularly long-term shareholders, participate in corporate governance to ensure that the corporation is being effectively managed on their behalf.

Institutional Ownership

Institutional ownership has substantially increased during the past several decades from less than 20% in 1970 to more than 55% of the overall equity market in 2001 (The Conference Board, 2003). Institutional ownerships (such as pension funds and mutual funds) have the resources and expertise to effectively participate in the monitoring function of corporate governance. Institutional investors' interests of their investment horizons can be classified into: (1) long-term, such as mutual, pension, and retirement funds; and (2) short-term, such as investment banks and private funds. These institutional investors, through their powerful influence in corporate governance, can positively impact the quality and reliability of financial statements. Financial institutions such as J. P. Morgan Chase and Citigroup have been scrutinized over their multiple and often conflicting roles at Enron. These financial institutions, by acting as investors, financial advisors, trading partners, investment bankers, and lenders, engaged in activities that created conflicts of interest that impaired their objectivity and integrity as part of monitoring mechanisms of Enron's corporate governance. Merrill Lynch & Co, Credit Suisse First Boston, and Wachovia Corp. also invested in Enron's private partnerships that were designed to hide liabilities and overstate earnings. Merrill Lynch (one of the

largest, most prestigious, and oldest investment banks) is under investigation for alleged fraudulent investment activities.

Institutional investors are considered as private gatekeepers that ensure corporate accountability and fair financial disclosures. The Conference Board (2003) makes the following best practice suggestions for the proactive participation of investors, both individuals and institutions, in corporate governance: (1) boards of directors should establish procedures to receive and consider shareholders' nominations for the board of directors and proposals for strategic business issues; (2) boards of directors should not preclude nominees and proposals received from smaller individual investors; (3) corporations should establish and communicate long-term strategies designed to attract long-term owners and to encourage short-term traders to become long-term owners; (4) policy makers should develop differential tax strategies for both long and short-term holding periods, to encourage investors to trade with a long-term investment horizon; and (5) institutional investors should provide incentives (e.g. compensation arrangements) for portfolio managers to promote long-term rather than short-term holdings.

Security Analysts

Security analysts, by considering financial reports in determining the company's earnings growth and potential, perform the monitoring function of corporate governance as depicted in Fig. 1. Security analysts often play an important role in recommending stock and affecting stock prices through market participants' transactions. Thus, corporate management may take advantage of the analyst's visible role and treat material information as commodity to obtain favor with particular analysts. As analysts play the game of obtaining inside information in return for more favorable reports on the company, the pressure to obtain selectively disclosed information and more favorable forecasts have continued to grow. Security analysts may participate in a gamesmanship process by biasly reporting on how a company is doing in forecasting earnings potentials and expectations. Analysts may, under pressure, feel that they are walking a tightrope of fairly assessing a company's performance without jeopardizing their business relationships with the company's management. Analysts' optimistic reporting attitudes and practices may also encourage management to tweak numbers to meet these high expectations, tailoring financial statements more for the benefit of consensus estimates than to reflect the financial reality of the company.

Traditionally, security analysts' "sell ratings" have accounted for less than one percent of their recommendations. Analysts are typically rewarded for their ability to obtain investment-banking business, and they are often encouraged from

the companies they cover, their employees, and institutional investors to maintain positive ratings. Section 501 of the Act directs the SEC to mandate National Securities Exchanges and registered securities exchanges to adopt: (1) conflict of interest rules; and (2) reasonably designed rules that require each securities analyst to properly disclose any conflicts of interest that are known or should have been known by the securities analysts, brokers, or dealers to exist at the time of distribution of the report.

The SEC issued the new Regulation Analyst Certification (Regulation AC) that requires brokers and dealers to include certifications by the research analysts in research reports that indicate: (1) their reports accurately reflect their personal views; and (2) whether or not they receive compensation or other payments in connection with their specific recommendations or views (SEC, 2003). Regulation AC also requires that broker-dealers obtain periodic certifications by research analysts in connection with the analyst's public appearance. Regulation AC is intended to foster the integrity of research reports and investor confidence in these reports.

CONCLUSION

Corporate governance has recently been scrutinized by the financial community, regulators, authoritative bodies and others concerned with the public's interests. Corporate governance is defined simply as the way a corporation is managed and monitored through proper accountability for managerial and financial performance. Corporate governance plays a crucial role in improving the efficiency of the capital market through its impact on corporate operating efficiency and effectiveness, and the integrity and quality of financial reports. New initiatives on corporate governance, including the Act and guiding principles by national stock exchanges and other professional organizations, should improve the quality and transparency of financial reports and audit functions, but should not be used as substitutes for needed reforms in the accounting profession and the financial community. The accounting profession has been provided with a unique opportunity to create significant and lasting reforms in modernizing accounting and auditing standards in order to restore public trust in the profession.

Financial reporting is an interactive supply chain process involving all corporate governance participants (as depicted in Fig. 1). This process consists of: (1) the preparation and certification of financial statements by corporate management under the oversight function of the board of directors, particularly the audit committee; (2) the verification and assurance of the fairness of financial statements by external auditors; (3) an evaluation of the quality of financial information by financial

analysts; (4) the assessment of compliance of financial statements with applicable laws and regulations by standard-setters and regulators; and (5) the monitoring and use of financial information by investors and other stakeholders. The effectiveness and quality of the financial reporting process depends not only on compliance with applicable rules and regulations, but also a firm commitment to the fundamental reporting concepts of integrity, reliability, quality, transparency, and accountability by all corporate governance participants involved in the reporting supply chain. This paper introduces a corporate governance structure consisting of seven interrelated mechanisms: oversight, managerial, compliance, audit, advisory, assurance, and monitoring functions. A well-balanced functioning of these seven interrelated functions can produce responsible corporate governance, reliable financial reports, and credible audit services. It is the author's hope that this paper generates more in-depth discussion on corporate governance. Future research should expand the discussion of each of these seven suggested corporate governance functions.

NOTES

1. S&P also develops a corporate governance model consisting of three dimensions: (1) ownership structure and investor rights; (2) financial transparency and information disclosure; and (3) board and management structure and process (Patel & Dallas, 2002). This model provides qualitative rankings of the relative quantity of the financial disclosures included in an S&P 500 firm's annual report and SEC filings (Form 10-K). These rankings are used to assess corporate governance as well as the transparency and disclosure practices of the S&P 500 firms. The S&P corporate governance scores are ranked from "1" to "10" from very weak to very strong corporate governance processes and practices respectively.
2. In signing the Act, President George W. Bush described it as "the most far-reaching reforms of American business practice since the time of Franklin Delano Roosevelt" (Bumiller, 2002). The SEC Commissioner, Harvey Goldschmid, called the Act the "most sweeping reform since the Depression-era Securities Laws" (Murray, 2002).
3. See Cunningham (2003) and Ribstein (2002) for in-depth critiques of the Act and the discussion of market versus regulatory responses to financial scandals.

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PART II:
RESEARCH REPORTS

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FAIR VALUE CAPITALIZATION OF MORTGAGE LOAN SERVICING RIGHTS

Robert J. Cochran, Edward N. Coffman and David W. Harless

ABSTRACT

This study examines whether the capitalization of mortgage loan servicing rights (MSRs) is consistent with FASB's objective of fair value accounting. The FASB issued SFAS No. 122*, "Accounting for Mortgage Servicing Rights, an amendment of* FASB Statement No. 65*" with the prescription that the MSRs be capitalized at their fair value. Fair value would imply that only servicing related firm characteristics influence the capitalization of MSRs. This study finds that several non-servicing related firm characteristics also exert a statistically significant influence on the capitalization of MSRs. As such, the evidence suggests that significant segments of the industry may have acted in a way that was at odds with the FASB's stated objective of fair value capitalization.*

INTRODUCTION

The Financial Accounting Standards Board (FASB) first considered the issue of accounting for the activities of mortgage banking concerns in 1982 with the issuance of *SFAS No. 65*, "Accounting for Certain Mortgage Banking Activities." One of the primary issues considered in the statement was the accounting

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treatment for the right of the mortgage company to service mortgage loans in the future for a fee, commonly known as mortgage loan servicing rights or MSRs. The statement was issued during a period when managerial excesses in the thrift industry (a major participant in the mortgage banking field) were well documented and contributed to the highly public failure of numerous savings and loans. The statement institutionalized a contradictory treatment for the accounting for MSRs based on the method of acquisition. MSRs acquired through an arm's-length purchase transaction were allowed to be capitalized on the balance sheet at the purchase price, but MSRs acquired through the loan origination process were not allowed to be capitalized on the balance sheet due to the lack of an objective measure of their value. The contradictory treatment did not sit well with either the affected firms or the FASB. Prior to 1995 the statement was amended twice (*SFAS Nos. 91 and 115* (FASB, 1986, 1993)). In November 1992, at the request of the Mortgage Bankers' Association, the FASB reconsidered the accounting for MSRs and eliminated the contradictory accounting. The approach adopted favored a "fair value" measure for originated MSRs and was prescribed in *SFAS No. 122*, "Accounting for Mortgage Servicing Rights, an amendment of *FASB Statement No. 65*." Fair value implies that non-servicing related factors should not influence the determination of the value of MSRs. *SFAS No. 122* offers managers a choice with respect to the capitalization of MSRs.

This study examines whether the FASB achieved the objective of fair value accounting in the application of *SFAS No. 122*, and *SFAS No. 125*, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities"[1] by examining non-servicing related firm characteristics to determine their influence on the measurement of fair value. The non-servicing related characteristics that are considered are those suggested by positive accounting theory (Watts & Zimmerman, 1978, 1986, 1990).

Managers of firms engaged in the business of servicing mortgage loans must decide on the proper level of capitalization (fair value) for the intangible asset representing the right to service mortgage loans for a fee. MSRs are created constantly as a by-product of the loan origination/sale process, and the amount of capitalization on newly created MSRs can be different from the amount capitalized on previously recognized MSRs. If, through the issuance of SFAS No. 122, the FASB successfully achieved the goal of fair value accounting for MSRs then no non-servicing related firm characteristics should influence the measurement of the fair value of MSRs. We find that, cross-sectionally, there do exist statistically significant relationships between non-servicing related firm specific characteristics (size, debt-to-equity and the importance of bonus compensation) and the level of capitalization chosen by managers of mortgage banking firms.

BACKGROUND INFORMATION ON MORTGAGE SERVICING RIGHTS

Mortgage loan servicing rights can be a significant asset on the balance sheet of mortgage-banking concerns. In the case of Countrywide Credit Industries Inc., the largest firm in the sample, fiscal year-end 2000 MSRs were $5.3 billion, or 34% of the firm's total assets. The unpaid principal balance of the servicing portfolio supporting Countrywide's MSRs was $248 billion.[2] To better appreciate the impact of *SFAS No. 125*, some aspects of the operation of a mortgage company are described below.[3]

Firms engaged in mortgage banking produce and sell mortgage loans just as any manufacturer would produce and sell a product. Mortgage loans are their product, and during the time mortgage loans reside on their balance sheet they are inventory. Countrywide Credit Industries Inc. originated $66.7 billion in mortgage loans in fiscal 2000. Of these originations, only $2.7 billion remained on Countrywide's balance sheet at year-end 2000. When a mortgage loan is originated, two distinct assets are created: (1) the loan instrument; and (2) the mortgage loan servicing right (MSR). Typically, one or both of these assets will be sold after origination. Firms of interest in this study tend to retain the MSR and to sell the loan instrument to an institutional investor or one of two government-sponsored entities (GSEs), the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).[4]

An entity can come to own MSRs by: (1) originating a loan (both assets) and selling only the loan asset (retaining the MSR); (2) buying a loan (both assets) and subsequently selling only the loan asset (again, retaining the MSR); or (3) buying an existing portfolio of servicing rights.

The owner of the MSRs, the servicer, has an obligation to perform certain functions including, but not limited to: (1) collecting and accounting for the monthly mortgage payments and remitting on a monthly basis the principal and interest collected to the owner of the loans; (2) collecting taxes and insurance escrow payments and making the associated payments; and (3) providing collection and foreclosure services on delinquent accounts. For these services, the servicer will earn a gross annual fee (service fee) typically ranging from 0.25 to 0.50% of the servicing portfolio's unpaid principal balance.[5]

As required by *SFAS No. 125*, MSRs are to be recorded on the balance sheet of the servicer at their fair value. The fair value of the MSRs is the present value of the future net servicing fees (gross fees collected less costs to service the loans) over the expected life of the loans. Many factors used in calculating the fair (or present) value of the future net servicing fees over the expected life of a loan must be

estimated, making the determination of the value of MSRs subjective. Estimates must be made about the servicing fees and servicing costs, the appropriate discount rate to reflect the risk inherent in the servicing asset, the life of the loans, the amount of ancillary income generated by the servicing function, and so on.

In order to better appreciate the income decreasing/increasing choice made possible by *SFAS No. 125*, it is helpful to contrast generally accepted accounting for servicing rights before and after the issuance of *SFAS No. 125*. Prior to SFAS No. 125, SFAS No. 65, "Accounting for Certain Mortgage Banking Activities," required a mortgage banking firm to capitalize the price paid to acquire servicing rights either by: (1) buying a loan and selling the loan asset but retaining the servicing rights; or (2) buying an existing portfolio of servicing rights. The price paid for the servicing rights was considered objective and quantifiable, and the capitalized asset was referred to as a "purchased mortgage servicing right" (PMSR).

The PMSR asset was amortized annually against the servicing fee collected on the portfolio at a rate that approximated the amortization rate of the loans being serviced (including prepayments and payoffs). An entity with capitalized PMSRs had to test the asset for impairment on an annual basis. The present value of the estimated future net servicing fees over the expected life of the loans in the servicing portfolio was calculated. The calculation required estimates (as described earlier) and the use of a discount rate that reflected the entity's view of the risk associated with the asset. The resultant present value was compared to the recorded book value of the PMSRs, and if the present value was less than the book value, a write down was required. If there was excess present value, then the book value remained at the original (but amortized) amount.

Servicing rights acquired by a firm originating a loan resulted in an "originated mortgage servicing right" (OMSR). Capitalization was not allowed because the price paid to acquire servicing rights in an origination transaction (i.e. a portion of the loan origination cost) was not easily allocable to the servicing rights, and any allocation of the origination cost to the servicing asset was considered subjective. When the loan portion of the originated asset was sold, the entire cost basis (including the portion related to the servicing rights) was included in the gain (loss) calculation. The result was that the current period cash gain (loss) related to the sale of the loan asset was understated, and no capitalized basis remained on the books for the servicing rights retained.

A consequence of this method of accounting was that a servicer might have portions of its servicing portfolio acquired through one of the two purchase methods for which there would be amortizable basis. Amortization of the basis results in a reduction of the future net service fees earned with respect to that portion of the portfolio. At the same time, there would be portions of the servicing portfolio obtained as a result of the origination process for which there would

be no amortizable basis. The result was a significantly higher reported return on the servicing function for the originated portfolio than for the purchased portfolio (i.e. total net service fee for the originated portfolio versus total net service fee less the current period amortization for the purchased portfolio). Two essentially similar assets could exist with different accounting treatments.

Unlike *SFAS No. 65, SFAS No. 125* presents managers of firms actively participating in the mortgage loan-servicing environment with an accounting choice. *SFAS No. 125* requires that the value of the OMSRs from the sale of an originated loan be capitalized on the balance sheet,[6] as are the PMSRs from a purchase transaction. PMSRs are the objectively measured result of an arm's-length transaction; OMSRs are a function of a multi-variable calculation and may not be entirely objective. The choice presented by *SFAS No. 125* relates to the level of OMSR capitalization and how conservative or aggressive a firm chooses to be in the calculation of the MSRs.

MSRs[7] are to be recorded at their "relative fair values" (*SFAS No. 125*, p. 21) at the time the loans are sold and the servicing retained. "Relative fair value" is determined by apportioning the total cost basis of the combination loan/MSR asset to each asset based on the individual asset's fair value[8] at the time one or both of the assets are sold.

It is common practice to account for loan sales on an aggregate cash basis, ignoring the MSRs (in essence, this was the pre-*SFAS No. 125* required accounting), and to capitalize the MSRs thereafter on an aggregate homogeneous portfolio basis. This second step is the additional accounting required by *SFAS No. 125*. The determination of the fair value of MSRs is sufficiently subjective that the asset can be capitalized within a range of acceptable values. To be able to compare choices of firms with differing sizes of servicing portfolios, we compare standardized MSRs by measuring MSRs as a percentage of the unpaid principal balance of the underlying servicing portfolio ((MSR% = capitalized MSRs ($) ÷ servicing portfolio ($)) × 100). For the sample companies reporting MSRs, the MSR% ranges from as low as 0.00% to as high as 3.80% (380 basis points). The implication is that on a loan of $100,000, some firms in the sample would capitalize no MSR while other firms would recognize as much as $3,800. The decision to capitalize 3.80% ($3,800) versus 0.00% ($0) on a $100,000 loan is an income increasing choice as the entire capitalized amount increases pre-tax net income dollar for dollar.

It is important to note that knowledge of the absolute dollars capitalized, without knowledge of the principal balance to which the MSRs relate provides no information as to whether a firm's MSR capitalization choice represents an income decreasing/increasing position. Simply knowing that Firm A capitalized $4,000 of MSRs while Firm B capitalized $8,000 of MSRs during the same period does not allow us to conclude which of the firms adopted an income decreasing/increasing

capitalization policy relative to the other. However, also knowing that Firm A's MSRs related to a portfolio of $200,000 (MSR% = 2.00%) while Firm B's MSRs related to a portfolio of $800,000 (MSR% = 1.00%) allows for the conclusion that Firm A made an income increasing accounting choice relative to Firm B. The MSR% (the dollars of MSRs standardized by the outstanding loan portfolio to which they relate) provides the information as to whether the firm adopts an income decreasing/increasing position relative to the capitalization of MSRs.

The 0.00%–3.80% range of MSR capitalization implies a very large range of total MSR capitalization across the sample firms. If this range were applied to the servicing portfolio of Countrywide Credit Industries Inc., the capitalized MSRs would range from as low as $0 to as high as $9.42 billion (calculated on the February 28, 2000 year-end servicing portfolio of $248 billion). This difference would translate to a dollar for dollar difference in the cumulative pre-tax net income of the firm for the four-year period since *SFAS No. 125* went into effect. Clearly, where managers choose to be on the spectrum of MSR% capitalization is an accounting choice. Lower levels of capitalization, as measured by the MSR%, represent income decreasing choices among accounting alternatives, while higher levels of capitalization represent income increasing choices. Additionally, over time, a firm can change where it is on the spectrum of MSR% capitalization since the MSR% relative to the loans sold in one year can be, and often is, different than the MSR% in subsequent years. The choice of the MSR% presents a rich environment not only for testing positive accounting theory, but also for testing whether the FASB was successful in its effort to implement "fair value" accounting relative to this asset.

HYPOTHESES DEVELOPMENT

The primary objective of this study is to determine if *SFAS No. 125* accomplished the stated objective of fair value accounting. We examine the classic positive accounting theory firm characteristics, size, debt-to-equity and the importance of bonus compensation, to determine if they influence the level at which managers capitalize MSRs. Since these firm characteristics are non-servicing related they should have no influence on the determination of "fair value." As such, we test the following hypotheses:

H_1. Managers of companies with greater total assets will choose income decreasing accounting alternatives and will capitalize MSRs at a lower level than will managers of companies with lower total assets.

H$_2$. Managers of companies with higher debt-to-equity ratios will choose income increasing accounting alternatives and will capitalize MSRs at a higher level than will managers of companies with lower debt-to-equity ratios.

H$_3$. Managers who operate under compensation plans with a higher bonus compensation percentage will choose income increasing accounting alternatives and will capitalize MSRs at a higher level than managers with lower bonus compensation percentage.

SAMPLE DATA AND SOURCES

Selection of firms for the sample was confined to companies with the four-digit Standard Industrial Classification (SIC) codes representing firms in the financial services sector most likely to engage in the business of mortgage loan servicing as a material core business. The sample is restricted to publicly traded firms in the four years subsequent to the mandatory implementation date of *SFAS No. 122* with data available on COMPUSTAT and the Securities and Exchange Commission's EDGAR database.[9] The capitalized value of the MSRs and the dollar value of the underlying servicing portfolios were obtained from each company's Annual Report as filed on Form 10-K (or Form 10-KSB for "small business issuers") on the EDGAR database. Compensation data was obtained from each company's Annual Proxy Statement as filed on Form DEF-14A provided on the EDGAR database. The resultant sample consisted of 577 firm/years.

MODEL SPECIFICATION

This study captures the accounting choice through a continuous dependent variable, MSR%, the book value of MSRs divided by the principal balance of the servicing portfolio. Our model is as follows:

$$\begin{aligned}\text{MSR_BP}_{it} &= \alpha_0 + \sum_{Y=97}^{00} \alpha_y \text{YR}_{it} + \alpha_1 \ln \text{SERVPORT}_{it} + \alpha_2 (\ln \text{SERVPORT}_{it})^2 \\ &\quad + \alpha_3 \ln \text{TOTASSETS}_{it} + \alpha_4 \text{DE}_{it} + \alpha_5 \text{BONUS\%}_{it} + \varepsilon_{it}\end{aligned}$$

The yearly dummy variables are included because the value of MSRs is sensitive to economic conditions. For example, the value of the MSRs is sensitive to the difference between the weighted average interest rate of the mortgages underlying the MSRs and the current market rate. Additionally, the variable ln SERVPORT

and (ln SERVPORT)^2 are included in the model to capture the effects of economies of scale in loan servicing. The servicing portfolio (the actual loans supporting the servicing rights) is not owned by the servicing entity and accordingly not included on the balance sheet of the servicing entity. Firms servicing larger portfolios can justifiably capitalize higher levels of MSRs due to their ability to generate a higher net servicing fee (resulting from a lower cost per loan serviced) due to economies of scale. Failure to include a proxy variable for economies of scale would bias the coefficient for the ln TOTASSETS variable (since ln TOTASSETS and ln SERVPORT are correlated) potentially canceling or obscuring the two distinct effects.

RESULTS

Table 1 reports descriptive statistics for the variables used in the models as well as other variables of interest. The mean of the MSRs as a percentage of the book value of stockholders' equity is 11.44%. Recognizing that stockholders' equity consists of contributed capital and retained earnings, it is apparent that the book value of the MSRs accounts for more than 11.44% of the total net income earned and subsequently retained by the sample firms.

Table 1. Descriptive Statistics.

Variable	Mean	Std. Dev.	Minimum	Maximum
Model variables				
MSR_BP	78.95	50.94	0.00	379.91
ln SERVPORT	6.33	2.20	−0.69	12.42
ln TOTASSETS	7.37	1.63	0.63	12.14
DE	11.47	5.11	0.12	44.95
BONUS%	26.69	19.43	0.00	94.06
Other variables				
Total Assets (millions)	6,381	16,498	1.9	186,514
MSRs (millions)	91	454	0.0	5,343
Servicing portfolio (millions)	5,806	22,254	0.5	247,680
Stockholders' equity (millions)	485	1,124	0.4	9,597
Ratio of MSR to stockholders' equity	11.44	0.30	0.00	350.63

Notes: Means and deviations are calculated for the 577 cross-sectional pooled observations used in the model. MSR_BP = Ratio of capitalized MSRs to the principal balance of the servicing portfolio (in basis points). ln SERVPORT = Natural log of the principal balance of the servicing portfolio. ln TOTASSETS = Natural log of the book value of total assets. DE = Ratio of the book value of total debt to the book value of total equity. BONUS% = (cash bonus ÷ (total cash bonus + total cash salary)) × 100.

Table 2. Regression Results.

Regressors	Expected Sign	a_i
Intercept		120.83 (4.69)***
1997		6.31 (1.27)
1998		17.14 (3.36)***
1999		23.91 (4.31)***
2000		41.15 (2.66)***
ln SERVPORT	+	−23.37 (−4.36)***
ln SERVPORT^2	+	2.66 (6.22)***
ln TOTASSETS	−	−7.34 (−2.54)**
DE	+	1.46 (1.86)*
BONUS%	+	39.81 (1.98)**
Sample size		577
Test of model significance		$F(9, 567) = 29.56$
p Value		$p = 2.7\text{E}{-42}$

Notes: The regression estimated is:

$$\text{MSR_BP}_{it} = \alpha_0 + \sum_{y=97}^{00} \alpha_Y \text{YR}_{it} + \alpha_1 \ln \text{SERVPORT}_{it} + \alpha_2 (\ln \text{SERVPORT}_{it})^2 + \alpha_3 \ln \text{TOTASSETS}_{it} + \alpha_4 \text{DE}_{it} + \alpha_5 \text{BONUS\%}_{it} + \varepsilon_{it}$$

Variables are defined as follows: MSR_BP_{it} = MSRs divided by the principal balance of loans serviced (measured in basis points); ln SERVPORT = the natural log of the servicing portfolio; ln TOTASSETS = the natural log of the book value of total assets; DE = the book value of total debt as a percentage of the book value of total equity; BONUS% = cash bonus as a percentage of the sum of cash bonus and cash salary.

* Significant at the 10% level.
** Significant at the 5% level.
*** Significant at the 1% level.

Table 2 presents model estimation results. The parameter estimates from the model are consistent with the predictions of positive accounting theory. The results for Hypothesis 1 suggest that managers of larger firms will be inclined to choose income decreasing accounting alternatives as compared to managers of smaller firms. The coefficient for ln TOTASSETS, −7.34 ($p = 0.011$) suggests that, other things equal, a firm with 1% more total assets than another firm will capitalize 7.34 fewer basis points of MSRs. Hence, the results suggest that, across firms, managers of larger firms will select income decreasing accounting alternatives, choosing to capitalize lower levels of MSRs than will managers of smaller firms.

Hypothesis 2 suggests that managers of firms with higher debt-to-equity ratios will choose income increasing accounting alternatives. The model reports a positive and significant coefficient for DE. Across firms, managers of firms with

higher debt-to-equity ratios (DE) will choose to capitalize MSRs at higher levels than will managers of firms with lower debt-to-equity ratios.

Hypothesis 3 suggests that managers who operate under a bonus compensation plan where bonus compensation is a greater portion of total compensation will choose income increasing accounting alternatives as compared to managers who operate under a bonus plan where bonus compensation is a smaller portion of total compensation. The model generates a coefficient for BONUS% that is in the predicted direction, and is significant ($p = 0.048$). This provides at least some evidence that managers of firms where bonus compensation is a higher proportion of total compensation will elect income increasing accounting alternatives and increase the level at which they capitalize MSRs as compared to managers of firms where bonus compensation is a lower proportion of total compensation.

The size of the servicing portfolio is an important control variable. While the coefficients for both ln SERVPORT and $(\ln \text{SERVPORT})^2$ are highly significant, the coefficient for ln SERVPORT is negative. The coefficient for $(\ln \text{SERVPORT})^2$ is positive and overcomes the effect of the coefficient for ln SERVPORT at a low servicing portfolio size. The model suggests that, at low servicing portfolio levels, the marginal effect of increasing the servicing portfolio is negative. When the servicing portfolio exceeds $81.04 million the marginal effect becomes positive. Hypothesis 1 is supported only when we control for differences in MSRs due to economies of scale through the natural log of the size of the servicing portfolio (and its square). Without the servicing portfolio variables, the coefficient for ln TOTASSETS would be insignificant ($p = 0.739$). Researchers should be cognizant of this possible source of omitted variable bias when there exist effects of size related to economies of scale that are distinct from (and in our case negatively correlated to) the effects of size related to political costs.

CONCLUSIONS

Our results support all three hypotheses of positive accounting theory. The FASB issued *SFAS No. 125* with the prescription that the MSRs be capitalized at their fair value. If the recorded values were fair value, the recorded values would not be influenced by non-servicing related firm characteristics (size, debt-to-equity and the importance of bonus compensation). We find that recorded values are influenced by non-servicing related firm characteristics. This finding suggests that the MSRs are capitalized at something other than their fair value and that *SFAS No. 125* has not accomplished the FASB's stated objective. In light of the recent study published by the SEC (2003), "Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States

Financial Reporting System of a Principles-Based Accounting System" in which the SEC advocates the development of standards on a "principles-based or objectives-oriented basis" the SEC should consider the results of this study. *SFAS No. 125*, although published prior to the SEC's advocacy of an objectives-oriented standards setting methodology, contained a clearly stated objective. The results of this study suggest that significant segments of the industry may have acted in a way that was at odds with the FASB's stated objective of fair value capitalization.

NOTES

1. *SFAS No. 122* was issued in 1995 and is the most comprehensive and explanative document issued by the Financial Accounting Standards Board covering the accounting treatment of mortgage loan servicing rights (MSRs). It has been superseded. In 1996, *SFAS No. 125*, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," was issued and covers a broad spectrum of financial assets and liabilities. *SFAS No. 125* supersedes *SFAS No. 122* in its entirety, but makes no material change to the required accounting for MSRs. In September 2000, *SFAS No. 140*, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of *FASB Statement No. 125*," was issued. *SFAS No. 140* is effective for transfers occurring after March 31, 2001. Early or retroactive application is not permitted. The firms examined in this study are subject only to the provisions of either *SFAS No. 122* or *SFAS No. 125*. The results of this study are still relevant subsequent to the effective date of *SFAS No. 140* since the provisions of *SFAS No. 125* regarding MSRs remain substantially in force and the accounting treatment for MSRs remains unchanged from the accounting treatment as required by *SFAS No. 122* and *SFAS No. 125*. All subsequent references to *SFAS No. 125* refer to both *SFAS No. 122* and *SFAS No. 125*.

2. The servicing portfolio refers to the unpaid principal balance of the loans that are being serviced. The servicing portfolio itself is neither owned by Countrywide nor recorded on Countrywide's balance sheet. Investors such as the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation own the serviced loans. Servicers only own and record the right to service the loans (the MSRs).

3. For a detailed description of the operation of a mortgage banking concern see McConnell (1976) and Hendershott and Villani (1994).

4. According to the Department of Housing and Urban Development, GSEs purchased $728 billion of the $1,284 billion (57%) of mortgage loans originated in 1999.

5. Services fees are not explicitly negotiated. The originator/servicer of a loan negotiates the sale of the loan at a specified time and yield to an investor. The yield is determined by the interest rate market at the time the sale is negotiated and has little to do with the stated rate on the loan itself. The majority of loans are sold in the form of Mortgage Backed Securities (MBSs) in a highly liquid market. The required yield on MBSs at any given time is generally lower than the rates quoted for mortgages. As such, if an originator/servicer is negotiating loan sales contemporaneously with the commitment to originate loans, there will arise a positive differential between the interest the originator/servicer receives from the borrower and the yield required to be remitted to the investor. This is the service fee.

6. MSRs on originated loans are recognized at the time the loan portion of the assets are sold. MSRs are not recognized on loans that remain on the firm's balance sheet.

7. Hereafter, all mortgage servicing rights, regardless as to how obtained (i.e. PMSRs and OMSRs) will be referred to as MSRs. *SFAS No. 125* removes all distinction between PMSRs and OMSRs and does not require that firms maintain any accounting records to differentiate between the two.

8. If a loan is originated in a competitive market, the fair value of the combination loan/MSR asset should equal the sum of the fair value of the loan and the fair value of the MSR. If this is the case, relative and actual fair values are the same.

9. This study focuses on companies engaged in mortgage banking activities within the financial services sector. Mortgage banking activities and the companies that engage in them are not confined to the financial services sector. While companies in the financial services sector are responsible for many of the largest servicing portfolios, there are significant portfolios serviced by companies outside this sector. For example, General Motors Corp., through GMAC Mortgage Group, serviced a portfolio in excess of $290 billion as of December 31, 1999. For such companies, their mortgage banking activities are ancillary business activities and materially different from their core business. While the servicing portfolios of these companies are large and the accounting for them is subject to the dictates of *SFAS No. 125*, the companies are so vastly different from the mortgage banking concerns in the financial services sector that they are excluded from this study.

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AUDITOR'S RESPONSIBILITY AND INDEPENDENCE: EVIDENCE FROM CHINA

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ABSTRACT

The auditor's responsibility and independence are crucial issues underlying the independent auditing function and has significant implications on the development of auditing standards and practices. Through a questionnaire survey, this study investigated auditor's responsibility and independence from the perspectives of audit beneficiaries and public practitioners in the People's Republic of China. The results reveal that the role and benefits of public accounting (independent auditing) have been positively recognized by Chinese audit beneficiaries and auditors, and there are increasing demands for expanding the applicability of public accounting in China. However this study obtained substantial evidence on the emergence of the "expectation gap" in China, with respect to audit objectives, auditor's obligation to detect and report fraud, and third party liability of auditors. In addition, the study found that the majority of audit beneficiaries and auditors are supportive of improving auditor independence by reducing governmental control or intervention and moving towards "self-regulation" of the profession. The causes and practical implications of the study findings are therefore analyzed contextual to the existing practices of public accounting in the changing Chinese social and economic conditions. This study should cast light on

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understanding of the institutional settings and updated development of independent audits in China and may also serve as an annotation to the recent accounting reform debates in the Western world.

INTRODUCTION

Following the exposures of notorious corporate reporting and accounting scandals such as Enron, World Com, and Xerox in recent years, public outcry mounted dramatically. As a result, the market regulators or government authorities have stepped up the regulation of corporate reporting and auditing practices in order to resume public confidence and ensure efficient functioning of capital markets. For instance, the U.S. government has rapidly passed a new legislation, i.e. the Sarbanes-Oxley Act, in July 2002, which brings in much tougher regulations on corporate governance and financial reporting and auditing. Under the new law, corporate executives (e.g. CEOs and CFOs) must personally certify the veracity of the financial statements, auditing partners are mandatorily required to be rotated for their clients every five years, auditing services must be strictly segregated from non-audit services such as management consulting, internal audits, tax planning, and design and implementation of accounting information system. Furthermore, the Act sets up a new independent body, i.e. the Public Company Accounting Oversight Board (PCAOB), which is mandated to regulate or police the audits of SEC listed companies and to discipline the misconduct of auditors (Afterman, 2002; Miller & Pashkoff, 2002).

The creation of PCAOB is regarded as a blow to the long-existed "self-regulation" of the accounting profession, thus igniting serious debate among accounting practitioners and academicians in the U.S. and other Western countries (DeFond et al., 2002; Heffes, 2002; Schacter & Scheibe, 2002). Some supporters welcomed the new legislation as a necessary means to protect the interest of investors and the general public (Miller & Pashkoff, 2002; Revsine, 2002). Others are questioning the desirability and feasibility of such a move (Craswell et al., 2002; Schacter & Scheibe, 2002; Sikora, 2002). Fuel to the debate came with certain more radical proposals for ousting the professions' role of "self-regulation," e.g. the audit services to be directly monitored by certain legislative or governmental bodies, or utilizing the insurance companies to serve as the middleman between auditors and audit beneficiaries (Francis et al., 1999; Reynolds et al., 2002). Obviously, those proposals would have brought about fundamental changes to the existing public accounting practice, thus, causing great concerns to public practitioners and the profession.

It is argued that a key theme underlying the current debates on reforming corporate financial reporting and auditing practices is of how to define the auditor's responsibility and to maintain auditor's independence. A related theoretical issue is whether the professions "self-regulation" or the public monitoring mechanism could more effectively prevent the occurrence of corporate reporting and auditing scandals, thus, better serve the interest of investors and the general public. In the U.S. and most Western countries, the profession's "self-regulation" has long been in place (AICPA, 1994; Carmichael, 1999; Chandler & Edwards, 1996). But there is an "expectation gap" on the responsibility of auditors, as the auditing profession in the industrialized world had long argued that the main objective of independent audits is to render an expert opinion on the fairness of financial statements. Hence, an auditor should not be a bloodhound against frauds and irregularities (AICPA, 1994; Bell & Carcello, 2000). However, users of auditing services generally believed that auditors must assume a responsibility beyond examining and attesting the fairness of financial statements and shoulder a direct obligation to protect the interest of audit beneficiary through detecting and reporting frauds or irregularities (Dean et al., 2002; Nelson et al., 1988; Palmrose, 1988; Sikka et al., 1998).

Various theories are available to explain the causes of the "expectation gap." Traditional thought has attributed the gap to a misperception of financial audits by users or the general public. In other words, the "expectation gap" is due to the over-expectations of the auditing function (Chapman, 1992; Kachelmeier, 1994; Kadous, 2000; Martens & McEnroe, 1991; Tidewell & Abrams, 1996). However, some studies argue that auditors should also be blamed for not meeting the users' expectation. To a large extent, the profession's refusal of performing the fraud detection duties had fueled the "expectation gap" (Dewing & Russell, 2001; Epstein & Geiger, 1994; Levi, 1986). In addition, the "expectation gap" could be an outcome of the contradiction of minimum government regulation and the profession's self-regulation (Sikka et al., 1992). Thus the professions' over-protection of self-interest might have widened the "expectation gap" (Chandler & Edwards, 1996; Heim, 2002; Sikka et al., 1998).

Another theory suggests that the responsibility of auditors is "an amalgamation of public policy consideration" (Chung, 1995; Kadous, 2000). As business operations have become much more complex owing to global competition and large-scale industrial restructuring, the investing public has increasingly relied upon auditors to monitor and assure the reliability of financial reporting. The "expectation gap" emerged as the profession has failed to react (Francis, 1994; Munter & Ratcliffe, 1998; Power, 1998). Nonetheless the "expectation gap" in relation to auditor's responsibility is mainly a time lag effect. Auditors and the profession must respond sooner or later to narrow the gap (Dewing & Russell,

2001; Farrell & Franco, 1998; Kadous, 2000; Kinney & Nelson, 1996; Martens & McEnroe, 1991; Sikka et al., 1998).

Auditors are expected to provide objective and reliable attestation services. The utility of the auditing function depends upon the integrity, objectivity, and independence of auditors (Craig, 1997; Kinney, 1999; Yost, 1995). Auditors' independence is crucial to maintain the integrity of financial reporting and the confidence of the capital market (Cox, 2000; GAO, 1996). Therefore, the auditor independence has been codified in the profession's auditing standards and ethical rules. In particular, auditors are obligated to maintain impartiality and intellectual honesty, and free from conflicts of interest in auditing engagements (Falk et al., 1999; Marden & Edwards, 2002; Shafer et al., 1999). Nonetheless the status of auditor independence can be assessed as "in appearance" and "in fact." Both characteristics are necessary, although "independence in appearance" was traditionally emphasized (Craig, 1997; Trackett & Woodlock, 1999). The focus has now been shifted to "independence in fact" as public accountants in North America have become actively involved in non-auditing services since the late 1980s (Hussey & Lan, 2001; Kleinman & Farrelly, 1996; Sutton, 1997; Swanger & Chewing, 2001). With the introduction of the Sarbanes-Oxley Act, the accounting profession is now under much strong pressure and stringent scrutiny to enhance the auditor independence and improve the quality of audit services (Firth, 2002; Geiger et al., 2002; Heffes, 2002; Melancon, 2000; Reinstein & Coursen, 1999).

This paper intends to examine the issues of the auditor's responsibility and independence from the perspectives of public practitioners and audit beneficiaries in a different economic and business setting. Differing substantially from the U.S. and other Western countries, the Chinese government has long adopted a highly-centralized planned economy and directly controlled over all aspects of economic life, including a strict regulation of business accounting and reporting as well as recently resumed public accounting practices. To date, public accounting in China remains under the government's tight control and frequent interventions, even though the Chinese economy has become much diversified resulted from more than two decades of economic reforms. In such an institutional setting, the auditing function has primarily been applied to serve specific purposes of the government's business administration. 'Compliance audit' has been emphasized in auditing regulations and practices in order to protect the state interest and to accommodate various administrative duties of government authorities. Hence, auditing services are required mainly to serve the government's needs for tax levy and business control at the macroeconomic level (Cao, 1998; Chong, 1999; Ge & Lin, 1993).

According to government regulations, Chinese CPAs had to form accounting/auditing firms to practice publicly. Originally almost all accounting/auditing firms in China were established or sponsored by the departments in charge of

public finance, taxation, state-auditing, state-owned property administration, and various industrial administrative authorities at varied levels of government. A large portion of public practitioners were either the retirees or incumbents of sponsoring governmental agencies (Dai et al., 2000; Huang, 1998; Lin, 1998). The government claimed that the sponsorship arrangement is necessary to ensure the quality of accounting/auditing firms and public practicing (Yu & Tang, 1998). However, as accounting/auditing firms have maintained close financial and personnel links with sponsoring governmental agencies, audit engagements are in fact subject to frequent interventions of the government (DeFond et al., 2000; Li, 1997).

Criticisms from domestic and overseas investors and creditors surfaced against the sponsorship arrangement. Some studies contended that the government sponsorship or interference had curtailed the independence of Chinese auditors and led to low credibility of audit services in China (Dai et al., 2000; Lin, 1998; Liu & Zhang, 1999). In particular, an emerging problem in Chinese public accounting practices is related to the ambiguity of auditors' responsibility and lack of independence by public practitioners. When the public accounting was restored in the early 1980s, Chinese CPAs were empowered to protect the state properties and interest. Auditors were generally expected to detect and report frauds and irregularities in their clients' operations (Wang & Chen, 1996). However the auditor responsibility and independence were not recognized in substance, or they were virtually ignored in Chinese auditing practices before the mid 1990s (Li & He, 1999; Lin, 1998; Zhou, 1997).

The role of public accounting in China has now changed owing to continuing progresses of the economic reforms since the mid-1990s. Verification of capital contribution and financial audits become the main tasks of Chinese CPAs in order to satisfy the statutory requirements for business restructuring with different ownership structures, such as formation of joint-ventures, conversion of the state-owned enterprises (SOEs) into stock companies, business combination or merger, business liquidation, and so on. With increasing volume of attestation services, Chinese auditors have been substantially exposed to market risks in a climate of increasing business failure or bankruptcy resulted from the official enforcement of the Bankruptcy Law and the Company Law since the mid-1990s (Li & Chen, 1997; Liu, 1998). Consequently, Chinese auditors could no longer ignore the responsibility and independence issues, as the governmental patronage is now legally challenged by other interested parties under varied business ownership structures (Qing, 1997; Zeng & Zhang, 1998). The public has increasingly challenged the responsibility and legal liability of auditors, especially since 1996 when the Supreme People's Court established liability for auditors to the interested parties who had relied upon untruthful or misleading audit reports.[1] Chinese auditors are now forced to consider their responsibility for fraud detection and

reporting as well as the need for enhancing their independence (Li & He, 1999; Lin et al., 2003).

The auditor's responsibility and independence is now a pressing concern with profound implications on Chinese auditing practices. Exploration of this issue could contribute to a better understanding of the audit function under the Chinese social and economic conditions. Light can also be cast on other issues such as the audit objectives, the third party liability of auditors, and the "due-care" of auditing procedures, contextual to China's changing business environment. In addition, the development of Chinese auditing may be, from another perspective, a meaningful annotation to the recent public debates on corporate reporting and auditing reforms in the U.S. and other Western countries.

STUDY PROPOSITIONS

Public accounting remains underdeveloped in China despite a relatively rapid progress after its restoration in the early 1980s. Few studies on the responsibility and independence of Chinese auditors are available at present. Chinese auditors have not yet recognized the "expectation gap" and its practical implications, although increasing attention is now being paid to the legal liability issue associated with auditor negligence or audit failure (Hu & Ge, 1998; Li & He, 1999). Nevertheless the debates on auditor's responsibility and independence in the industrialized world over the last two decades are relevant to the growth of public accounting in China, since the country is now in transition towards a market-oriented economy. Hence an empirical investigation into the auditor's responsibility and independence contextual to the Chinese business environment is warranted.

Sikka et al. (1998) point out that the "expectation gap" is a clash between auditors and the public over preferred meanings of the nature, objectives, and outcomes of the audits. Perception of the auditors' responsibility is determined by the role of auditing function in a given society. In addition, the preferred meaning of, and the expectations associated with, the auditing function changes over time (Power, 1998). Could various interested parties positively recognize the role of public accounting is nonetheless a precondition for studying the responsibility of Chinese auditors. In the present course of Chinese economic transition, the reliability of accounting information is crucial to facilitate decision-making of financial statement users, and the audit function affects the welfare of a broad range of societal parties. In light of the "public policy consideration" theory, various interested groups should recognize the merits of independent auditing under the changing social and economic conditions in China. Hence, the first study proposition is presented as:

Proposition 1 (P-1). The role and benefits of public accounting (independent auditing) have been positively recognized by audit beneficiaries and auditors in the Chinese society.

One main focus of this study is to investigate what is the public's perception or expectation in relation to auditor's responsibility in the Chinese business environment. Although the "expectation gap" has persisted in the industrialized world over the last two decades, does such a gap exist in China's distinct social and economic settings? Even though the auditing function has long been a supplementary tool for governmental business administration, the expectations of audit beneficiaries may have evolved in pace with the changes in social and economic conditions. Would Chinese auditors or the profession have met the public expectations is an issue with significant practical implications. Thus, the second proposition of our study is stated below:

Proposition 2 (P-2). An "expectation gap" in relation to auditor's responsibility exists in the current business environment in China.

More specifically, the "expectation gap" is a reflection of different perceptions regarding audit objectives, auditor's obligation for fraud detection and liability for negligence or audit failure, among auditors and various interest groups. Therefore this proposition can be supplemented by three sub-propositions. Firstly, the audit objectives should reflect the needs of various interest groups. In China, the auditing function had mainly been required to ensure the compliance with the government's business legislation or regulations, in order to maintain the truthfulness and legitimacy of accounting records in individual business entities (Cao, 1998; Peng & He, 1993). Would Chinese audit beneficiaries and auditors agree upon the audit objectives? This question is relevant to evaluate the utility of public accounting in China. Therefore, the second proposition is further specified in an alternative form;

Proposition 2.1 (P-2.1). The perceptions concerning the objectives of independent auditing (public accounting) differ substantially among audit beneficiaries and auditors in China.

The "expectation gap" centers on the obligation to detect and communicate errors, frauds, and irregularities discovered in audit engagements. Chinese auditors had traditionally been equipped with a wide range of legal rights and duties in order to facilitate governmental control of business operations. Under government regulations, auditors were empowered to detect, stop, and report the frauds, inefficiency, and irregularities in clients' operations (Chong, 1999; Peng & He, 1993). Chinese auditors have, in recent years, become reluctant to bear the obligation

for fraud detection owing to increasing litigation exposures (Li & Chen, 1997; Liu & Zhang, 1999). Some Chinese practitioners have advocated a restriction of direct commitment to fraud detection and reporting (Hu & Ge, 1998; Li, 1997). There is, however, no evidence that Chinese audit beneficiaries would accept this view. Hence, another sub-proposition will specifically address the perceived auditor's responsibility for fraud detection and reporting in the Chinese business environment:

Proposition 2.2 (P-2.2). Perceptions concerning auditor's duties in detecting and reporting frauds and irregularities differ substantially among audit beneficiaries and auditors in China.

Although an audit engagement is a contract between an auditor and business management, many interest parties such as present and potential investors, creditors, and government authorities, may rely upon audit results to evaluate business performance and make a variety of decisions. The public generally expects that auditors should be liable for losses suffered by third parties owing to auditor negligence or audit failure (Dewing & Russell, 2001; Francis, 1994; Shafer et al., 1999). The issue of third party liability is thus one of the major factors underlying the 'expectation gap' (Falk et al., 1999; Farrell & Franco, 1998). It is worthwhile to particularly examine the liability of auditors to a third party in the Chinese auditing environment:

Proposition 2.3 (P-2.3). Perceptions concerning auditor's liability to third parties in relation to auditor negligence and audit failure differs substantially among audit beneficiaries and auditors in China.

The independence of auditors is a crucial premise to the utility of auditing function (Arnold et al., 2001; GAO, 1996; Shafer et al., 2002). However, the issue of auditor independence was understated when the public accounting was restored in China, because most interested parties had got used to the administrative pattern of direct government control derived from the former centralized economy (Zeng & Zhang, 1998). Nevertheless, the independence of auditors is now under scrutiny following the exposures of corporate reporting or accounting scandals in China and other Western countries. Public concerns about the auditor independence should have risen in correspondence with the changing social and economic conditions. Consequently, the Chinese auditing profession should have been pushed towards improving the independence status of auditors. The third proposition is therefore established as below:

Proposition 3 (P-3). The importance of auditor independence has been increasingly recognized by audit beneficiaries and auditors in China.

SUBJECTS AND DATA

A mailing survey was conducted to collect data. The survey instrument was designed according to the existing practices of public accounting in China, which contained three sections corresponding to the propositions outlined above. Each section contained a few detailed questions relating to the issues of audit role and objectives, auditor obligation for fraud detection, and auditor independence. A background section was included in the questionnaire to collect demographic data of the respondents, such as education, job specification, and work experience. Responses to each question were designed as "strongly disagree" to "strongly agree" expressed on a Likert scale of 1–5, with "no opinion" or "neutral" being a score of 3. The survey instrument was originally prepared in English and translated into Chinese for distribution in China. The list of survey questions is presented in Appendix.

The survey subjects consisted of audit beneficiaries (e.g. investors, creditors, government officials, business management, and academics) and public practitioners in China. Initially 50 copies of the questionnaire were mailed in the Beijing area. Minor modification of the survey instrument was made after the pilot test. In total, 800 survey questionnaires were distributed in two batches inside China. 300 copies were sent to external user groups of financial analysts from investment institutions, credit and loan officers at commercial banks, and government officials in charge of business financing and accounting at various governmental authorities (e.g. the departments of public finance, taxation, administration of state-owned properties, industrial administrations, state auditing, etc.). The survey subjects were randomly selected from the data sources of *Almanac of China's Financing and Banking Institutions* (1997), *China Securities Yearbook* (1999), and *Handbook of Chinese Governmental Institutions and Agencies* (Vols 1 & 2, 1997). Another 300 questionnaires were sent to business management subjects in SOEs and PLCs randomly selected from *China Industrial Enterprises 1000* (1997–1998) and *China Listed Companies Reports* (1998) respectively, with the questionnaires addressed to the general managers or financial controllers (chief-accountants) in the sample enterprises. One hundred and twenty questionnaires were mailed to practising public accountants at the accounting/auditing firms listed in *China Securities Yearbook* (1999). Another 80 copies were sent to educators engaged in auditing teaching and research at universities across the country. Each questionnaire was accompanied by a cover letter, which outlined the study objectives, respondent confidentiality, and the availability of survey results upon request. A pre-stamped return envelope was included. Collection of the returned questionnaires was assisted by accounting faculty members in a university in Mainland China.[2]

A total of 209 questionnaires were returned, with an overall response rate of 26.1%. Excluding 11 substantially uncompleted questionnaires, the number of useable questionnaires was 198. The adjusted overall response rate was 24.8%. Of the usable returned questionnaires, 71 came from business managers/accountants, 51 from government officials, 21 from investment analysts and bank officers, 30 from practicing public accountants, and 25 from auditing educators, with the response rates of 23.6, 34.0, 14.0, 25 and 31.3% respectively. To control for the potential effect of "non-response bias," Mann-Whitney ranked tests were run to compare the means of the questionnaires returned in weeks 2–6 and 7–10 following the date of distribution, which indicated no particularly significant difference.[3]

About 69.3% of the survey respondents had completed post-secondary schooling, and 27% of them held post-graduate degrees. About two-thirds of the respondents had work experience of more than six years, while a quarter of the total respondents had work experience of more than 20 years. In addition, over 75% of the respondents held professional titles or ranks at an intermediate level or above.[4] The profile data indicated that the majority of respondents were experienced, i.e. they held positions at middle or senior levels within the sample enterprises, investment institutions, banks, governmental departments, or accounting/auditing firms.

RESULTS

Data collected from the returned questionnaires are summarized in Table 1. Firstly the frequency (percentage) of respondents who agreed or disagreed to each survey question are displayed, separated by beneficiary and auditor groups.[5] Descriptive statistics, such as the group means and standard deviations, are also presented. Independent sample *t*-tests of the group means were run, with *t*-statistics and significant level shown in the Table. Overall the views of audit beneficiaries and auditors were statistically different for 10 of the survey questions while the two groups were consistent in their responses to the remaining five questions.

Role and Objectives of Auditing Function

Panel A in Table 1 presents the data relating to the perception of the role and objectives of audit function. The majority of respondents in both groups positively agreed to the role of public accounting (independent auditing) for "ensuring the truthfulness and reliability of accounting information released by

Table 1. Summary Statistics on Survey Questions.

	Beneficiaries		Auditors		*t*-Statistics (*p*-Value)
	Agree (Disagr.)	Means (S.D.)	Agree (Disagr.)	Means (S.D.)	
Panel A – Audit role and objectives					
Q1.1 All business entities must be audited by CPAs to ensure truthfulness and reliability of accounting information.	82.0% (16.3%)	4.210 (1.149)	91.6% (8.4%)	4.600 (0.932)	–1.741 (0.083)*
Q1.2 Audit reports assist users to assess efficiency and effectiveness of business operations.	86.9% (10.7%)	4.273 (0.921)	74.6% (24.6%)	3.967 (1.188)	1.569 (0.118)
Q1.3 Audits by CPAs can free financial statements of material errors, frauds or irregularities.	73.8% (24.6%)	3.615 (1.119)	56.5% (38.3%)	3.133 (1.279)	2.091 (0.038)**
Q1.4 An audit is to ensure client's compliance with the state's legislation and regulations.	96.4% (3.6%)	4.600 (0.657)	93.0% (2.7%)	4.433 (0.817)	1.208 (0.229)
Q1.5 An audit is to ensure accuracy and legitimacy of accounting records.	95.4% (3.0%)	4.557 (0.655)	50.0% (43.4%)	4.033 (1.245)	2.368 (0.021)**
Q1.6 An audit is to prevent and stop frauds or irregularities, inefficiency and wastage in clients' operations.	74.4% (25.4%)	3.748 (1.257)	54.6% (44.6%)	3.067 (1.413)	2.633 (0.009)***
Q1.7 An audit is to ensure fairness and completeness of financial statement presentation.	90.2% (6.6%)	4.521 (0.805)	100.0% (0.0%)	4.867 (0.346)	–2.302 (0.023)**
Panel B – Responsibility for fraud detection					
Q2.1 Client's management is primarily responsible for the truthfulness and reliability of financial statements.	9.8% (39.2%)	3.741 (1.398)	89.3% (10.3%)	4.433 (1.040)	–2.565 (0.010)***
Q2.2 A CPA must be responsible for detecting and reporting errors and frauds in an audit engagement.	88.7% (8.5%)	4.217 (1.028)	41.3% (55.3%)	2.833 (1.177)	6.528 (0.000)***
Q2.3 A CPA must be liable for fraudulent or misleading information contained in prospectus disclosure.	81.2% (15.9%)	4.126 (1.131)	40.8% (53.6%)	2.867 (1.332)	5.370 (0.000)***

Table 1. (*Continued*)

	Beneficiaries		Auditors		*t*-Statistics (p-Value)
	Agree (Disagr.)	Means (S.D.)	Agree (Disagr.)	Means (S.D.)	
Q2.4 Auditors should disclose in the audit report the uncovered frauds, inefficiency or irregularities.	89.2% (9.6%)	4.352 (0.947)	65.6% (32.2%)	3.633 (1.352)	3.483 (0.001)***
Q2.5 Auditors are liable for losses of interested parties if failed to disclose potential problems in audit report.	82.4% (15.6%)	3.909 (1.204)	3.4% (23.2%)	3.690 (1.004)	0.918 (0.360)
Panel C – Auditor independence					
Q3.1 Auditors should maintain independence and impartiality when performing audit engagements.	98.3% (1.2%)	4.762 (0.530)	96.7% (3.3%)	4.733 (0.640)	0.262 (0.794)
Q3.2 It is imperative to address, and improve the independence of auditors in the present practices.	97.6% (1.8%)	4.811 (0.530)	100.0% (0.0%)	4.767 (0.430)	0.451 (0.652)
Q3.3 The credibility of audit reports will be impaired with governmental sponsorship for accounting/auditing firms.	89.3% (8.3%)	4.392 (0.872)	69.6% (25.3%)	3.800 (1.157)	3.719 (0.002)***

Notes:

(1) All questions are listed here in a truncated form to facilitate table presentation.
(2) Responses to survey questions are denoted on a Likert scale of 1–5, the highest score represents strongest agreement and the lowest score stands for strongest disagreement. Neutral view to each question is indicated by the score of 3.
(3) For frequency calculation, responding scores of "4" and "5" are combined to calculate the percentage of "Agree;" while "1" and "2" are combined to calculate the percentage of "Disagree." Difference between the two for each question is the portion of respondents who expressed "No opinion."
(4) Summary statistics are based on independent sample *t*-tests of the group means.

* Significant at the 0.10 level.
** Significant at the 0.05 level.
*** Significant at the 0.01 level.

business entities." Regarding the necessity of audits performed by certified public accountants for all types of business entity, a greater portion of auditor respondents agreed positively. The mean of the auditor group was 4.600 while that for the beneficiary group was 4.210 (Q1.1). These data indicate that auditor respondents

had shown somewhat stronger support for extending public accounting services to all business entities regardless of their ownership structures (significant at the 0.10 level). In addition, a majority of respondents in both groups agreed that "audit reports can assist users to assess the efficiency and effectiveness of business operations" (Q1.2), the group means were 4.273 and 3.967 for audit beneficiaries and auditors respectively (with no statistically significant difference). Concerning the question of whether the financial statements audited by public accountants "can be free of material errors, frauds or irregularities"(Q1.3), 73.8% of respondents in the beneficiary group agreed (mean = 3.615). This suggests that the beneficiary respondents had a sufficient comprehension of the positive role of auditing in relation to the quality of financial reporting. In general, these data support proposition P-1, which stated that audit beneficiaries and auditors have recognized the important role or the merits of public accounting in the current Chinese business environment.

Regarding audit objectives, both beneficiary and auditor groups agreed that an audit engagement should "ensure clients' compliance with the state economic legislation and financing and accounting regulations." (Q1.4). The group means were 4.600 and 4.433 respectively (with no significant difference). However, the views of the two groups differed at statistically significant levels over other audit objectives. The beneficiary group strongly agreed that an audit engagement is "to ensure the accuracy and legitimacy of clients' accounting records," but a significant portion (43.4%) of auditor respondents disagreed (Q1.5). The means were 4.557 and 4.033 for the beneficiary and auditor groups respectively (significant at the 0.05 level). The beneficiary group also agreed that an audit engagement "is to prevent and stop frauds, irregularities, inefficiency, and wastage in clients' operations" (Q1.6, mean = 3.748). But 44.6% of auditor respondents expressed disagreement with their group mean (3.067) substantially lower than that of beneficiary respondents (significant at the 0.01 level). Though auditors were overwhelmingly supportive of the audit objective "to ensure the fairness and completeness of financial statement presentation"(Q1.7), the beneficiary group was relatively less enthusiastic about it, and their group mean was lower than that of auditor respondents (significant at the 0.05 level). Overall, these data support the proposition P-2.1, which stated that there is currently a gap in the perception of audit objectives among audit beneficiaries and auditors in China.

Responsibility for Fraud Detection and Communication

Panel B in Table 1 demonstrates substantial differences between Chinese audit beneficiaries and auditors in perceptions of auditors' obligation to detect and

report frauds. For instance, auditor respondents strongly agreed that "management should be primarily responsible for the truthfulness and reliability of the financial statements," but the beneficiary respondents, overall, were less supportive (Q2.1). The group mean of beneficiary respondents was substantially lower than that of auditor group (significant at the 0.01 level). For the statement of "A CPA must be responsible for detecting and reporting errors and frauds in auditing engagement" (Q2.2), the majority of beneficiary respondents strongly agreed, with a group mean of 4.217. However, a majority of the auditor respondents disagreed, with a group mean of 2.833 (significant at the 0.01 level). Similar evidence was observed on the issue of auditors' liability to present and potential investors for fraudulent or misleading information associated with published prospectus that contains an audit report (Q2.3). The group means were 4.126 and 2.867 for the beneficiary and auditor respondents respectively (significant at the 0.01 level). In addition, the two groups held substantially different views on the auditor's obligation to "disclose frauds, inefficiency, or irregularities in audit reports" (Q2.4), the means of beneficiary and auditor groups were 4.353 and 3.633 respectively (significant at the 0.01 level). However, no significant difference was found in the respondents' perceptions concerning auditors' liability for the losses suffered by interest parties owing to audit negligence or failure (Q2.5), though a greater portion of auditor respondents expressed 'disagree,' with the group mean somewhat lower than that of the beneficiary respondents. Data shown in Panel B provide substantial evidence to support proposition P-2.2, which stated that there is an "expectation gap" in relation to auditor's responsibility for fraud detection and reporting in China.

Auditor Independence

Panel C in Table 1 summarizes the prevailing views on the issue of auditor independence in China. The majority of the respondents strongly agreed that auditors (public accountants) must maintain a high degree of independence in auditing engagements (Q3.1). The group means were 4.762 and 4.733 for the beneficiary and auditor groups respectively (with no significant difference). The respondents also strongly agreed that "it is imperative to address, and improve the independence of auditors in the present practices of public accounting," with means of 4.811 and 4.767 for the beneficiary and auditor groups respectively (Q3.2). This data implies that the respondents were unsatisfied with the independence status of Chinese auditors. It could be further interpreted that the independence of Chinese auditors is currently questionable, and both audit beneficiaries and auditors are demanding a significant improvement. These data

support proposition P-3 that the importance of auditor independence has been increasingly recognized by auditors and audit beneficiaries in China.

However, the two groups of respondent held different views on whether government sponsorship of accounting/auditing firms impairs the credibility of audit reports (Q3.3). The 89.3% of beneficiary respondents agreed that the links between accounting/auditing firms and their governmental sponsors had a negative effect on the credibility of audit reports (mean = 4.392), but only 69.6% of auditor respondents agreed, with a mean of 3.800 (different at 0.01 significant level). This indicates that a majority of Chinese audit beneficiaries were unsatisfied with the present regulatory system of public accounting. They generally agreed that governmental sponsorship or direct governmental control would undermine the credibility of audit services since it would have prevented auditors from attaining independence or impartiality in public practicing.

Subgroup Comparison

Public accountants serve a variety of users in society. Conflicts of interest exist among various users with different decision needs (Solomons, 1991). Varied interests of different beneficiary groups may influence their expectations of auditor's performance. In the present course of China's economic transition, there is a great diversity among audit beneficiaries with respect to their business ownership structures, information needs, and utilization of auditing services, which may affect their perceptions of auditor's responsibility and independence. Therefore the beneficiary respondents were divided into several subgroups, i.e. investors/creditors, governmental users, business managers/accountants, and academics, for further detailed comparison. Descriptive statistics of those subgroups are presented in Table 2. Nonparametric Kruskal-Wallis Chi-square tests of the subgroup means were run. The testing results indicated that there were statistically significant differences among the four beneficiary subgroups on their viewpoints relating to four questions listed in our survey instrument.

For instance, somewhat varied views existed on the audit role and objectives. The investor respondents were strongly supportive of the auditing role in assisting the assessment of business efficiency (Q1.2), while the government respondents expressed considerable reservation about this role (significant at the 0.01 level). Again, government officials, in line with auditor respondents, were less confident of whether an audit could free financial statements from material errors, frauds, or irregularities (Q1.3), as their group mean was substantially lower than that of other beneficiary subgroups (significant at the 0.05 level). In addition, governmental respondents were less supportive of the audit objective to ensure the

Table 2. Descriptive Statistics by Subgroups of Respondents.

	Auditors ($n = 30$)		Government ($n = 51$)		Investors ($n = 21$)		Management ($n = 71$)		Educators ($n = 25$)		Kruskal-Walls Statistics	
	Means	S.D.	Means	S.D.	Means	S.D.	Means	S.D.	Means	S.D.	χ^2	*p*-Value
I. Audit role and objectives												
Question 1.1	4.600	0.932	4.019	1.225	4.333	1.065	4.340	1.116	4.400	0.867	3.328	0.334
Question 1.2	3.967	1.188	4.000	1.039	4.762	0.436	4.324	0.875	4.000	1.000	13.426	0.004***
Question 1.3	3.133	1.279	3.255	1.214	3.714	1.189	3.845	0.966	3.560	1.044	8.411	0.038**
Question 1.4	4.033	1.245	4.500	0.615	4.476	0.928	4.623	0.571	4.280	0.980	2.718	0.437
Question 1.5	4.433	0.817	4.560	0.705	4.571	0.746	4.638	0.593	4.560	0.712	0.304	0.959
Question 1.6	3.067	1.413	3.690	1.161	3.714	1.419	3.868	1.280	3.880	1.054	2.957	0.398
Question 1.7	4.867	0.346	4.196	1.004	4.714	0.463	4.700	0.645	4.600	0.867	14.048	0.003***
II. Responsibility for fraud detection												
Question 2.1	4.433	1.040	3.686	1.450	3.862	1.446	3.775	1.365	3.920	1.077	0.150	0.985
Question 2.2	2.833	1.177	4.177	1.014	4.524	0.749	4.155	1.104	4.440	0.712	2.873	0.412
Question 2.3	2.867	1.332	4.059	1.173	4.333	1.065	4.113	1.128	4.040	1.136	1.387	0.709
Question 2.4	3.633	1.352	4.400	0.881	4.571	0.746	4.254	1.038	4.240	0.970	2.809	0.554
Question 2.5	3.690	1.004	3.941	1.156	4.143	1.153	3.817	1.257	3.840	1.248	1.551	0.679
III. Auditor independence												
Question 3.1	4.733	0.640	4.686	0.616	4.714	0.718	4.831	0.377	4.800	0.408	1.559	0.669
Question 3.2	4.767	0.430	4.726	0.603	4.905	0.301	4.845	0.468	4.720	0.678	2.814	0.421
Question 3.3	3.800	1.157	4.014	0.990	4.762	0.436	4.538	0.861	4.160	0.943	6.549	0.086***

Notes:

(1) The group means are calculated based on a Likert scale of 1–5, denoted as "strongly disagreement" to "strongly agreement" in responding to each survey question.

(2) Kruskal-Wallis Chi-square tests were run based on the means of 4 beneficiary subgroups (i.e. government, investors and creditors, management, and educators). The means of auditor group is listed for the purpose of reference and comparison.

** Significant at the 0.05 level.

*** Significant at the 0.01 level.

fairness and completeness of financial statement (Q1.7) than the other beneficiary subgroups (significant at the 0.01 level). These data suggest that government users preferred the audit objectives of ensuring the accuracy of accounting records, and the compliance with state regulations over assisting the assessment of business operating efficiency and ensuring the fair presentation of financial statements.

Regarding the auditors' obligation to detect frauds (Q2.1 to 2.5), the perceptions of beneficiary respondents were fairly consistent. They all supported the notion that auditors should bear direct responsibility for fraud detection and reporting, and a liability for audit negligence or failure. These views differed significantly from those of the auditor respondents. In addition, there was no substantial variance in the perception of the importance of auditor independence among all subgroups. However the government respondents were inclined to have greater reservations, compared to investor and business management respondents, on the issue of whether government sponsorship or control of accounting/auditing firms would impair the credibility of audit reports (Q3.3).

SUMMARY AND CONCLUSIONS

This study has empirically investigated the issue of auditor's responsibility and independence in the social and economic contexts in China. The results demonstrate that Chinese audit beneficiaries and auditors agree that, in general, the independent audit function could enhance the reliability of financial statements and play a positive role in the Chinese economy. Most respondents were supportive of extending public accounting services to all types of business entities. This implies that public accounting has a great potential to grow in China. The support of expanding public accounting services by various interested groups could be interpreted as the demand for a further deregulation of business administration. Hence, promotion of independent auditing should contribute positively to the growth of a market-oriented economy in China.

This study found that there is an "expectation gap" with respect to audit objectives, auditor's obligation to detect frauds and third-party liability of auditors. The different perceptions among Chinese audit beneficiaries and auditors could be attributed to the unique institutional settings in China. In an economy dominated by state ownership and government controls, the auditing function is subject to government intervention, and is mainly engaged for "compliance audits." The emerging "expectation gap" signifies that Chinese public accountants now prefer to limit their responsibility for fraud detection by adopting the professional line prevailing in Western countries. This may be a necessary step for the growth

of public accounting in China with respect to a breakaway from the traditional role in governmental business administration. Nonetheless the Chinese auditing profession must contemplate how to reconcile its self-interest and the public needs for credible auditing services.

It is argued that the "expectation gap" in China is mainly derived from the varied perceptions of auditor's responsibility for fraud detection and communication between audit beneficiaries and auditors. Such findings are consistent with the results of similar studies in the U.S. and other Western countries. The audit beneficiary respondents in this study overwhelmingly expected that auditors should shoulder direct responsibility for detecting frauds and irregularities. Along with growing economic diversification, Chinese audit beneficiary groups may have increasingly relied upon public accounting services with rising expectations. On the other hand, Chinese auditors are currently hesitant to shoulder direct responsibility for fraud detection and reporting for the sake of reducing their risk exposure. Under the umbrella of government sponsorship, Chinese public accountants had once avoided the liability for audit negligence or failure. However, they are now exposed to greater uncertainty and risks in public practicing due to rapid progresses of market-oriented economic reforms and increasing complexity of business operations. Although, lawsuits against Chinese auditors have not reached the stage of "litigation explosion" as evidenced in the U.S., legal challenges of auditor's responsibility have increased and contributed to emergence of the "expectation gap" in China. It is premature to predict the effects of this "expectation gap," but Chinese public accountants must now make greater efforts to deal with the issue of auditor's responsibility.

This study found that Chinese auditors and audit beneficiaries were unsatisfied with present status of auditor independence in China, and they have generally demanded for improving auditor independence, by reducing or eliminating direct governmental control of public accounting. One interesting point can be drawn in comparison with the recent development in the industrialized world. Although there are growing concerns about weakening auditor independence under the profession "self-regulation" in the U.S. and other Western countries, Chinese audit beneficiaries and auditors have consistently perceived a move towards the professionalism as a means to improve the auditor independence. Such a contradictory phenomenon could be explained on two grounds. First, it stems from the different economic systems operating in China and the West as stringent governmental control has persisted over the public accounting practices in China. Second, non-audit services have yet been developed in Chinese public accounting, thus their potential impact on the independence of Chinese auditors is less substantial.

In fact, under the government sponsorship arrangements, most Chinese public accountants lacked independence as they must be closely associated with

government departments or agencies that have dominant interests in business entities. It is difficult for Chinese auditors to maintain objectivity or impartiality in audit engagements, because they must protect the state's interest in the entities to be audited. Therefore, a breakaway from governmental sponsorship or a switch to "self-regulation" is viewed as a necessary step to foster auditor independence in China. Nonetheless, the Chinese experience may imply that there is no direct association between the lack of (or impaired) auditor independence and the profession's "self-regulation." The auditor independence could be ensured even under the profession's "self-regulation." In other words, the auditor independence may not be warranted by imposing more regulatory or governmental oversight over public accounting such as the recent development in the U.S.

This study has certain limitations. The sample size is relatively small due to the difficulty in doing a survey study in China. An overall response rate of 24.8% after two rounds of questionnaire distribution is less than satisfactory. The small sample size and low response rates may have affected the validity of data analysis. Besides recognizing the difficulty of conducting survey studies in China, caution is necessary when drawing inferences from the study findings. In addition, comparative analysis of the experience in China and the industrialized world has not yet been conducted in detail. These issues should be the focus of future studies.

NOTES

1. This ruling was made by The Supreme People's Court of China in its Judicial Interpretation No. 56 (1996) as a reply to the People's High Court of Sichun Province concerning the case of *Deyang Oriental Trading Company vs. Taiyuan Nanjiao Chemical Plant*. Deyang Accounting Firm, auditor of the defendant, was suited by the plaintiff for its untruthful verification of the capital contribution made by the defendant. This case has a profound impact on the legal liability of auditors in China. Lawsuits against Chinese auditors increased and local courts have held more auditors liable in recent years.
2. All pre-stamped returning envelopes were addressed to the faculty member in order to facilitate mailing correspondence inside China.
3. Among the returned questionnaires, 163 were collected within weeks 2–6 following the distribution date. Another 46 were collected in weeks 7–10 after reminder letters were sent out in week six. The Mann-Whitney ranked test yielded no particularly significant difference between the means of the questionnaires returned in weeks 2–6 and 7–10. Thus the potential effect of "no-response bias" was expected to be immaterial.
4. In China the government has run accreditation programs for various professional designations (titles), such as engineers, economists, accountants, auditors, statisticians, asset appraisers, and so on. Varied ranks at junior, intermediate, and senior levels are offered within each designation. The professional titles and ranks serve as the indicators of technical proficiency and seniority associated with varied levels of compensation and benefits. However these ranks are usually rewarded in terms of candidates' job seniority. Holders of

the professional titles or ranks at the intermediate level should normally have 6–10 years of work experience, while over 15–20 years of experience is required for the senior ranks.

5. To facilitate data analysis, the opinion scales of "4" and "5" are combined to calculate the percentage frequency of "agree;" while "1" and "2" are combined for the "disagree" percentage. Thus the frequency scores of "agree" or "disagree" indicate the percentages of respondents who generally agreed, or disagreed, with each question.

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APPENDIX: LIST OF THE SURVEY QUESTIONS

Part I Role and Objectives of Auditing Function

1.1. The financial statements of all business entities, regardless ownership structure, must be audited by certified public accountants in order to ensure the truthfulness and reliability of accounting information.
1.2. Audit reports can assist financial statement users to assess the efficiency and effectiveness of business operations.
1.3. Financial statements audited by certified public accountants can be free of material errors, frauds or irregularities.
1.4. An objective of audit engagement is to ensure the accuracy and legitimacy of accounting records.
1.5. An objective of audit engagement is to ensure clients' compliance with the state's economic legislation, financing and accounting regulations.
1.6. An objective of audit engagement is to prevent and stop frauds or irregularities, inefficiency, and wastage in clients' operations.

1.7. An objective of audit engagement is to ensure the fairness and completeness of financial statement presentation.

Part II Responsibility for Fraud Detection and Communication

2.1. The responsibility for the truthfulness and reliability of financial statements lies primarily with client' management.
2.2. A certified public accountant must be responsible for detecting and reporting errors and frauds when performing an audit.
2.3. A certified public accountant must be liable to present and potential investors if significantly misleading or fraudulent information is contained in a firm's published prospectus which contains an audit report.
2.4. Auditors should disclose in audit reports the frauds, inefficiency, or irregularities that have been uncovered in the auditing engagement.
2.5. When an enterprise goes bankrupt, its auditor(s) should be liable for the losses sustained by the interested parties if the auditor(s) failed to disclose the potential problems in the audit report.

Part III Auditor Independence

3.1. Auditors should maintain independence and impartiality when performing audit engagements.
3.2. It is imperative to address, and improve the independence of certified public accountants in the present auditing practice in China.
3.3. The credibility of audit reports will be impaired if accounting/auditing firms maintain ties with governmental sponsoring institutions.

A STUDY OF THE ECONOMIC CONSEQUENCES OF REGULATION FD (FAIR DISCLOSURE)

Afshad J. Irani and Irene Karamanou

ABSTRACT

In this paper we examine the market reaction to the events that led to the adoption of Regulation Fair Disclosure (FD). The new regulation requires that if and when a firm discloses material nonpublic information to select individuals like analysts and institutional investors, it must make public announcement of that information immediately if the disclosure was intentional and promptly if it was unintentional. The rule has triggered a tremendous amount of debate as opponents raise the concern that the rule will result in a reduction in the amount and quality of information disseminated to the market. The SEC maintains that the rule will result in fairer markets. The stock market reaction around significant FD events supports the SEC's position. In particular, firms with poor information environments and greater propensity to selectively disclose information exhibit significantly positive abnormal returns on the first date that major provisions of the expected regulation are made public.

1. INTRODUCTION

In this paper we examine the effects of Regulation Fair Disclosure (FD) on equity prices by looking at the market reaction around the events that led to

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its final adoption. FD was passed by the Securities and Exchange Commission (SEC) to combat the practice of selective disclosure, whereby firms disclose market-moving information to a select group of analysts or fund managers before making the same information public. The new rule requires that firms must now make public disclosure of such information either simultaneously if the act was intentional or promptly if it was not intentional. Violations of the new rule will result in the imposition of injunctions and fines by the SEC.

The new rule has triggered considerable debate regarding its potential costs and benefits. The SEC and proponents of the rule argue that FD will result in fairer markets by ensuring the prompt dissemination of information to all market participants. Financial analysts and institutional investors argue that firms will be reluctant to disclose all information simultaneously to all market participants in fear of unknowingly releasing proprietary information or because of higher disclosure-related legal liability. According to them, the rule will result in a "chilling effect" on information as firms will try to abide by the new law by reducing the amount of information they make public (Hassett, 2000). In this paper we shed light on this controversy by using the stock market reaction around major events leading to the rule's final adoption as an indication of the market's assessment of the regulation's overall costs and benefits.

Even though FD is not expected to have a significant impact on a firm's future cash flow, it is expected to affect the firm's cost of capital in two ways.[1] First, FD is expected to affect the level of firm disclosure. Botosan (1997) shows that disclosure is inversely related to the cost of capital. If the market anticipates FD to have a positive effect on disclosure then expected cost of capital will decrease, leading to a favorable stock market response on event dates. Second, eliminating trading based on selective disclosure may also help reduce a firm's cost of capital. Bhattacharya and Daouk (2002), for example, show that country-level equity cost of capital decreases after the initial enactment of insider trading laws.

Our study complements in a number of ways other FD studies investigating the effects of the regulation. First, we examine the *anticipated* effect of FD as opposed to its *actual* effect. Many of the studies that examine the ex post effects of FD have been constrained by the short time period of post-FD data. This could confound results if expected long term effects differ from the actual short term effects of FD.[2] In addition, studies examining the ex post effects of FD by looking at differences in the pre- and post-FD environment assume adequate control for other confounding factors, a problem controlled for in an event study through usage of narrow event windows. Finally, in addition to the information effect, the market reaction incorporates the expected benefit of reduction in trading based on selective disclosure. This in turn, could provide further insight into the rule's overall effectiveness.

Results indicate that investors expect FD to have a positive effect on the capital market. Specifically, we find that the market reacts more positively when the expected benefits stemming from the elimination of selective disclosure are greater. Firms with poorer information environments and a greater propensity to disclose information to analysts and institutional investors exhibit higher abnormal returns around the publication of a *Wall Street Journal* article which for the first time identified some of the ways the SEC was contemplating to combat selective disclosure.

The rest of the paper is organized as follows. The next section outlines the major provisions of the rule as well as the continuing debate. Section 3 develops the hypotheses, the research method is outlined in Section 4, and the results are presented in Section 5. Concluding remarks are given in the last section.

2. REGULATION FAIR DISCLOSURE

2.1. Major Provisions

In general the new law requires that whenever an issuer or a person acting on its behalf discloses material nonpublic information to certain enumerated persons, the issuer must make public disclosure of that information, either simultaneously if the disclosure was intentional or promptly if it was unintentional. Enumerated professionals include sell-side analysts, many buy-side analysts, large institutional investment managers, other market professionals or any other holder of an issuer's securities if it is reasonably foreseeable that such person may be likely to trade on the basis of selectively disclosed information. The requirement of public disclosure can be met by an 8-K filing, a press release distributed through widely disseminated news or wire service, or any other non-exclusionary method of disclosure including the webcasting of conference calls.

Issuers in violation of the law are subject to SEC enforcement through injunctions and fines. However, FD does not create a new duty for purposes of Rule 10b-5 liability; private plaintiffs cannot rely on an issuer's violation of the new law as a basis for private legal action.

2.2. The Debate

Firms engage in selective disclosure when they inform some analysts or shareholders on market-moving information ahead of the rest of the market. For example, First Union was accused of excluding some analysts from meetings when analyst

Tom Brown was not allowed to enter the premises after criticizing the company. KeyCorp in early December of 1999 held a conference to discuss a restructuring plan and invited only 20 analysts, to the dislike of other analysts (Padgett, 1999). The press was also often excluded from conferences. Dow Jones & Co. was banned from a conference after the organizers banned reporters (*Dallas Morning News*, 1999). In an article dated August 10, 2000, the *Wall Street Journal* estimated that 40% of firms were still limiting participation in conference calls, "a practice that is not defensible" (Hassett, 2000).

The SEC focused on this issue after a number of companies discussed financial topics with analysts during closed conference calls and then waited hours before making a public announcement. Some stocks moved as much as 25% during the interim period (*The Los Angeles Times*, 1999). For example, retailer Abercrombie & Fitch has been accused in two lawsuits of informing a Wall Street analyst about disappointing quarterly earnings before making the information public (*Dallas Morning News*, 1999). On June 9, 2000 the stock of Electronic Data Systems Corp. plummeted at the beginning of the trading session on NYSE. Some analysts admitted to having the information about softer-than-expected earnings the night before the public release of the information. In early 1999 the shares of General Motors and Lehman Brothers rose by 3.2 and 6.8% respectively after company officials informed certain analysts of positive news (Sugawara, 2000).

In support of regulation to halt such selective disclosure, the SEC argued that the effects of selective disclosure are similar to those of insider trading. These include substantial losses to investors, less liquid markets, and higher transactions costs (SEC, 2000). FD is expected to result in fairer disclosure of information to all investors, increase investor confidence, enhance market efficiency and liquidity, and help reduce the cost of capital. In addition, the regulation will benefit investors seeking unbiased analysis by placing all analysts on equal footing and by enabling them to express their honest opinion without the fear of being denied access to corporate information.

Opponents of the rule expect that the new rule will result in a chilling effect on information disclosure. Firms fearing violation of the rule will reduce and possibly eliminate communication with analysts resulting in the flow of less information to the marketplace, thus generating greater earnings surprise and stock price volatility. In addition most of the information analysts get is the result of carefully designed questions. Eliminating break-out sessions which usually occur after the end of conference calls will also lead to the disclosure of less relevant information. As S. Kaswell of the Securities Industry Association (SIA) puts it, "The playing field will be more level, but it will be empty" (Hassett, 2000).

The SEC on the other hand believes that issuers will have good reason to continue releasing information given the market demand for information and a

company's desire to promote its products and services. *Business Week* argues that fears of a "chilling" effect are unfounded. Doing what it takes, e.g. opening closed conference calls to all investors, is a "no-brainer" (*Business Week*, 2000).

The corporate world is also split on the anticipated effects of the rule. A survey released on August 7, 2000 by the National Investor Relations Institute (NIRI) shows that 42% of 462 investor relation professionals expect to limit communication practices while another 12% will do so significantly.[3] On the other hand, in a survey of members belonging to the Business Roundtable, Financial Executives International, and the American Society of Corporate Executives conducted in September 2000, 76% of the respondents felt that the total amount of information released to the market would either improve or stay the same.[4]

Early anecdotal evidence cited is also mixed. Banking analysts say that banks have released less information in the aftermath of the rule and also replaced in-person question-and-answer sessions with conference calls and webcasts (Rieker, 2000). Some corporate managers are not answering queries they would have previously discussed, "fearful that the answers might cross into forbidden territory" (Opdyke, Lucchetti & Oster, 2000). The SEC's proposal has recently caused Wells Fargo & Co. to announce the end of its quarterly conference calls claiming that unsophisticated investors could misinterpret the information disclosed (Domis, 2000). In support of FD, other articles claim that company earnings preannouncements are on the rise, while webcasts and conference calls open to the public show dramatic increases (Leckey, 2000). For example, Xilinx Inc. and Altera Corp. have recently opened up their earnings conference calls on the Internet using the SEC's suggested model (Plitch, 2000).

In a similar vein, existing academic papers on the preliminary effects of the new regulation also offer contradicting results. Heflin, Subramanyam and Zhang (2003) find that the first two months in the post-FD period were characterized by no economically significant changes in analyst forecast bias, accuracy and dispersion. Overall, their results are not consistent with the claim that FD will result in the chilling of information. In contrast, Mohanram and Sunder (2002) find lower accuracy and greater dispersion in the post-FD period. Similarly, Irani and Karamanou (2003) find lower analyst following and greater dispersion in the 11 month period after FD. Heflin et al. (2001) find no significant net increase in stock return volatility around earnings information release dates while Shane, Soderstrom and Yoon (2002) find that stock market reactions around earnings announcements are significantly lower after FD. Finally, Straser (2002) finds an increase in information asymmetry in the post-FD period while Sunder (2002) documents a decrease.

A possible reason behind these contradictory results is that the post FD period is not long enough to reliably assess its effects. Examining the market reaction

around the events that led to its adoption thus provides an indication of the market's initial assessment of the expected long-term effects of the new rule. This is an important question since the rule's effect on information availability may not be the market's only concern. While it is important to examine the ex post effects of FD on the level of information, the market reaction to the new rule will also depend on its assessment of the rule's success in eliminating trading based on selective disclosure. Even if the market expects FD to have a negative effect on the amount and quality of publicly available information, an overall positive reaction can still be observed if the market expects the rule's benefits to outweigh its costs. Thus this paper complements other studies that examine the ex post effects of FD.

3. HYPOTHESIS DEVELOPMENT

If FD is expected to result in net benefits to the market, we expect to see a positive reaction around the information events that led to the adoption of FD. As the SEC argues, "By enhancing investor confidence in the markets, therefore, the regulation will encourage continued widespread investor participation in our markets, enhancing market efficiency and liquidity, and more effective capital raising" (SEC, 2000). The market could react negatively if it expects a chilling effect or if it considers that the costs of the regulation will outweigh its potential benefits. The overwhelming response by individuals in favor of the proposal provides preliminary evidence on the value individual investors attach to the new rule. We thus form our hypothesis based on the expectation that the market reacts positively to the new rule.

Given that we expect all firms in the market to be affected to some degree by the rule, a meaningful and testable firm-specific abnormal return cannot be obtained on any event date since the market return will move in the same direction as the individual firm return. However, the Appendix describes some additional tests to measure whether our *sample* of firms exhibits positive abnormal returns.

Yet, not all firms in the sample will be affected to the same degree by the new rule, and therefore stock returns are expected to vary cross-sectionally based on individual firm characteristics. The market reaction to the new rule is expected to be positively related to the expected net benefits which the elimination of selective disclosure practices will afford to individual investors. These benefits stem from two different factors, prevailing information environment and propensity to selectively disclose information.

First, we argue that the benefit of selective disclosure elimination is lower for firms with rich information environments. Investors of such firms are more able

to anticipate the information selectively disclosed thus reducing the potential benefits of selective disclosure elimination. In a similar vein, firms with rich information environments may be less prone to engage in selective disclosure as the benefits to the recipients of such disclosure are limited. We thus expect the market reaction to the events that led to the adoption of FD to be inversely related to the richness of the firm's information environment and vice versa.

Second, we expect the benefits of FD to be greater for firms with greater propensity to selectively disclose information to either shareholders or individual financial analysts. First, firms that are under pressure from major shareholders to privately convey information are more likely to do so. Second, the propensity to selectively disclose information increases as the firm is more willing to use the information as a means to gain favors from certain individuals, especially financial analysts. The above discussion leads to the following hypothesis (stated in alternative form):

H1. The greater the expected net benefits from elimination of selective disclosure the more positive is the market reaction to events leading to the adoption of FD.

4. RESEARCH DESIGN

4.1. Event Study Methodology

Table 1 presents the most significant events around the adoption of FD. The events were identified from a search of the *Lexis-Nexis Academic Universe* and the *Dow Jones News Retrieval Service*. The first event we examine represents a *Wall Street Journal* article which for the first time made clear that the SEC was currently working on a rule to limit selective disclosure and identified some of the ways the SEC was examining to combat it. These include possible ways the fair disclosure requirement can be met either by a statement filed with the SEC, a news release, or even by opening conference calls to investors (Schroeder, 1999). The second event reflects the SEC's decision to seek public comment on the proposed rule.

Table 1. Outline of Events that Led to the Adoption of FD.

Event	Date	Description
1	11/16/99	*WSJ* article describing some of the provisions in the SEC proposal not yet available to the public.
2	12/15/99	The SEC voted to solicit public comment on the proposed rule.
3	8/10/00	SEC adoption

Some of the provisions of the new proposal were described in length in a large number of articles published on or the day after the SEC's decision. The last event represents the date the final rule was adopted by the SEC.

In order to test the hypothesis proposed we employ the portfolio weighting procedure developed by Sefcik and Thompson (1986). The advantage of this method compared to a simple cross-sectional regression is that the portfolio weighting procedure accounts for cross-sectional heteroskedasticity and cross-correlation. The procedure requires the construction of portfolio returns, R_{pt}, for each day in the period using as weights the values of the pth variable (including a constant term).

The pth equation of the system takes the form:

$$R_{pt} = \alpha_p + \beta_p R_{mt} + \sum_{k=1}^{3} g_{pk} D_{kt} + e_{pt} \quad (1)$$

where $k = 3$ is the total number of event dates examined. R_{mt} represents the value-weighted market return on day t; D_{kt} takes the value of 1 on the three days surrounding each event date $(-1, 0, +1)$ and the value of 0 for the remaining days in the period; g_{pk} represents abnormal returns related to the pth characteristic on event k. The estimation period for Eq. (1) runs from 1/1/99 to 12/31/00.[5]

4.2. Variable Construction

We measure the expected net benefits of FD by constructing four variables that either capture the richness of the information environment, the propensity to selectively disclose information to major shareholders and individual financial analysts, or both.

Our first measure is firm size (SIZE). Prior literature suggests that size is a good proxy for the information environment (Brown, Richardson & Schwager, 1987; Collins, Kothari & Rayburn, 1987; Lang & Lundholm, 1993). Since the quality and quantity of available information are increasing in SIZE, the net benefits of selective disclosure elimination are mitigated for larger firms and thus SIZE should be negatively related to the market reaction around the events that led to the adoption of FD.

Our second measure is analyst following. Analyst following (FOLL) has also been associated with the informativeness of a firm's disclosure policy (Abarbanell et al., 1995; Lang & Lundholm, 1996), and a number of studies have used it as a proxy for the informativeness of the firm's environment (Dempsey, 1989; Han, Manry & Shaw, 1999). Since the net benefits of eliminating selective disclosure are diminishing in the richness of the information environment, FOLL should

also be negatively related to event returns. However, greater FOLL could also be capturing the level of analyst competition (O'Brien & Bhushan, 1990). This in turn, increases the need for private information acquisition enabling firms to use their private information to gain favors with a select group of analysts (see Francis & Philbrick, 1993) and Das, Levine and Sivaramakrishnan (1998). Irani and Karamanou (2003) document a decrease in analyst following after FD consistent with the argument that selective disclosure is positively related to analyst following. If FOLL captures the propensity of the firm to selectively disclose information then it should be positively related to market returns.

Our third measure of the regulation's expected net benefits is the dispersion in analyst forecasts, DISP. Lang and Lundholm (1996) show that forecast dispersion for firms with more informative disclosure is lower while Abarbanell, Lanen and Verrecchia (1995) show that investor informedness is decreasing in dispersion. In addition to reflecting poor information environment, high dispersion could also be indicative of greater private information acquisition by analysts (see Barron, Kim, Lim & Stevens, 1998), and hence greater selective disclosure. Under both scenarios, the net benefits of selective disclosure elimination are greater for firms with greater dispersion in analyst forecasts, leading to a more positive market reaction.

Finally, we posit that firms with greater institutional ownership concentration, IO3, are more prone to selectively disclose information. The SEC acknowledges that firms selectively disclose information to either financial analysts or large stockholders which in most cases are institutions (SEC, 2000). Therefore, we expect the market to react positively on the various event dates if it expects FD to reduce and possibly eliminate selective disclosure to large institutional owners.

Firm size (SIZE) is measured by the natural logarithm of the market value of equity (stock price $\times$ shares outstanding) on the last day of the quarter that ends before the start of the estimation period on 1/1/99. Forecast dispersion (DISP) equals the average dispersion of the four quarters of 1998, the year that precedes the start of the estimation period. For each quarter, dispersion is measured as the standard deviation of all analyst forecasts made till the end of the quarter in question divided by the beginning of quarter stock price, with only the most recent forecast for each analyst used in the computations.[6] Analyst following (FOLL) is the average of quarterly analyst following over the four quarters of 1998, where quarterly analyst following equals the number of analysts issuing a forecast for a given quarter. IO3 is computed as the percentage of shares held by the three institutions holding the most shares at the end of the last quarter before the start of the estimation period (i.e. the fourth quarter of 1998). We report results based on the percentage shares the top three institutions hold, thus acknowledging that selective disclosure is more likely to occur in cases of large stockholders. For instance, a

company spokesman of Alteon WebSystems Inc. acknowledged that companies such as Alteon often give "more context" to some fund managers because of the amount of assets invested in the company's stock (Opdyke et al., 2000).[7]

Analyst forecast data and the stock split factors are obtained from *First Call*. The *First Call* summary tape is used to measure analyst forecast dispersion and analyst following. The summary tape provides all the information contained in the detail tape, albeit in a condensed form. All summary measures use only the most recent forecast made by each analyst for the period under review, thus eliminating any stale forecasts. In our case, the last summary measure for each quarter was used to obtain analyst forecast dispersion and analyst following for each quarter. Stock prices and shares outstanding are obtained from the *Center for Research in Security Prices* (CRSP) database while institutional ownership is obtained from *Compact Disclosure*.

5. RESULTS

We arrive at our final sample of 938 firms by starting with all firms with forecast data on *First Call*. The sample is first reduced to include only firms with December 31 fiscal year-ends. This requirement is imposed so that variable measurement in relation to the start of the estimation period is constant for all firms. Second, the sample is further reduced to include only those firms that have available forecast data for all four quarters of 1998 (to compute DISP, FOLL). Third, in order to compute DISP it was essential to drop all firms followed by less than two analysts per quarter. The above constraints yield a total of 1502 firms.

Fourth, end of quarter prices for five consecutive quarters ending with the fourth quarter of 1998 and shares outstanding for the fourth quarter of 1998 must be available on CRSP (to compute SIZE and for deflating DISP). 1274 firms met this requirement. Next, each firm must have institutional ownership data as of the end of 1998 on *Compact Disclosure*. Finally, all firms are required to have non-missing daily returns on CRSP for the time period under review (1/1/1999–12/31/2000). Table 2 outlines the above elimination procedure.

Panel A of Table 3 presents descriptive statistics for the test variables while panel B shows the distribution of firms across the various stock exchanges. About 98% of the firms belong to either the NYSE or the NASDAQ, with the former accounting for 61.8% of the total. In addition, sample firms seem to be evenly distributed among 2-digit SIC codes (results not tabulated).

Table 4 presents variable correlations, most of which are significant. As expected, FOLL and SIZE are positively correlated and DISP and SIZE are negatively correlated (see for example, Lang & Lundholm, 1996). FOLL and IO3 are also negatively correlated. This is expected given the definition of IO3. This

Table 2. Sample Elimination Procedure.

	Number of Firms
Firms with December 31 fiscal year end and four quarters of forecast data for 1998 in First Call	1502
Less: Firms without price data and number of shares outstanding in CRSP	228
Less: Firms with missing institutional ownership data on Compact Disclosure	330
Less: Firms with missing returns for the test period (1/1/1999–12/31/2000)	6
Final sample size	938

correlation suggests that if a large percentage of a company's shares is owned by three institutions, then analysts' expected benefits are low due to a smaller number of other investors interested in the firm (O'Brien & Bhushan, 1990). The negative correlation between SIZE and IO3 can be explained by the low probability of one investor owning a large percentage of a big company.

Table 5 shows the results of the portfolio weighting procedure of Eq. (1). The table presents results after the elimination of outliers.[8] The following discussion should be viewed in light of the fact that results without outlier elimination are weaker. The model variables are significantly associated with only the first event's abnormal returns, suggesting that the market conditionally incorporated the

Table 3. Descriptive Statistics.

Panel A: Test variables ($N = 938$)

	Mean	Median	Minimum	Maximum
FOLL	7.47	6	2	29.25
SIZE	13.82	13.69	9.26	19.63
DISP	0.0018	0.0007	0.0004	0.0913
IO3	17.43	16.60	0.0	72.82

Panel B: Stock-exchange membership

Stock-Exchange	Number of Firms	Percentage of Final Sample
NYSE	580	61.8%
AMEX	18	1.9%
NASDAQ	339	36.1%
Other	1	0.1%

Note: DISP represents the average standard deviation of analyst earnings forecasts scaled by beginning of quarter price, FOLL is the average number of analysts issuing a forecast, SIZE is the natural logarithm of the market value of equity on 12/31/1998, IO3 is the shareholding of the three institutions owning the most shares in a firm's stock. DISP and FOLL are both averaged over the four quarters of 1998. There is a 0.1% rounding error in the last column of panel B.

Table 4. Variable Correlations. Pearson/Spearman are Above/Below Diagonal (p-Values in the Second Row).

	FOLL	SIZE	DISP	IO3
FOLL	***1.00***	0.64	−0.12	−0.11
	0.00	0.01[a]	0.01[a]	0.01[a]
SIZE	0.63	***1.00***	−0.28	−0.17
	0.01[a]	***0.00***	0.01[a]	0.01[a]
DISP	−0.19	−0.43	***1.00***	0.05
	0.01[a]	0.01[a]	***0.00***	0.09[b]
IO3	−0.10	−0.19	0.10	***1.00***
	0.01[a]	0.01[a]	0.01[a]	***0.00***

Note: DISP represents the average standard deviation of analyst earnings forecasts scaled by beginning of quarter price, FOLL is the average number of analysts issuing a forecast, SIZE is the natural logarithm of the market value of equity on 12/31/1998, IO3 is the shareholding of the three institutions owning the most shares in a firm's stock. DISP and FOLL are both averaged over the four quarters of 1998.

[a] Represent p-values at the 0.01 levels of significance.

[b] Represent p-values at the 0.10 levels of significance.

anticipated effect of the rule mostly on that date. This event is when the market for the first time became aware of some of the major provisions of the SEC's upcoming proposal.[9] DISP is positively related to returns on that event date in accordance with the market expecting more benefits for firms with poorer information

Table 5. Results. (p-Values in Second Row).

	Expected Sign	Event 1	Event 2	Event 3	F-Stat
FOLL	?	0.00068	0.00038	0.00005	2.82
		0.05	0.27	0.89	**0.02**
SIZE	−	−0.00100	−0.00065	0.00011	3.98
		0.20	0.29	0.54	**0.01**
DISP	+	0.45808	−0.28959	0.14962	5.438
		0.02	0.91	0.24	**0.01**
IO3	+	0.00012	0.00015	0.00005	3.28
		0.02	**0.01**	0.22	**0.01**

Note: DISP represents the average standard deviation of analyst earnings forecasts scaled by beginning of quarter price, FOLL is the average number of analysts issuing a forecast, SIZE is the natural logarithm of the market value of equity on 12/31/1998, IO3 is the shareholding of the three institutions owning the most shares in a firm's stock. DISP and FOLL are both averaged over the four quarters of 1998.

Reported p-values are one-tail probabilities except the p-value for FOLL, which is based on a two-tail test.

environments and propensity to selectively disclose private information. FOLL and IO3 are both positively related to returns on the same event date suggesting that the market reacts more positively for firms with a greater propensity to disclose private information to analysts and major institutional investors.

Given the fact that results are weaker when outliers are not eliminated, we reexamine the sensitivity of our results to the method selected by running three simple models, one for each event, where abnormal returns are regressed on the four variables and standard errors are adjusted for cross-sectional heteroskedasticity (White, 1980).[10] Without outlier elimination, both FOLL and DISP are positive and significant on our first event. While IO3 is not significant, SIZE now becomes negatively significant as predicted by our hypothesis. With outlier elimination (studentized residual at the ±2.5 level) all four variables are significant with FOLL, DISP and IO3 being positively and SIZE being negatively related to abnormal returns.

Overall these results suggest that the market expects the rule to have a positive effect on firms with poor information environments and greater propensity to selectively disclose private information. These results support the proposed hypothesis and the SEC's contention that the rule is expected to have an overall positive effect on the market. The evidence provided in this paper seemingly contradicts mixed or inconclusive evidence provided by studies examining the ex post effects of FD on disclosure. This inconsistency may be due to implementation difficulties rather than the merits of the regulation per se.

6. CONCLUSION

In this paper we examine the market reaction to the events that led to the adoption of Regulation Fair Disclosure as an indication of the market's assessment of the overall long-term effects of the new rule. Our evidence is consistent with the market anticipating an overall positive effect. Specifically, the market reacts more positively for firms with poor information environments and greater propensity to selectively disclose information to analysts and large stockholders. This evidence suggests that the market agrees with the SEC's contention that selective disclosure is detrimental and that eliminating this practice will be beneficial, at least for some companies.

The controversy around the adoption of FD is not yet fully resolved, as the actual long-term effects of the rule still need to be assessed. Future research should thus examine the long-term effects of the rule on analyst forecast properties, the amount and quality of information disseminated by firms, and the effects of the rule on the functioning of the capital markets. However, these studies will have to wait until more reliable post-implementation data become available.

NOTES

1. One item that may affect future cash flows is legal and disclosure costs associated with FD compliance; however those are expected to be insignificant for most firms.
2. In fact anecdotal evidence suggests that the short term effects of FD are expected to be more negative than its expected long term effects.
3. The survey was downloaded from the surveying organization's website at (http://www.niri.com).
4. The survey was downloaded from the surveying organization's website at (http://www.fei.org).
5. See the appendix for more details.
6. Results do not change qualitatively if DISP is not scaled.
7. We have also run the models using overall institutional ownership percentage. Results are qualitatively the same.
8. Outliers were eliminated based on the studentized residual at the ± 2.5 level. Using a cutoff point of ± 2.0 or ± 3.0 does not affect the interpretation of results. Before the elimination of outliers, FOLL is still significant at the 0.05 level. However, DISP and IO3 exhibit significance levels of 0.13 and 0.19 respectively on event 1. IO3 continues to be significant at the 0.01 level on event 2.
9. We obtain weaker results when we execute the model using one overall event that takes the value of 1 on all nine days that cover the three events. Specifically, DISP is positive but exhibits a one-tail significance level of 0.20 and FOLL is positive with a two-tail significance level of 0.07. SIZE continues to be insignificant. IO3 is the only variable that remains significant (p-value < 0.01). These weak results confirm our findings that the market fully responded to the regulation's expected effects on the first event of the period with the two later events not providing any new information about the regulation.
10. We have computed abnormal returns based on the market model estimated during the 125-day period ending 60 days before the first day of our first event.

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APPENDIX: METHOD AND ADDITIONAL ANALYSES

To examine whether the market reaction around the events under consideration is explained by the four variables that proxy for the rule's expected net benefits we employ the method developed by Sefcik and Thompson (1986). We first create portfolio returns for each day in the period using as weights each one of the explanatory variables. The weighting is achieved by constructing a matrix F whose columns represent the values of the four explanatory variables along with a constant term and whose rows represent the number of firms in the sample:

$$F = (1, \text{SIZE}, \text{FOLL}, \text{DISP}, \text{IO3})$$

The portfolio weights are created as follows:

$$W = \begin{bmatrix} W_1' \\ W_2' \\ W_3' \\ W_4' \\ W_5' \end{bmatrix} = (F'F)^{-1}F'$$

The portfolio return is then computed for each day in the period as follows:

$R_{pt} = W'_p R_{it}$, where $p = 1, 2, \ldots, 5$ and R_{it} is the vector of individual firms' returns on day t. Thus R_{pt} represents the portfolio return on day t using the values of the pth variable as weights.

Finally, the model is estimated by running a total of $p = 5$ equations of the form:

$$R_{pt} = \alpha_p + \beta_p R_{mt} + \sum_{k=1}^{3} g_{pk} D_{kt} + e_{pt}$$

where $k = 3$ the total number of event dates examined.

R_{mt} represents the value-weighted market return on day t. D_{kt} takes the value of 1 on the three days surrounding each event date $(-1, 0, +1)$ and the value of 0 for the remaining days in the period. g_{pk} represents abnormal returns related to the pth characteristic on event k. The estimation period for Eq. (1) includes company returns from 1/1/99 to 12/31/00.

As explained in the text, we do not expect to obtain a *mean* positive firm-specific abnormal return around the events examined. This is because we expect all firms in the market to be affected by the new rule and therefore, risk and market adjusted abnormal returns should on average equal the benchmark market return. Nevertheless we employ the basic methodology in Schipper and Thompson (1983) to examine whether we can observe a mean positive abnormal return for our sample of 938 firms.

Initially, we conduct the following tests without imposing restrictions on the parameters of interest. First, we compute a simple average of the firm abnormal returns around the three event dates (see Note 9). Second for each firm we estimate abnormal returns by regressing firm returns on the market return and three event dummy variables. For both tests, the average return on both the first and third event is positive and significant.

We also run the two models by imposing the restriction that the parameters of interest are equal across all firms. First we use a pooled estimation (with White adjusted standard errors) where daily returns are regressed on market returns and three event dummies. Second, we construct daily portfolio returns using equal weights which are also regressed on market return and the three event dummies. For the pooled estimation, the coefficients for the first and third events are significantly positive, while for the weighted procedure none of the event coefficients are significant. Overall, the evidence contradicts our expectation of not observing abnormal returns on any event dates due to the market-wide effect of the rule. One possible explanation is that this reaction is sample specific as our sample is comprised of firms with large analyst following and high institutional ownership rendering them more susceptible to selective disclosure.

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AN EXPLORATORY STUDY OF AUDITOR PERCEPTIONS OF SANCTION THREATS

William E. Shafer and Roselyn E. Morris

ABSTRACT

The ongoing debate regarding the desirability of extending certain provisions of the Sarbanes-Oxley Act to auditors of nonpublic companies creates a need for a better understanding of the effectiveness of existing sanctioning mechanisms in the accounting profession. To provide input on this issue, the current paper reports the results of an exploratory study of perceived sanction threats among CPA/auditors employed by small public accounting firms. A survey of AICPA members in public practice was conducted to assess the perceived threat of sanctions for auditor acquiescence in a client earnings manipulation scheme. The results indicate that, prior to the passage of the Sarbanes-Oxley law, CPAs perceived a relatively high threat from many types of professional sanctions, and that most sanction threats appeared to act as a deterrent to fraud. However, the perceived likelihood of criminal conviction and CPA license revocation were relatively low. The findings also indicate that the materiality of the financial statement manipulation had a significant effect on all of the sanction threats examined, and the level of assurance on the financial statements affected perceptions of certain types of sanctions.

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INTRODUCTION

The effectiveness of sanctions as deterrents of aggressive financial reporting is a fundamental regulatory issue in the accounting profession. Very few empirical studies have explicitly investigated the perceived efficacy of sanctions against CPAs in public accounting practice, although currently there seems to be ample reason to question their deterrent value. The spate of recent financial statement restatements that have implicated both company management and their auditors in aggressive or fraudulent reporting clearly suggests that regulatory oversight of the accounting profession is lacking. The Sarbanes-Oxley Act of 2002 was passed in the wake of these scandals to enhance the effectiveness of accounting regulation. The many provisions of this landmark legislation include the imposition of harsher sanctions against company officers and directors and independent auditors for fraudulent financial reporting, and the creation of the Public Company Accounting Oversight Board (PCAOB), which has broad disciplinary powers over auditing firms. Although the Sarbanes-Oxley legislation applies primarily to publicly-traded companies and their auditors, there has been a great deal of debate regarding the possibility of a "cascade effect" of this legislation, i.e. the possibility that some provisions of the legislation will be extended to auditors of nonpublic companies at the state level (e.g. Benton, 2003; Calcara, 2002; Stimpson, 2002). Legislation extending certain provisions of Sarbanes-Oxley to nonpublic companies has been proposed in several states (AICPA, 2003), and the AICPA and state CPA societies have been vigilant in their attempts to curb this cascade effect.

An issue that should be central to the debate over the need to extend the provisions of Sarbanes-Oxley is whether the regulatory and sanctioning mechanisms applicable to private company auditors are adequate. To provide input on this issue, the current paper reports the findings of a survey of auditors employed by small CPA firms. The study sought to address several basic questions regarding private company auditors' perceptions of sanction threats for fraudulent financial reporting. We assessed CPAs' estimates of the likelihood and severity of various sanctions, as well as the relationship between perceived sanction threats and the likelihood of complicity in a client earnings manipulation scheme. Due to the recent controversy over "abuses of materiality" by public companies and their auditors, we also addressed the questions of whether private company auditors feel that small intentional earnings manipulations are material on qualitative grounds, and whether the materiality of a misstatement has a significant impact on perceived sanction threats. Finally, the study tested the effects of the level of CPA assurance (audit, review, compilation) on perceived sanction threats.

The findings suggest that, prior to the passage of the Sarbanes-Oxley legislation, private company auditors perceived a relatively high likelihood of sanctions being

imposed for fraudulent reporting, and generally felt that the various sanctions would have severe personal consequences for them. There were certain exceptions. For instance, the perceived likelihood of criminal conviction and the loss of the CPA license were relatively low. The results also reveal strong correlations between most sanction threats and the estimated likelihood of fraudulent reporting by both participants and their peers, suggesting that sanctions deter such behavior. However, the threat of criminal conviction did not appear to deter fraudulent reporting. Materiality had a statistically significant effect on the perceived threat of all sanctions tested, although the absolute differences between the high and low materiality conditions were relatively small. While most participants felt that small intentional misstatements were material on qualitative grounds, a significant minority failed to recognize the qualitative aspects of such misstatements. The level of CPA assurance on the financial statements had a significant effect on the perceived threat of criminal conviction and formal admonishment by professional associations, but did not significantly affect the other sanction threats.

RESEARCH QUESTION DEVELOPMENT

A great deal of research in law and criminology addresses the role of perceived sanction threats in deterring crime, including corporate and white-collar crimes (e.g. Elis & Simpson, 1995; Makkai & Braithwaite, 1994). These studies commonly employ perceptual deterrence models, which measure the perceived likelihood and severity of various sanctions being imposed, and test the effects of these perceptions on participants' estimated likelihood of committing various offenses (Braithwaite & Makkai, 1991). This line of research addresses the basic policy issue of whether perceived sanction threats deter illegal or unethical behavior. Theories of auditor independence also recognize the influence of sanction threats on professional judgment (Shockley, 1982). In fact, several studies have assumed that auditors' willingness to consent to aggressive reporting essentially involves a trade-off between the risk of client loss and the risk of sanctions such as litigation (Farmer et al., 1987; Hackenbrack & Nelson, 1996; Trompeter, 1994). However, relatively few accounting studies have explicitly examined the role of sanctions in deterring financial statement manipulations.

Even before the recent spate of financial reporting scandals, the effectiveness of sanctioning mechanisms in accounting, particularly the profession's self-regulatory efforts, were being questioned. Former SEC Chairman Arthur Levitt expressed serious reservations regarding the effectiveness of AICPA regulation of auditors, saying that "Indeed, more effective oversight must be brought to bear on the AICPA, which seems unable to discipline its members for violations of its own

standards of professional conduct" (Levitt, 2000). Former SEC Chief Accountant Lynn Turner also openly questioned the effectiveness of the self-regulatory efforts of the AICPA and its Public Oversight Board (POB), suggesting that the POB had not imposed appropriate, timely discipline for miscreants, and that the AICPA Professional Ethics Executive Committee had often failed to investigate or take action on serious financial frauds (Colson, 2001). Levitt (2002) suggests that the AICPA intentionally kept the POB on a "short leash," limiting its power and effectiveness.

Such misgivings regarding the effectiveness of the accounting profession's self-regulatory efforts ultimately led to the inclusion of a provision in the Sarbanes-Oxley Act that established a new independent body, the Public Company Accounting Oversight Board, to oversee audits of public companies. The PCAOB effectively replaced the AICPA Public Oversight Board and stripped the AICPA of much of its regulatory power over auditors of SEC registrants. The Board possesses broad authority for oversight of the financial reporting process, including the power to review audit firm practices and impose fines and other disciplinary measures against officers and directors of public companies and the auditors of those companies. Section 209 of the Act directed state regulatory authorities to make independent determinations of the proper standards applicable to nonpublic companies and their auditors, which some have interpreted as encouragement of states to enhance the regulation of auditors of nonpublic companies (Benton, 2003). In the absence of any cascade effects of Sarbanes-Oxley, the much-maligned self-regulatory mechanisms of the accounting profession that apply to private company auditors will survive largely intact. Thus, an important issue that should be considered in the debate over whether to extend certain provisions of Sarbanes-Oxley to auditors of nonpublic entities is the effectiveness of existing sanctions against auditors of nonpublic companies. Accordingly, the following research question was investigated.

Research Question 1. Do auditors of nonpublic companies perceive a significant threat of sanctions for acquiescence in client earnings manipulation schemes?

A closely related issue is whether the perceived threat of sanctions effectively deters unethical or unlawful behavior. This is a fundamental regulatory issue in any profession, and is usually the focal point of the study of sanctions in law and criminology. However, the issue has largely escaped attention in the accounting literature. Shafer et al. (1999) appears to be the only study to explicitly test the effects of perceived sanction threats on auditors' willingness to subordinate their judgment to clients. The findings indicate that perceived threats arising from legal and regulatory sanctions deter aggressive reporting, but the threat of

sanctions by professional disciplinary bodies does not have a similar deterrent effect. The Shafer et al. (1999) paper dealt with an instance of aggressive, but not fraudulent, financial reporting by an audit client. It is also important to examine the effectiveness of perceived sanction threats as deterrents to intentional or fraudulent earnings manipulation schemes, as reflected in the following research question.

Research Question 2. Do perceived sanction threats deter private company auditors from acquiescing in intentional earnings manipulation schemes?

The effect of materiality on auditors' willingness to comply with client earnings manipulations has also spawned a recent controversy. Former SEC Chairman Arthur Levitt targeted the "abuse of materiality," or intentional manipulations of earnings in amounts that fall below traditional materiality thresholds, as one of several common earnings management techniques the Commission was concerned about (Levitt, 1998). The SEC subsequently issued Staff Accounting Bulletin (SAB) 99, *Materiality in Financial Statements* (SEC, 1999), to reinforce the position that qualitative factors may render small misstatements material. SAB 99 also indicates that *intentional* financial statement manipulations may constitute fraud under the Securities Exchange Act of 1934, regardless of their size. If auditors of publicly traded companies feel that intentional earnings manipulations may be justified on the grounds of immateriality, it seems likely that auditors of private companies will have similar views. Due to the lack of empirical data on this issue, this study investigated the following question.

Research Question 3. Do auditors of private companies feel that intentional earnings manipulations are material on qualitative grounds, even if they fall below conventional materiality thresholds?

Fang and Jacobs (2000) contend that the assertion in SAB 99 that a company may be liable for fraud for small intentional earnings manipulations controverts both statute and years of case law that clearly establish a materiality requirement in actions based on fraud. Consequently, they suggest that the SEC's position is not legally enforceable. This argument raises the question of whether there is a significant perceived threat of sanctions for immaterial financial statement misstatements. However, little empirical evidence is available regarding this issue. Libby and Kinney (2000) found that auditors are less likely to require correction of immaterial errors if those errors cause earnings to fall below analyst-forecasted targets, which was one of the situations targeted by SAB 99. They also found that recent changes in professional auditing standards that mandate communications regarding uncorrected errors to a company's audit committee (AICPA, 2002, AU 380.10) did not increase the likelihood of error corrections that would cause the

company to miss its earnings targets. These findings raise doubts regarding the ability of regulatory authorities to effectively mandate corrections of misstatements that fall below conventional materiality thresholds. However, the Libby and Kinney (2000) study did not address the possible reasons for this apparent regulatory failure, such as the lack of credible sanction threats. In light of the doubts regarding the enforceability of prohibitions against immaterial misstatements, an obvious question that should be addressed is whether there is a significant perceived threat of sanctions for such manipulations. Thus, the following issue was investigated.

Research Question 4. Does the materiality (dollar amount) of earnings manipulations have a significant effect on perceived sanction threats?

Another factor that potentially affects the perceived threat of sanctions is the level of assurance on financial statements. Many private companies only present compiled or reviewed financial statements, e.g. pursuant to lending agreements. Consequently, the effect of the level of assurance on perceived sanctions for aggressive reporting is an important regulatory issue in the market for private company financial statement services. If the perceived threat of sanctions declines with the level of assurance, CPAs may be more likely to engage in aggressive reporting in the case of reviewed or compiled statements. Professional standards make it clear that the accountant should not issue an unmodified review or compilation report if he or she is aware of material misstatements in the financial statements (AICPA, 2002, AR 100). Nevertheless, it should be more difficult to prove accountant involvement in an intentional earnings manipulation strategy in the case of a review or compilation as opposed to an audit. For instance, it should generally be easier to make a case for the accountant's ignorance of client fraud schemes in the case of either a review or compilation, because there is no requirement to actively search for fraud on these engagements. Thus, CPAs may perceive the threat of sanctions to be lower in the case of lower levels of assurance. This reasoning prompted the following research question.

Research Question 5. Does the level of CPA assurance on financial statements affect the perceived threat of sanctions?

METHODOLOGY

Instrument

The research instrument included: (1) a cover letter; (2) a financial reporting case; and (3) a supplemental data sheet. The case (see Appendix) presented background

information and summary financial results for a hypothetical privately held company, and indicated that the company was preparing to submit its annual financial statements to a local bank through which it obtained most of its financing. It also said that the company's senior management was concerned about the technical violation of certain debt covenants, and went on to describe a fraudulent financial reporting scheme that was perpetrated to increase earnings. The case concluded by indicating that the company's external CPA became aware of the fraud scheme, but agreed to waive any adjustment to the financial statements in the face of client pressure. The case was reviewed by three CPA/auditors employed in public practice, and slight revisions were made based on their recommendations.

The materiality of the fraud scheme and the level of CPA assurance were manipulated on a between-subjects basis. In the High (Low) Materiality condition, the scheme involved the acceleration of the recognition of \$2,000,000 (\$100,000) of revenue, which reduced the company's reported net loss by \$500,000 (\$25,000). The fraud overstated revenue by approximately 25 (1.25)%, and understated the pretax loss by approximately 78 (3.9)% in the High and Low Materiality conditions, respectively. Thus, the amounts involved in the Low Materiality condition were below traditional materiality thresholds, while in the High Materiality condition they clearly exceeded such thresholds. There were three levels of CPA assurance on the company's financial statements: (1) no assurance (Compilation); (2) limited assurance (Review); and (3) positive assurance (Audit). The two manipulations resulted in a 2×3 design.

To provide a check for the materiality manipulation, participants rated the materiality of the misstatements on an eleven-point scale anchored on "immaterial" and "highly material." To verify participants' attendance to the assurance manipulation, they were asked to indicate without referring back at the case whether the financial statements were audited, reviewed, or compiled. To assess the likelihood of fraudulent financial reporting and provide a basis for assessing the deterrent effects of sanction threats, participants estimated the probability that: (1) a typical CPA employed in a similar position; and (2) they personally would acquiesce in the fraud. Responses were provided on eleven-point scales anchored on "0%" and "100%." Previous studies in accounting have assumed that responses regarding an "average" or "typical" CPA provide a more accurate estimate of what participants would do personally, due to the effects of social desirability response bias (e.g. Arnold et al., 1999; Cohen et al., 1995). We do not assume that such responses represent what participants themselves would do, but interpret them literally as perceptions of peer behavior.

The perceived threat of sanctions was assumed to be a function of: (1) the likelihood that the hypothetical company would default on its debt obligations to the bank; (2) the likelihood of various sanctions being imposed, given that the

company defaulted on its debt; and (3) the perceived severity of the sanctions in question. This approach is similar to that used in the law and criminology literature, which generally assumes that the threat of sanctions is a product of their perceived likelihood and severity (Braithwaite & Makkai, 1991). Sanctions were grouped into three categories: (1) legal sanctions (loss of litigation, other fines or settlements, criminal prosecution and conviction); (2) professional and regulatory sanctions, including AICPA, state CPA Society, or State Board of Accountancy actions (formal admonishment with publicity of wrongdoing, probationary suspension, expulsion from membership in the AICPA or state CPA Society, permanent revocation of CPA license by the State Board of Accountancy); (3) other sanctions (termination from current job, personal feelings of guilt or remorse). Participants were also provided an "other" category to identify sanction threats not included in the instrument, but the number of responses to this category was negligible. Estimates of the likelihood of detection and likelihood of sanctions being imposed were provided on eleven-point scales anchored on "0%" and "100%." Estimates of the severity of each potential sanction were provided on an eleven-point scale anchored on "no problem at all" and "very severe problem."

Participants

Instruments were mailed to a random sample of 2,000 AICPA members whose membership information indicated that they were employed in public accounting and had an interest in auditing. After a follow up mailing, a total of 315 responses were obtained. Fourteen respondents were eliminated because they failed the manipulation check for the assurance level, and another 24 were eliminated for providing incomplete responses. Thus, a total of 277 usable responses were obtained, providing an effective response rate of approximately 14%. A comparison of the responses to the audit case and demographic data for the early and late respondents indicated no significant differences.

A demographic profile of participants is provided in Table 1. As the data indicate, virtually all participants (273) were employed by local CPA firms; it is therefore reasonable to assume that these CPAs provide financial statement services primarily for private companies. Approximately 89% of respondents were partners in their firms, and 86% were male. This gender composition is not surprising, in light of the fact that a strong majority of CPAs occupying higher-level positions in the U.S. are male (Doucet & Hooks, 1999). The majority of participants had earned only a bachelors degree, although approximately 25% had a masters. The average respondent was 51 years old and had approximately 22 years of public accounting

Table 1. Demographic Profile of Participants.

	Number	%
Sample size	277	
Gender		
Male	237	85.6
Female	40	14.4
Position		
Partner	247	89.2
Manager	17	6.1
Senior	13	4.7
Firm type		
National or international	2	0.7
Regional	2	0.7
Local	273	98.6
Highest degree		
Bachelors	207	74.7
Masters or above	70	25.3
% of time spent on		
Auditing/Attestation		35.7
Tax		32.8
Consulting		17.2
Other (e.g. administration)		14.3
Age		
Mean	51	
Standard deviation	8.7	
Public accounting experience (years):		
Mean	22	
Standard deviation	8.9	

experience. On average, participants spent approximately 35% of their time doing auditing or attestation services, with most of the remainder split between tax and consulting. This mix of services is not surprising among a group of small-firm CPAs.

Univariate ANOVA and regression models were used to test for possible effects of various demographic factors on participants' responses. The ANOVA models indicated that neither gender, position, nor education level affected responses. Regression models revealed that neither age, public accounting experience, nor the percent of time spent on auditing/attestation affected responses. Based on these results, the demographic variables were excluded from further analysis.

RESULTS

Perceived Sanction Threats

Participants' estimates of the likelihood of the hypothetical company defaulting on its debt obligations and the perceived likelihood of each of the sanction threats are reported in Table 2. This data is relevant to Research Question 1. The perceived

Table 2. Assessed Likelihood of Default and Sanctions.

	Materiality		
	Low ($n = 133$)	High ($n = 144$)	Pooled ($n = 277$)
Likelihood of default			
Compilation (n = 89)[a,b]	0.69	0.66	0.68
	(0.19)	(0.21)	(0.20)
Review (n = 91)	0.66	0.66	0.66
	(0.20)	(0.18)	(0.19)
Audit (n = 97)	0.64	0.64	0.64
	(0.20)	(0.22)	(0.21)
Pooled (n = 277)	0.67	0.65	0.66
	(0.20)	(0.20)	(0.20)
Likelihood of sanctions, given default			
Loss of litigation			
Compilation	0.72	0.74	0.73
	(0.24)	(0.22)	(0.24)
Review	0.75	0.80	0.78
	(0.24)	(0.18)	(0.20)
Audit	0.71	0.82	0.77
	(0.24)	(0.17)	(0.21)
Pooled	0.72	0.79	0.76
	(0.24)	(0.18)	(0.21)
Other fines or settlements			
Compilation	0.67	0.68	0.67
	(0.28)	(0.25)	(0.27)
Review	0.70	0.77	0.75
	(0.28)	(0.18)	(0.23)
Audit	0.65	0.73	0.69
	(0.28)	(0.23)	(0.27)
Pooled	0.67	0.74	0.71
	(0.28)	(0.23)	(0.26)
Criminal prosecution and conviction			
Compilation	0.37	0.43	0.39
	(0.29)	(0.31)	(0.30)

Table 2. *(Continued)*

	Materiality		
	Low ($n = 133$)	High ($n = 144$)	Pooled ($n = 277$)
Review	0.43	0.53	0.49
	(0.28)	(0.27)	(0.28)
Audit	0.45	0.53	0.49
	(0.31)	(0.29)	(0.29)
Pooled	0.41	0.51	0.46
	(0.29)	(0.28)	(0.29)
Formal admonishment with publicity			
Compilation	0.66	0.64	0.65
	(0.28)	(0.27)	(0.28)
Review	0.67	0.72	0.70
	(0.28)	(0.25)	(0.26)
Audit	0.71	0.79	0.76
	(0.26)	(0.22)	(0.24)
Pooled	0.68	0.74	0.71
	(0.27)	(0.25)	(0.26)
Suspension from AICPA/State society			
Compilation	0.65	0.64	0.65
	(0.28)	(0.29)	(0.28)
Review	0.61	0.69	0.66
	(0.29)	(0.26)	(0.27)
Audit	0.67	0.74	0.72
	(0.29)	(0.22)	(0.26)
Pooled	0.65	0.71	0.68
	(0.29)	(0.25)	(0.27)
Expulsion from AICPA/State society			
Compilation	0.52	0.54	0.53
	(0.30)	(0.32)	(0.31)
Review	0.49	0.60	0.56
	(0.34)	(0.27)	(0.30)
Audit	0.51	0.59	0.55
	(0.30)	(0.31)	(0.31)
Pooled	0.51	0.58	0.55
	(0.31)	(0.30)	(0.30)
Revocation of license by state board			
Compilation	0.36	0.47	0.42
	(0.31)	(0.30)	(0.31)
Review	0.41	0.54	0.48
	(0.31)	(0.29)	(0.31)
Audit	0.42	0.49	0.46
	(0.30)	(0.32)	(0.31)

Table 2. (*Continued*)

	Materiality		
	Low ($n = 133$)	High ($n = 144$)	Pooled ($n = 277$)
Pooled	0.40	0.51	0.46
	(0.30)	(0.31)	(0.31)
Termination from job			
Compilation	0.42	0.55	0.49
	(0.34)	(0.34)	(0.31)
Review	0.59	0.59	0.59
	(0.38)	(0.34)	(0.31)
Audit	0.63	0.65	0.64
	(0.32)	(0.31)	(0.31)
Pooled	0.56	0.61	0.58
	(0.35)	(0.33)	(0.34)
Guilt or remorse			
Compilation	0.81	0.87	0.83
	(0.21)	(0.12)	(0.19)
Review	0.84	0.81	0.82
	(0.22)	(0.23)	(0.22)
Audit	0.76	0.83	0.80
	(0.28)	(0.22)	(0.24)
Pooled	0.80	0.84	0.82
	(0.23)	(0.21)	(0.22)

[a] Reported numbers are mean responses. Numbers in parentheses represent standard deviations.
[b] All likelihood estimates were provided on an eleven-point scale where 0 = "0%" and 10 = "100%," and converted to decimal percentages.

severity of all sanctions was relatively high, generally ranging from 7.8 to 9.5 on the eleven point scale, and little variation across experimental cells was evident. Consequently, only participants' likelihood estimates are included in the table, since these numbers have a more intuitive interpretation.

The highest likelihood estimates were obtained for the loss of litigation and personal feelings of guilt or remorse. Across all experimental conditions, participants estimated a 76% chance that they would be successfully sued by the financial statement users if the company defaulted on its debt obligations. The likelihood of personal feelings of guilt generally exceeded 80%, which indicates that most respondents felt that even immaterial financial statement manipulations are unethical. The lowest likelihood estimates were obtained for criminal prosecution and conviction and revocation of the CPA license. Based on the likelihood estimates, the significance of these sanction threats might be questioned. For example, when the likelihood of the company defaulting on its debt is multiplied by the overall likelihoods of criminal conviction and license revocation given debt

default, the resulting estimates are both approximately 30%. Even in the case of a highly material earnings manipulation, the perceived likelihood of each of these sanctions was only 33%.

Deterrent Effects of Sanctions

Participants' estimates of the likelihood of fraud are reported in Table 3. These assessments reflect a large disparity between the likelihood of fraud by a typical CPA and respondents' self-reports, which suggests that self-reports were affected by a social desirability bias. In the Low Materiality condition, respondents estimated a 40% chance that a typical CPA would acquiesce in the client's fraud scheme, but only a 14% chance that they personally would succumb to such pressure. Participants' estimates of the likelihood of a typical CPA committing fraud also appear to provide cause for concern. Across both materiality conditions, respondents felt there was a 35% probability that their peers would succumb to client pressure to manipulate reported results. Even when the amounts involved

Table 3. Assessed Likelihood of Fraud.

	Materiality		
	Low	High	Pooled
Typical CPA			
Compilation[a,b]	0.39	0.37	0.38
	(0.24)	(0.22)	(0.23)
Review	0.41	0.30	0.35
	(0.25)	(0.25)	(0.23)
Audit	0.40	0.31	0.35
	(0.24)	(0.25)	(0.25)
Pooled	0.40	0.33	0.35
	(0.24)	(0.23)	(0.24)
Participants			
Compilation	0.13	0.10	0.12
	(0.18)	(0.10)	(0.16)
Review	0.13	0.08	0.10
	(0.15)	(0.10)	(0.13)
Audit	0.17	0.09	0.13
	(0.21)	(0.15)	(0.18)
Pooled	0.14	0.09	0.12
	(0.19)	(0.12)	(0.16)

[a] Reported numbers are mean responses. Numbers in parentheses represent standard deviations.
[b] Responses were provided on an eleven-point scale where 0 = "0%" and 10 = "100%," and converted to decimal percentages.

Table 4. Correlations Between Sanctions and the Likelihood of Fraud.

Threat of	Estimated Likelihood of Fraud by	
	Typical CPA	Participants
Loss of litigation	−0.177**	−0.164**
Other fines or settlements	−0.150*	−0.156**
Criminal conviction	−0.042	−0.080
Formal admonishment	−0.149*	−0.107
Suspension from associations	−0.170**	−0.147*
Expulsion from associations	−0.174**	−0.155**
Revocation of license	−0.215**	−0.164**
Termination from job	−0.165**	−0.193**
Guilt or remorse	−0.074	−0.257**

*Significant at the 0.05 level.
**Significant at the 0.01 level.

were highly material, they felt there was a 33% likelihood of acquiescence in the fraud scheme.

To determine if sanction threats deter auditors from complicity in client fraud (Research Question 2), the correlations between each of the sanction threats and participants' behavioral intentions, measured as the estimated likelihood of acquiescing in the earnings manipulation scheme, were examined. The correlation coefficients are reported in Table 4. As the data indicate, all of the sanctions examined were negatively correlated with behavioral intentions, measured by either the likelihood of a typical CPA or the likelihood of respondents themselves acquiescing in the fraud scheme. With three exceptions, the correlation coefficients were all significant at the 0.05 level or smaller. The correlations between the likelihood of criminal sanctions and the likelihood of fraud were not significant, which suggests that the threat of criminal sanctions is not an effective deterrent against financial statement fraud. The relationship between the likelihood of formal admonishment by professional bodies and respondents' self-reported likelihood of fraud was also not significant. Finally, the correlation between the likelihood of fraud and the likelihood of personal feelings of guilt or remorse was not significant based on the estimates for a typical CPA. In contrast, this relationship was highly significant (0.000 level) when the likelihood of fraud was based on self-reports.

Materiality Judgments

A summary of participants' materiality assessments is provided in Table 5. Judgments in the Low Materiality condition reflected considerably less consensus,

Table 5. Materiality Assessments.

	Materiality		
	Low	High	Pooled
Assurance level			
Compilation[a,b]	7.77	9.00	8.16
	(2.75)	(0.83)	(2.38)
Review	6.73	9.22	8.32
	(2.88)	(0.59)	(2.16)
Audit	7.00	9.32	8.32
	(2.97)	(0.65)	(2.31)
Pooled	7.24	9.23	8.27
	(2.88)	(0.67)	(2.27)

[a] Reported numbers are mean responses. Numbers in parentheses represent standard deviations.
[b] Responses were provided on an eleven-point scale where 0 = "immaterial" and 10 = "highly material."

as indicated by the large standard deviations of the responses. A review of the responses revealed that this lack of consensus was largely attributable to 28 subjects in the Low Materiality condition who assessed materiality below the midpoint of the scale, in most cases at a negligible level. Virtually all of the other 105 participants in the Low Materiality condition rated materiality above 7 on the 11-point scale, and the mean materiality assessment for this group was 8.7.

This pattern of results indicates that the majority of participants felt the fraud scheme was highly material on qualitative grounds, despite the fact that its financial statement impact was well below conventional materiality thresholds. However, a significant minority (approximately 20%) essentially ignored the qualitative aspects of the manipulation scheme, and approached the materiality decision from a purely quantitative perspective. Thus, in response to Research Question 3, it appears that most CPA/auditors practicing in small firms adopt an approach similar to that espoused by the SEC in SAB 99, although there is significant disagreement on this issue.

Effects of Assurance Level and Materiality on Sanctions

To address the effects of assurance level and materiality on perceived sanction threats (Research Questions 4 and 5), ANCOVA models were run for each type of sanction with assurance level (Compilation, Review, Audit) as the independent variable and participants' materiality assessments as a covariate.[1] All ANCOVA models were run using three alternative dependent measures: (1) the likelihood

Table 6. Effects of Assurance Level and Materiality on the Perceived Likelihood of Sanctions.

Dependent Variable, Likelihood of	Independent Variable/Covariate	*F* Value	Significance	R^2
Loss of litigation	Assurance	1.4	0.241	0.126
	Materiality	35.8	0.000	
Other fines or settlements	Assurance	1.9	0.147	0.095
	Materiality	24.5	0.000	
Criminal conviction	Assurance	3.2	0.042	0.085
	Materiality	11.8	0.001	
Formal admonishment	Assurance	3.5	0.033	0.096
	Materiality	21.2	0.000	
Suspension from associations	Assurance	1.5	0.222	0.114
	Materiality	31.7	0.000	
Expulsion from associations	Assurance	0.2	0.810	0.065
	Materiality	18.4	0.000	
Revocation of license	Assurance	0.3	0.774	0.060
	Materiality	16.6	0.000	
Termination from job	Assurance	2.7	0.073	0.062
	Materiality	6.5	0.011	
Guilt or remorse	Assurance	0.7	0.496	0.043
	Materiality	4.9	0.028	

of sanctions; (2) the likelihood of default times the likelihood of sanctions; and (3) the likelihood of default times the likelihood of sanctions times by severity of sanctions. All substantive results were the same across the three measures; thus, only the results based on the likelihood of sanctions are reported here.

The results are summarized in Table 6. The effects of materiality were highly significant (0.000 level) for all sanctions, with the exception of job termination and guilt. The effects of materiality on these latter two sanctions were also significant at the 0.05 level. The effects of assurance level was significant at the 0.05 level for criminal prosecution and conviction and formal admonishment by professional bodies, and was significant at the 0.10 level for job termination. Assurance level did not have a significant effect on the perceived likelihood of the remaining sanctions.[2] The R^2 values for the ANCOVA models ranged from 0.043 to 0.126, indicating that materiality and assurance account for a relatively small portion of the overall variation in the perceived likelihood of sanctions.

LIMITATIONS, CONCLUSIONS AND SUGGESTIONS FOR FUTURE RESEARCH

This study is subject to a number of limitations; consequently, the results should be interpreted with caution. The relatively low response rate (14%) raises the possibility that the results may have been affected by nonresponse bias. Other inherent limitations associated with mail surveys should also be acknowledged. For example, due to the lack of control over the administration of the survey, we have little assurance that the intended recipients completed the instruments themselves, rather than delegating it to a subordinate. It should also be recognized that, although CPAs employed by small firms were the most appropriate population for the current study, this group is not representative of the CPA profession as a whole. The vast majority of public company audits in the U.S. are performed by the large international accounting firms, and perceptions of sanction threats for such audits would be expected to differ significantly from those relating to nonpublic companies due to differences in the legal and regulatory environments of public and nonpublic companies. Accordingly, the findings of this study should not be generalized beyond audits of nonpublic companies by small CPA firms.

Research on sensitive issues such as professional ethics is also particularly susceptible to social desirability response bias (Randall & Fernandes, 1991). A common approach used to address this issue in previous accounting studies has been to ask participants to estimate the likelihood of questionable behavior by an “average” or “typical” CPA, and to assume that such responses represent what participants themselves would do under similar circumstances. We also elicited estimates of the likelihood of questionable behavior by both a “typical CPA” and respondents themselves. The large differences observed between these two sets of estimates (see Table 5) clearly suggest that self-reports were influenced by social desirability bias; therefore, these estimates should be interpreted with caution. We interpreted respondents’ estimates of the likelihood of fraud by a typical CPA literally as perceptions of what their peers would do; however, as discussed below, even this conservative interpretation raises concerns regarding auditors’ ethical standards.

Bearing in mind these limitations, the study does provide evidence relating to several important issues and raises a number of questions that should be addressed in future research. Notably, prior to the passage of the Sarbanes-Oxley Act, participants in this study felt that the likelihood of sanctions for complicity in a fraudulent financial reporting scheme was relatively high. The perceived likelihood of most sanctions exceeded 50%, and several exceeded 70%. Two exceptions were the perceived likelihood of criminal conviction and license revocation, which were

both below 50%. Most sanction threats were also correlated with the likelihood of auditor acquiescence in fraudulent reporting, which implies that existing sanctions act as a deterrent to such behavior. However, the likelihood of criminal conviction was not correlated with the assessed likelihood of fraud by participants or their peers. Perceptions of a low probability of criminal conviction and license revocation could be due to the observance of past instances of fraudulent reporting that did not result in such sanctions. The effectiveness of criminal sanctions for financial fraud has often been questioned. For instance, it has been asserted that state prosecutors have lagged well behind the SEC in pressing for criminal convictions (Schroeder, 2001), and that relatively low-profile fraudsters often escape criminal prosecution (McTague, 2003). If there is a perception that low-profile cases of public-company fraud often avoid criminal sanctions, it is not surprising that CPAs would expect a low likelihood of conviction arising from audits of nonpublic companies.

The findings of the current study also reveal that private company auditors have a rather cynical view of the ethical standards of their peers. Even in the case of a highly material fraud scheme, participants felt there was a 33% chance that their peers would bow to client pressure for an unqualified opinion on the financial statements. In addition, although the threat of guilt or remorse was highly correlated with participants' self-reports of the likelihood of fraud, it was not correlated with the likelihood of fraud by a typical CPA. Participants apparently felt the threat of formal sanctions would deter their peers from acquiescence in client fraud schemes, but moral or ethical considerations would not have a similar deterrent effect. Such pessimism among CPAs regarding the ethical standards of their peers should concern accounting regulators. Numerous studies in the business ethics literature have demonstrated that perceptions of peer behavior are an important predictor of unethical actions (Ferrell & Gresham, 1985). In the current case, this implies that the likelihood of auditor complicity in client fraud schemes may be surprisingly high.

Although materiality had a statistically significant effect on the perceived likelihood of sanction threats, the absolute differences in the likelihood of sanctions between the High and Low Materiality conditions were relatively small. It appears that auditors feel there is a significant threat of sanctions even in the case of small financial statement manipulations. Most participants also felt that a small intentional earnings manipulation was material on qualitative grounds. However, a significant minority did not acknowledge the qualitative significance of the fraudulent manipulation, and appeared to make their materiality decisions on a strictly quantitative basis. This finding indicates that the "abuses of materiality" addressed by SEC Staff Accounting Bulletin No. 99 are also present to some extent among private companies. It also raises a question regarding the

adequacy of auditors' education and training on the proper application of the materiality concept, suggesting that perhaps accounting educators should place more emphasis on the qualitative aspects of materiality. Finally, the level of CPA assurance had relatively weak effects on the perceived threat of sanctions. This result implies that CPAs are no more likely to acquiesce in earnings manipulation schemes on reviews and compilations vis-à-vis audits.

The relatively low deterrent value of criminal sanctions perceived by our participants could be interpreted as support for the need to impose more stringent criminal penalties against auditors of private companies. However, due to the dynamic nature of the current accounting regulatory environment, such conclusions should await the results of further research on sanction threats. There are reasons to believe that the effectiveness of sanctions as deterrents to fraudulent reporting may improve even in the absence of formal changes in state law that extend Sarbanes-Oxley provisions. For example, the AICPA is attempting to implement more stringent disciplinary measures in an effort to restore public confidence in the accounting profession, and state leaders have also asserted that there is a need for more stringent enforcement of existing sanctioning mechanisms against auditors (Stimpson, 2002). The debate surrounding the adequacy of accounting regulation in the U.S. will undoubtedly continue for years. Accounting scholars can contribute to this debate by continuing the investigation of the effectiveness of sanctioning mechanisms against all professional accountants, including private and public company auditors, as well as those employed in industry and government. In addition to studies of perceptions of existing sanction threats, future research should investigate the deterrent value of alternative sanctioning mechanisms. This issue could be addressed in studies that manipulate the likelihood and severity of various sanctions using an experimental approach, similar to that of Grant et al. (1996).

NOTES

1. A one-way ANOVA indicated that the effect of the materiality manipulation on assessed materiality was significant at the 0.0001 level, which indicates that the experimental manipulation had a highly significant effect on materiality judgments. However, participants' assessments of materiality were included as a covariate in the ANCOVA models to provide a more refined measure, due to the fact that most respondents in the Low Materiality condition felt that the misstatement in question was material on qualitative grounds.

2. To test the potential effects of assurance level on the likelihood of aggressive reporting, two separate ANCOVA models were run with the estimated likelihood of fraudulent reporting by: (1) a typical CPA; and (2) participants themselves as the dependent variables, assurance level as the independent variable, and materiality judgments as a covariate. The

effect of assurance level on the estimated likelihood of fraud was not significant for either model. These results indicate that, consistent with professional standards, auditors are no more likely to comply with aggressive reporting in the case of compilation or review engagements than in the case of audits.

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APPENDIX: EXPERIMENTAL CASE

High Materiality, Audit version

Photek, Inc. is a privately held company that develops, manufactures, and markets high-performance film-coated glass used in such products as computer screens, photocopiers, and projection televisions. The company was incorporated in 1995, and from its inception through 1997 was primarily engaged in the development of process and product technology, with limited commercial production. The company has successfully developed a unique, proprietary process for applying thin film coatings to glass and other products that it believes represents a fundamental technological breakthrough. However, since the implementation of this technology in early 1998 they have not captured a significant share of the market for this type of process, and the majority of their sales have been to two principal customers. Photek has implemented a just-in-time purchasing and production system under which they only produce products for which sales orders have been received; consequently, the company does not carry significant amounts of inventory.

It is now January, 2001, and the company is preparing for an audit of their GAAP-based financial statements for the year ended December 31, 2000. The financial statements will be provided to First Federal Bank, a local bank through which Photek obtains the majority of its financing. Photek has several long term notes and a revolving line of credit with First Federal, which are secured by substantially all of the company's assets. In order to maintain its lending relationship

with the bank, Photek is required to have its annual financial statements audited by an independent CPA. The bank also conducts its own field examinations or inspections of its collateral semi-annually. The audit is being performed by Tyler, Murphy and Jenkins, a large local CPA firm. Summarized financial information for Photek as of and for the three years ended December 31, 2000 follows:

			Preliminary
	1998	1999	2000
Balance sheet			
Current assets	$313,802	$874,912	$1,213,678
Property and equipment	755,809	878,891	972,201
Other assets	31,782	52,434	74,914
	$1,101,393	$1,806,237	$2,260,793
Current liabilities	$787,399	$946,924	$1,216,241
Long term liabilities	633,691	983,068	1,593,376
Common stock and paid-in capital	798,600	1,734,526	1,947,746
Retained earnings (deficit)	(1,118,297)	(1,858,281)	(2,496,570)
	$1,101,393	$1,806,237	$2,260,793
Income statement			
Revenue	$1,097,683	$4,035,382	$8,063,848
Cost of sales	1,219,954	3,458,226	6,232,346
Gross (loss) profit	(122,271)	577,156	1,831,502
Operating expenses	489,084	1,173,424	2,175,750
Interest expense	74,688	143,716	294,041
Net (loss) income	$(686,043)	$(739,984)	$(638,289)

As indicated above, the company has suffered recurring operating losses and has a large accumulated deficit as of the end of the current year, and a net loss for the year. The company incurred substantial charges for process and product development during the year ended December 31, 2000 (reported as Operating expenses), in an effort to develop other technologies that may prove profitable in the future.

After seeing the preliminary results presented above for the year ended December 31, 2000, the company's founder and CEO, Jim Munitz, became very concerned about the company's technical violation of certain debt covenants. Consequently, he devised a plan to improve the reported performance. The plan involved backdating sales invoices and shipping documents for a large number of sales made during the first quarter of 2001, so the sales could be recognized in the year 2000. One of the company's freight carriers agreed to backdate their bills of lading to correspond with the company's shipping documents. The plan accelerated the recognition of approximately $2,000,000 in revenue for the year ended December 31, 2000, which increased the above reported gross profit and reduced the reported net loss by approximately $500,000 (resulting in a reported loss of approximately $138,000), and also allowed the company to avoid technical violation of its debt covenants.

Bob Jenkins, CPA, is the partner in charge of the Photek audit. During the course of the audit, Jenkins' firm became aware of the premature revenue recognition scheme. When Jenkins confronted Munitz with the findings, Munitz argued that it was just an issue of timing, and would have no long-term effect on the company's financial position. Because he did not want to lose Photek's business, Jenkins decided to waive the adjustment relating to the accelerated sales recognition, and issued an unqualified opinion on the company's financial statements.

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THE SARBANES-OXLEY ACT: COSTS AND TRADE OFFS RELATING TO INTERNATIONAL APPLICATION AND CONVERGENCE

Erin Marks

ABSTRACT

Demand for international capital increased with widespread privatization efforts in the 1980s and 1990s stemming from the collapse of Communism in the former Soviet Union and Eastern Europe and from economic reform in China, Latin America, and Southeast Asia.

The Sarbanes-Oxley Act, perceived as the most important piece of legislation affecting public companies since the securities acts of the l930s, was enacted in the wake of several accounting scandals involving public companies and seeks to protect investors by improving corporate disclosures made pursuant to the securities laws. Unlike securities legislation and regulation in the recent past that accommodated or exempted foreign private issuers, the Act largely ignores the variations of foreign securities laws and extends the reach of U.S. law into many aspects of the internal affairs and governance regimes of foreign firms and their auditors. With the passage of the Act, fund sourcing cost-benefit analysis has therefore changed for foreign firms seeking access to U.S. capital markets. The costs associated with a U.S. listing may now seem disproportionate to the benefits. Aspects of

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this new cost benefit trade off and the implications for international standard setting and convergence are examined in this paper.

The recent era of globalization has markedly changed the landscape for securities regulation. The level of international investment has increased dramatically in the past ten years.[1] U.S. holdings of foreign securities have risen over 500% since 1991, reaching almost $2 trillion by the end of 2001. Foreign holdings of U.S. securities increased by approximately 425% to $5 trillion during the same period. Foreign companies registered with the Securities and Exchange Commission totaled 173 in 1981, 439 in 1991, and over 1300 by 2001.[2] These cross-listings have had a profound impact on the New York Stock Exchange. Foreign listings on the NYSE have grown from approximately 2% of all listings in 1975 to around 5% in the early 1990s to nearly 17% today.[3]

The internationalization process occurred due to several economic, political, and social factors. Demand for international capital increased with widespread privatization efforts in the 1980s and 1990s stemming from the collapse of Communism in the former Soviet Union and Eastern Europe and from economic reform in China, Latin America, and Southeast Asia.[4] In response, regulators loosened disclosure regulations to attract foreign issuers and investors.[5] Institutional investors grew and strengthened, and currently hold over 50% of the U.S. equity market, up 20% from 1975. Investors overall began to seek international diversification in the 1980s in order to reduce the overall risk associated with their portfolios.[6] Technological innovations facilitated global communication and enhanced analytical tools used for risk management and arbitrage, thus allowing increased participation in securities markets internationally.[7]

An environment of global competition among national regulators arose from the heightened demand for foreign investing and issuing.[8] Capital ultimately flows to the market with "the least government intervention, the highest liquidity, the lowest transaction costs... and the lowest tax burden."[9] Even though foreign firms encountered regulatory costs in entering U.S. capital markets, foreign firms increasingly listed on U.S. exchanges during this period of internationalization for various reasons. Foreign firms gain market value and liquidity, build an international reputation, and earn prestige from a U.S. listing.[10] Moreover, listing on a U.S. exchange facilitates cross-border mergers in many instances.[11] The benefits of listing on a U.S. exchange therefore outweighed the costs enough to justify entry for foreign firms into the U.S. capital markets.

Since the passage of the Sarbanes-Oxley Act in 2002, the cost-benefit analysis has changed for foreign firms seeking access to U.S. capital markets. The costs associated with a U.S. listing may now seem overly cumbersome and disproportionate to the benefits. Since foreign firms can choose to list in other capital markets,

such as London or Frankfurt,[12] the U.S. may witness a decline in the number of foreign firms listing on its national securities exchanges. To remain competitive in the landscape of the global capital market system, the U.S. must take steps to level the international playing field.

This Note will begin in Part I with a historical overview of SEC regulation of foreign private issuers. The U.S. generally loosened disclosure regulations for foreign issuers throughout the period of internationalization to maintain a competitive advantage in attracting participants from the emerging markets.

Part II discusses the Sarbanes-Oxley Act of 2002 and its application to foreign private issuers. In an attempt to rescue the integrity of U.S. markets after a series of corporate collapses, Congress expeditiously passed the Sarbanes-Oxley Act on July 30, 2002 to tighten disclosure rules and enhance enforcement mechanisms. Breaking from past securities law tradition, Congress wrote Sarbanes-Oxley to apply to domestic and foreign private issuers alike.[13] Despite opposition and possible retaliation, the SEC is determined to apply this law equally.

Part III outlines the theoretical concepts of regulatory competition and convergence, and contemplates what steps the U.S. should take next. For purposes of clarity and focus, this Note will address issues related to disclosure regulation and leave issues of corporate governance standards aside.[14] Commentators speculated that the regulatory behavior of loose disclosure standards would result in a race to the bottom. Information and transaction costs were extraordinarily high in markets with stringent disclosure rules, leading issuers and investors to the inexpensive markets with lax disclosure rules. The U.S. hit rock bottom in 2002 when Enron, WorldCom, and several other large corporations declared bankruptcy and revealed scandalous disclosure practices. Sarbanes-Oxley alters the competitive position of the U.S. as it raises the costs for foreign firms to issue securities in the U.S. markets. To shift the regulatory landscape to a race to the top and retain its competitive advantage, the U.S. must work quickly toward accepting international accounting standards. Otherwise, the U.S. markets will drive foreign business out of New York and into the market with lower costs and less stringent disclosure regulations.[15] Part IV gives an overview of the work accomplished thus far on the international standardization of accounting rules.

1. HISTORICAL OVERVIEW OF SEC REGULATION OF FOREIGN ISSUERS

The SEC serves to protect investors and maintain the integrity of the securities markets.[16] Congress passed the Securities Act of 1933 (“Securities Act”) and the

Securities Exchange Act of 1934 ("Exchange Act") to restore investor confidence in the U.S. after the stock market crash of 1929.[17] The Securities Act covers the initial distribution of securities and requires registration of shares, unless such registration is specifically exempt.[18] Congress set forth the broad purpose of the Securities Act:

> The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; [and] to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion.[19]

The Exchange Act governs post-distribution trading in securities by obligating publicly traded companies to report audited financial information periodically and annually and by regulating proxy solicitations and tender offers.[20] Congress further articulated the fundamental motivation for the Exchange Act:

> The purpose of the act is identical with that of every honest broker, dealer, and corporate executive in the country, viz., to purge the securities exchanges of those practices which have prevented them from fulfilling their primary function of furnishing open markets for securities where supply and demand may freely meet at prices uninfluenced by manipulation or control.
>
> The act strikes deeply not only at defects in the machinery of the exchanges but at causes of disastrous speculation in the past. It seeks to eradicate fundamental and far-reaching abuses which contain within themselves the virus for destroying the securities exchanges. It is the most important defense yet erected against the forces of prostration and despair which sprang full-armed from the debacle of October 1929.
>
> The wise and proper administration of the act, fortified by the intelligent and helpful cooperation of the exchanges, should release the American investor from the pall of apprehension which has paralyzed his confidence in securities during the last 5 years.[21]

In drafting these revolutionary pieces of legislation, congressional pioneers laid the foundation of U.S. securities law, consisting of registration, full and fair disclosure of material information, and the prevention of fraud in relation to the offering and sale of securities.[22]

With regard to foreign private issuers, the SEC mildly addressed the demands of foreign participants in U.S. capital markets before the 1990s. Foreign private issuers first obtained exemption from U.S. securities laws in 1935 upon their discharge from Exchange Act Section 14, relating to proxy rules, and Section 16, covering the reporting requirements and liability requirements for short-swing profits.[23] Section 14 provides the SEC with its principal authority over matters of corporate governance. For example, under Section 14, U.S. corporations must reveal extensive information about executive compensation.[24] Consequently, foreign private issuers need not comply with the proxy rules of Section 14 relating to corporate governance.[25] Section 16 deals with insider trading. Even though

Section 16 is now largely obsolete due to the magnitude of SEC Rule 10b-5 which also deals with insider trading, it further demonstrates the historical willingness of the SEC to accommodate foreign private issuers.[26]

In the late 1970s, the SEC created several forms to simplify the process by which foreign private issuers could register their securities in the U.S. capital markets pursuant to the Securities Act.[27] The SEC also provided foreign private issuers with Form 20-F pursuant to the Exchange Act to comply with the mandatory periodic disclosure requirement.[28] These steps gave foreign private issuers condensed versions of the forms required of U.S. firms.[29]

Further, the SEC took direct steps to ease the disclosure requirements applicable to foreign private issuers in 1990. On April 24, 1990, the SEC introduced Regulation S and Rule 144A.[30] Regulation S limits the extraterritorial application of the Securities Act by eliminating the registration requirements for many offshore transactions and by providing greater predictability with regard to the application of U.S. securities law to offshore offerings.[31] Rule 144A eliminates registration requirements for private placement offerings to institutional investors and offers foreign issuers an alternative to the hefty registration and disclosure requirements of the other securities laws.[32] Private placements, however, have limitations. First, shares may be sold at a discount in a private placement to compensate investors for limited liquidity and transferability.[33] Second, small investors typically are limited from participation in private placements, thus limiting the amount of capital available to the issuer. Finally, the cost of equity is higher in private placements relative to public offerings.[34]

The SEC has taken additional steps to reduce the disclosure requirements applicable to foreign private issuers. Foreign private issuers can choose any comprehensive body of accounting principles for preparation of their financial statements, provided they reconcile the information to the Generally Accepted Accounting Principles that apply in this country.[35] The SEC adopted the Multi-Jurisdictional Disclosure System (MJDS) in July 1991, under which the U.S. and Canada agreed to accept disclosure documents of issuers if they meet the reporting requirements of the issuer's domestic regulations.[36] The SEC announced this plan as the "first step" in facilitating the demands of international securities transactions.[37] This reciprocal disclosure agreement works for the U.S. and Canada given the similarity of existing disclosure rules between the two countries.[38] Since 1994, first-time registrants have been required to reconcile their financial statements from only the preceding two years.[39] Moreover, the SEC announced a revision package altering the disclosure standards for foreign private issuers to international disclosure standards in 1999. The new law required amendments of several forms, revision of Regulation S-X, and alteration of the definition of "foreign private issuer."[40]

Since its inception in the 1930s and particularly throughout the period of internationalization in the 1990s, the SEC has expressed its desire to attract foreign issuers to U.S. capital markets through accommodating and reducing disclosure requirements for foreign private issuers. These regulatory decisions easing disclosure requirements have bolstered the demands of foreign firms in raising capital in the U.S. stock markets. Thus, the U.S. markets in the 1990s witnessed an explosion of foreign firms registering with the SEC, enabling their ability to raise capital in the U.S. markets.

2. OVERVIEW OF THE SARBANES-OXLEY ACT OF 2002

2.1. General Application

On July 30, 2002 President George W. Bush signed into law the Sarbanes-Oxley Act of 2002.[41] Congress drafted the law after several large corporations collapsed in bankruptcy due to the exposure of questionable disclosure practices in 2001–2002. On December 2, 2001, the seventh largest company in the U.S., Enron Corporation, declared bankruptcy amid an investigation relating to off-the-books partnerships used to hide debt and inflate profits.[42] Enron's collapse led to a flurry of corporate investigations that eventually revealed the widespread business practice of accounting fraud. In January 2002, Global Crossing Ltd. filed for bankruptcy protection after shady accounting practices surfaced. Global Crossing engaged in network capacity swaps with other telecommunication firms to inflate revenue artificially.[43] Eventually, Global Crossing restated its revenue by $19 million, erased $1.2 billion in assets and liabilities, and changed net losses from $13 million to $4.8 billion.[44] WorldCom filed the largest bankruptcy in history on July 21, 2002[45] and subsequently admitted to misreporting $9 billion in profits from 1999.[46] WorldCom deceptively represented itself as a profitable firm in 2001 and the first quarter of 2002 by capitalizing and deferring costs rather than immediately recognizing them as expenses.[47] Employees lost their jobs and retirement savings. Shareholders lost fortunes as the market value of the shares of many of these firms quickly dwindled down to pennies. Overall, 168 companies with assets totaling $368 billion filed for bankruptcy in 2002.[48] Five of the 10 largest bankruptcies in history occurred in 2002, including WorldCom, Global Crossing, and Adelphia Communication Corp. Accounting scandals played a significant role in the failure of all of them.

Sarbanes-Oxley serves to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws."[49] The statute extensively adds to securities law and is the most important piece of legislation

affecting public companies since the formation of the SEC in 1934.[50] The reforms in the Act substantially affect the accounting profession, disclosures by public companies, corporate governance, and criminal penalties for securities fraud.[51] More specifically, the Act establishes the Public Company Accounting Oversight Board,[52] provides for pervasive regulation of the public accounting profession,[53] creates a framework for major reforms in corporate governance,[54] requires enhanced and more timely disclosures by public companies,[55] mandates increased criminal penalties for violations of the securities laws,[56] prohibits senior officers and directors from trading company securities during blackout periods,[57] and incorporates "whistle-blower" protection for employees reporting violations.[58] The Act also calls for several studies to be directed to Congress on issues including the consolidation of public accounting firms, the adoption of a principles-based accounting system, and the mandatory rotation of public accounting firms.[59]

2.2. Application to Foreign Issuers

Sarbanes-Oxley makes little distinction between domestic and foreign issuers, and applies equally to both in several respects. Unlike securities regulations in the past that accommodated or exempted foreign private issuers, the Sarbanes-Oxley Act largely ignores the variations of foreign securities laws and extends the reach of U.S. law into many aspects of the internal affairs and governance regimes of foreign firms and their auditors.[60]

One possible explanation for this shift in policy lies with congressional sentiment against U.S. companies that incorporate offshore for tax advantages. The practice, often referred to as "corporate inversion," became a hot political issue after the September 11 terrorist attacks.[61] Tyco left the U.S. to incorporate in Bermuda in 1997 to lower its effective tax rate.[62] In May 2002, Stanley Works announced plans to reincorporate in Bermuda to save up to $30 million per year paid in taxes on foreign-earned income.[63] Under intense political pressure, however, Stanley Works abandoned plans to reincorporate in Bermuda in August 2002, and Tyco began to consider a move back to the U.S. to end doubts about its transparency and corporate governance in October 2002.[64] By applying Sarbanes-Oxley extraterritorially, Congress sent a message to U.S. companies considering a move offshore: foreign firms would no longer enjoy protection under the U.S. securities laws.[65] Senator Enzi expressed some concerns about the overreaching international application of Sarbanes-Oxley:

> I believe we need to be clear with respect to the area of foreign issuers and their coverage under the bill's broad definitions. While foreign issuers can be listed and traded in the U.S. if they agree to conform to GAAP and New York Stock Exchange rules, the SEC historically has

> permitted the home country of the issuer to implement corporate governance standards. Foreign issuers are not part of the current problems being seen in the U.S. capital markets, and I do not believe it was the intent of the conferees to export U.S. standards disregarding the sovereignty of other countries as well as their regulators.[66]

According to SEC Commissioner Roel Campos, the law will apply equally to domestic and foreign firms to the extent possible:

> We intend to implement fully the Sarbanes-Oxley Act for all companies, foreign and domestic. That is our mandate. And, as we write our rules to implement the act, foreign companies can expect that many of the new rules will apply to them. But we are prepared to consider how we can fulfill the mandate of the act through our rulemaking and interpretive authority on ways that accommodate the home country requirements and regulatory approaches of the home jurisdiction of our foreign registrants and potential registrants.[67]

Even though the U.S. has expressed a willingness to accede to the interests of foreign issuers and potential issuers, the Sarbanes-Oxley Act will apply to foreign private issuers in many respects.

Focus on the application of Sarbanes-Oxley to foreign private issuers calls into question the ability of the U.S. to apply its securities laws extraterritorially. Under the dual "conduct" and "effect" tests used by the U.S. courts to determine the extraterritorial reach of antifraud rules, a U.S. court has subject matter jurisdiction if a foreign defendant's activities in the U.S. go beyond a "merely preparatory" level and involve actions or omissions that directly cause losses.[68]

Another situation triggering extraterritorial application of U.S. law involves a predominantly foreign transaction that has "substantial effects" in the United States.[69] In *Schoenbaum v. Firstbrook*,[70] for example, an American plaintiff and shareholder of a Canadian corporation alleged a violation of Section 10(b) of the Exchange Act.[71] The plaintiff alleged that the company's controlling shareholders arranged to buy shares from the corporation for a price below fair market value.[72] The transaction took place in Canada, but the U.S. Court of Appeals for the Second Circuit found that the sale of undervalued stock in Canada had "effects" on the U.S. market by unjustifiably deflating the stock listed on the American Stock Exchange.[73] The court held that transactions involving foreign stocks registered and listed on a national securities exchange and causing damage to the interests of American investors warrant the exercise of subject matter jurisdiction for violation of the Securities Exchange Act.[74] The court placed no weight on the fact that the transaction took place wholly outside the U.S. Judge Lumbard stated:

> Congress intended the Exchange Act to have extraterritorial application in order to protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities markets from the improper foreign transactions in American securities.[75]

Given the extensive reach of U.S. law, foreign private issuers become vulnerable to suit in the U.S. for breaches of securities laws. Such extensive application of U.S. law may seem unfair and even dangerous.[76] However, the current situation holds that issuing securities on a U.S. exchange entails the risk of substantial litigation and the costs of compliance with U.S. law.[77]

Representatives of foreign private issuers extensively lobbied the SEC to use its exemptive powers to relieve them from the cumbersome Sarbanes-Oxley Act. Several interested parties residing in foreign jurisdictions submitted comments to the SEC explaining the conflicts of law arising from U.S. imposition of Sarbanes-Oxley standards on firms in their countries. These comments typically called for exemption of their countries' firms from compliance with Sarbanes-Oxley either in full or in part.[78] Senator Enzi commented on the issue during the congressional hearings: "I believe it is in the intent of the conferees to permit the Commission with wide latitude in using their rulemaking authority to deal with technical matters such as the scope of the definitions and their applicability to foreign issuers."[79] On April 9, 2003, for example, the SEC released a final rule for standards relating to listed company audit committees. Even though the final rule applies to both foreign and domestic firms, the SEC included several provisions to address the interests of particular jurisdictions.[80] Nevertheless, foreign private issuers must accept the level at which the SEC imposes compliance given the extensive body of law supporting extraterritorial application of U.S. securities laws.

The following paragraphs will briefly outline certain sections of Sarbanes-Oxley that apply to foreign firms to provide some insight into the mechanics of the law. The SEC accepted numerous comments regarding the application of Sarbanes-Oxley to foreign firms and granted partial exemptions from provisions conflicting with home country laws.[81] The SEC has refused, however, to deviate from the spirit of the law in its international application.[82]

(1) Public Company Accounting Oversight Board
Sarbanes-Oxley explicitly applies the functions of the Public Company Accounting Oversight Board to foreign public accounting firms that prepare audit reports for issuers under the SEC.[83] A foreign accounting firm that does not issue an audit report for an Exchange Act reporting issuer additionally may be subject to the Board's authority if it plays a substantial role in an audit.[84] If a foreign firm issues an audit opinion or otherwise performs material services upon which an auditing firm relies, then that foreign firm essentially has consented to produce its audit work papers for the Board and to be subject to jurisdiction in U.S. courts.[85] A foreign public accounting firm that supplies an opinion to a registered public accounting firm also consents to provide audit work papers upon the Board's request.[86] The statute, however,

grants the Commission authority to exempt foreign public accounting firms from the provisions of the Act.[87] This exemption clause specifically refers to foreign public accounting firms and therefore does not apply to all foreign private issuers.

(2) Audit Committees

Sarbanes-Oxley calls for the SEC to direct U.S. securities exchanges and NASDAQ to adopt rules ordering each listed firm to form an independent audit committee with direct responsibility for the appointment, compensation, and oversight of the work of the registered public accounting firm for the issuer.[88] Each member of the audit committee must be a member of the board of directors and must be independent in all other respects.[89] The independent audit committee must establish procedures for the handling of complaints regarding accounting or auditing matters as well as for the treatment of concerns raised by employees about questionable accounting or auditing matters.[90] To be considered independent for the purposes of this provision, a member of the audit committee may not accept consulting or compensatory fees from the issuer or be an employee of the issuer or any of the issuer's subsidiaries.[91] The SEC has the power to grant individual exemptions to the independence requirement. In other words, the SEC may allow certain relationships to qualify as independent if the SEC deems this appropriate given the surrounding circumstances.[92] Many foreign firms urged the SEC to use its exemption powers to relieve them from compliance with this provision.[93] The requirement compelling members of the audit committee to have independent status directly conflicts with laws in other counties. The SEC has promulgated the final rules with concessions to foreign firms in areas of direct conflict with local rules.[94] Under the final rules, non-executive employees can sit on the audit committee of a foreign private issuer in certain conditions, supervisory or non-management boards can comprise the audit committee in cases of two-tiered board systems, and an audit committee member can be a representative of an affiliate or of a foreign government under a specific set of facts.[95] Moreover, the final rule exempts listed issuers that are foreign governments and foreign private issuers with boards of auditors.[96]

(3) Certification of Financial Statements

Sarbanes-Oxley also directs the SEC to adopt regulations requiring issuers to have their principal executive and financial officers provide certifications in each annual and quarterly report filed or submitted under the Exchange Act.[97] Such corporate officers must certify that:

(a) they have reviewed the report;
(b) the report does not contain any untrue material facts or any material omissions of fact that cause the report to mislead;

(c) the financial statements fairly present the financial condition and operation results of the firm;
(d) they are responsible for establishing and maintaining disclosure controls to ensure that material information relating to the company is disseminated properly;
(e) they are responsible for establishing and maintaining internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements;
(f) they have evaluated the effectiveness of the company's disclosure controls;
(g) they have disclosed any material change in the company's internal control over financial reporting; and
(h) they have disclosed all significant deficiencies in internal control over financial reporting and fraud involving management to auditors.[98]

An amendment to the federal mail fraud statute imposes criminal penalties on any CEO or CFO who violates these standards.[99] Further, reincorporation outside the U.S. does not serve to exempt a firm from or lessen the legal force of this provision.[100]

(4) Insider Trades during Pension Fund Blackout Periods

The Act also prohibits any director or executive officer of an issuer from directly or indirectly trading any equity security of the issuer in connection with their employment during any blackout period.[101] Blackout periods are periods during which more than 50% of the participants in "individual account plans" are temporarily prohibited from trading in company securities held in their accounts.[102] "Individual account plans" are pension plans that provide for an individual account for each participant and for benefits based on the amount of and earnings on the contributions.[103] Any profit realized by a director or officer in violation of this provision is recoverable by the issuer, and any shareholder can sue in the name of the issuer if the company fails to seek recovery.[104] The prohibition on transactions during blackout periods is not limited to U.S. pension plans, and therefore applies to foreign private issuers.[105] Specifically, the law applies to foreign private issuers under the rule as long as the situation meets certain conditions.[106]

(5) Auditor Independence

The provisions regarding auditor independence have raised many concerns for foreign private issuers. Many jurisdictions follow laws that directly conflict with the auditor independence rules promulgated by the Sarbanes-Oxley Act.[107] The concessions listed above as part of the SEC proposals largely address concerns about the conflicts surrounding imposition of auditor independence rules on foreign firms.[108] The SEC enacted laws that addressed the apprehension of foreign firms with respect to auditor independence.

(a) Services outside the Scope of Practice of Auditors

The scope of services provision of Sarbanes-Oxley prohibits public accounting firms from contemporaneously providing issuers with audit and non-audit services.[109] Non-audit services include bookkeeping, the design of financial information systems, appraisal or valuation services, fairness opinions, contribution-in-kind reports, actuarial services, internal audit outsourcing services, management functions or human resources, investment banking, and legal services.[110] Several commentators expressed concerns regarding extraterritorial application of this scope of services provision.[111] The SEC made various concessions in the final rules release. With respect to legal services the SEC noted: "In determining whether or not a service would impair the accountant's independence solely because the service is labeled a legal service in a foreign jurisdiction, the Commission will consider whether the provision of the service would be prohibited in the United States as well as in the foreign jurisdiction."[112] Moreover, the SEC agreed to determine appraisal and valuation issues related to foreign firms on an ad hoc basis and consider requests for exemption from foreign auditors, as the laws of some countries require auditors to provide contribution in-kind reports or valuation services.[113] Further, an exemption provision grants the Oversight Board power to release any person, issuer, public accounting firm, or transaction from the prohibition on services.[114] Overall, the SEC calmed the concerns of foreign private issuers with regard to this scope of services provision through its promulgation of the final rules.

(b) Pre-approval Requirements

Moreover, Sarbanes-Oxley demands that the audit committee of the issuer pre-approve all auditing and non-audit services.[115] The provision does not cover de minimus non-audit services. De minmus services must equate to less than 5% of the total revenues paid to the auditor by the issuer during the fiscal year, not be recognized by the issuer as non-audit services at the time of the engagement, and be disclosed to and approved by the audit committee of the issuer.[116] The provision delegates responsibility to the audit committee for choosing one or more of its members who are also independent members of the board of directors for the function of granting pre-approvals. The member or members of the audit committee with the right to pre-approve auditing and non-audit activities must present such decisions to the audit committee at each of its scheduled meetings.[117]

(c) Audit Partner Rotation

This provision of Sarbanes-Oxley compels issuers to rotate their employment of public accounting firms for the performance of auditing

services.[118] It prohibits a public accounting firm from performing auditing services to an issuer if the lead audit partner having primary responsibility for the audit or the audit partner responsible for reviewing the audit has performed audit services for that issuer in each of the five previous fiscal years.[119] Commentators expressed concern that a widespread rotation would affect audit quality adversely, and would be hard, if not impossible, to achieve practically.[120] In drafting the final rules, the SEC acknowledged the qualms expressed by commentators that strict application of the initial rule would have had have a particularly adverse impact in foreign countries, especially in emerging countries with limited pools of accountants and experts.[121] The SEC also drafted the rules to avoid an immediate rotation of hundreds of partners in various countries. Thus, for all partners with foreign accounting firms, the rules are effective as of the beginning of the first fiscal year after the rules become effective.[122] Similarly, the first fiscal year the law is in place will constitute the first year of service for such partners no matter how many years the partner had previously served in that capacity.[123]

(d) Auditor Reports to Audit Committees

Sarbanes-Oxley requires accounting firms to communicate their practices and decisions to the audit committees of the issuers for which they perform audits. Each registered public accounting firm must report to the audit committee all critical accounting policies and practices to be used, all alternative treatments of financial information within GAAP, the ramifications of the use of such alternative disclosures, and the treatment preferred by the accounting firm, as well as any other communication between the accounting firm and the issuer's management.[124] Accordingly, like a domestic issuer, a foreign private issuer will have to disclose whether it has an audit committee financial expert in its Exchange Act annual report.[125] To actuate this provision, the SEC plans to amend forms filed by foreign issuers to require the audit committee financial expert disclosure.[126] Furthermore, the SEC has allowed foreign firms delayed compliance until it promulgates independence standards for financial experts.[127]

(e) Conflicts of Interest

The Sarbanes-Oxley Act attempts to prevent conflicts of interest from occurring between issuers and their auditors. It prohibits an issuer from using a public accounting firm for the performance of an audit if the accounting firm employed one of the issuer's senior employees in the past year, and the senior employee worked in some capacity on the audit of the issuer.[128] Senior employees include CEOs, CFOs, controllers, chief accounting officers, and any other people serving in equivalent

positions.[129] In response to concerns raised by commentators, the SEC promulgated the final conflict of interest rules with further specificity and leniency for foreign firms. For example, the cooling-off period applies to any participant in the audit who will provide more than ten hours of audit, review, or attest services.[130] Members of an audit team, including those employed by foreign accounting firms, can also take positions with subsidiaries of an issuer and can even accept key positions at the issuer in certain circumstances with the approval of the audit committee.[131] Moreover, the SEC provided an additional exemption for emergency or unusual circumstances to quash anxiety expressed by commentators about the onerous cost of compliance in foreign jurisdictions. The company's audit committee must establish that an exemption is in the best interest of investors. The SEC further emphasized that this exemption is to be invoked only in rare and unique circumstances.[132]

(6) Rules of Professional Responsibility for Attorneys
Sarbanes-Oxley calls for the SEC to promulgate rules setting forth minimum standards of professional conduct for attorneys "appearing and practicing before the Commission."[133] Under the statute, the final standards must include a rule requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary by the company or any agent "up the ladder" to the chief legal counsel or chief executive officer and then to the board of directors as a last resort.[134] The final rule provides that a "non-appearing foreign attorney" does not "appear and practice before the Commission."[135] The definition specifically excludes from the rule attorneys who meet all of the following three criteria:
(i) admitted to practice law in a jurisdiction outside the United States;
(ii) do not represent themselves as practicing or giving legal advice on U.S. law; and
(iii) engage in activities that constitute appearing and practicing before the Commission only incidentally to a foreign law practice or in consultation with U.S. counsel.[136]

The final rule therefore excludes most foreign attorneys. However, foreign attorneys who independently provide legal advice regarding U.S. securities law are subject to the rule, as are those who engage in activities that are more than incidental to a foreign law practice.[137]

(7) Enhanced Financial Disclosures
Even though the international community currently holds the position in favor of strict disclosure rules as set forth in Sarbanes-Oxley, the SEC has concerns regarding the impact of the Act on the competitive behavior of foreign jurisdictions and the decisions of foreign companies.[138] The London

> Stock Exchange reportedly amplified its marketing efforts to attract issuers scared off by the heightened U.S. standards.[139] Moreover, several issuers interested in listing on a U.S. exchange opted either to list with an exchange outside the U.S. or to wait for further guidance from the SEC following the enactment of Sarbanes-Oxley.[140] The next section outlines one provision of Sarbanes-Oxley that directly addresses disclosure issues and applies evenly to foreign and domestic firms.

Sarbanes-Oxley contains additional disclosure regulations applicable to both foreign and domestic firms alike with respect to off-balance sheet transactions and pro-forma information. According to Section 401, each financial report, containing financial statements prepared in accordance with (or reconciled to) U.S. GAAP and filed with the SEC, must reflect all material correcting adjustments identified by a registered public accounting firm.[141] The rules stipulate that each annual and quarterly financial statement must disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships that may have a material effect on the financial condition of the issuer.[142] The rules also oblige firms to ensure that pro forma financial information does not contain any misleading statements or omissions of material fact.[143] Firms have to reconcile such pro forma information with the financial condition and results of operations of the issuer under U.S. GAAP.[144] Pro forma information includes information filed with the SEC, issued in a public disclosure, or delivered in a press release.[145]

To implement these provisions of Sarbanes-Oxley, the SEC set forth several amendments with respect to off-balance sheet transactions and pro forma information. A detailed explanation of the SEC determinations with respect to off-balance sheet transactions follows in order to illustrate how and why the SEC promulgated the amendments to apply equally to foreign and domestic firms. It is important to note, however, that the disclosure requirements pertaining to pro forma information also broadly apply to foreign private issuers.[146]

The SEC amendments require issuers to explain off-balance sheet arrangements in a separately captioned subsection of the Management's Discussion and Analysis (MD&A) section of their financial statements. The amendments also require issuers to provide an overview of certain known contractual obligations in a tabular format.[147] The SEC decided that this provision applies equally to domestic and foreign issuers, and offered several reasons for this determination.[148] First, the provision does not distinguish between foreign private issuers and U.S. companies. Second, investors will benefit equally from expanded off-balance sheet disclosure on the annual reports of foreign private issuers and domestic issuers.[149] Third, the MD&A requirements for the annual statements of foreign private issuers previously mirrored such requirements for the annual statements of U.S. public

companies. Even though Canadian firms under the MJDS system will have to adapt to some changes, the new requirements calling for the disclosure of off-balance sheet transactions and a table of contractual obligations falls in line with the principles of the MJDS system and ultimately benefits and protects investors. Finally, this provision applies only to the annual statements filed by foreign private issuer since the SEC does not require foreign private issuers to file quarterly reports.[150]

3. DISCLOSURE DEBATE BETWEEN REGULATORY COMPETITION AND CONVERGENCE

Disclosure induces managers to manage better, prevents them from acting opportunistically, and reduces the risks of fraud and manipulation.[151] The SEC faces the dilemma of sustaining "meaningful disclosure requirements to protect the large community of individual investors, while at the same time, maintaining such a regulatory system might send both investors and issuers to other markets."[152] The U.S. has a significant interest in attracting foreign private issuers to its capital markets. Increased foreign activity provides the U.S. financial industry with jobs and fees, enhances liquidity and fairness for U.S. investors trading foreign securities, and brings substantial capital to the U.S.[153] Several surveys have identified disclosure costs as the single most important factor taken into consideration by managers contemplating multinational securities offerings.[154] The benefits of listing on a foreign securities exchange must ultimately outweigh the costs for potential issuers. To retain a competitive advantage, capital market regulators must therefore closely monitor disclosure costs.

Foreign firms seek entry into the U.S. capital markets to attain various benefits. A dual listing on a U.S. exchange by a foreign firm commonly increases the value of the firm's shares.[155] Firms in smaller markets gain liquidity, build an international reputation, and earn prestige from a U.S. listing.[156] Listing on a U.S. exchange has become an almost necessary step along the path to economic development in some areas, for example.[157] Some firms flock to the U.S. markets simply to gain access to those markets due to the unavailability of markets in their home country.[158] The "eat or be eaten" perception in business leads foreign firms to the U.S. to facilitate cross-border mergers. Protection of minority shareholders under U.S. law also appeals to foreign firms not afforded such protection at home.[159]

Given the tremendous benefits associated with listing on an American securities exchange, the U.S. has held a competitive advantage relative to other capital markets. The Sarbanes-Oxley Act, however, will change the competitive landscape and will likely damage the advantage of the U.S. The U.S. must therefore manage disclosure regulation carefully to balance the interests of investors in favor of strict

disclosure rules with the interests of foreign private issuers in favor of low cost disclosure rules.

3.1. Regulatory Competition

Before Sarbanes-Oxley in 2002, the SEC chose to play the game of regulatory competition in construing disclosure rules for foreign private issuers. "Regulatory competition is a contest among regulatory jurisdictions to attract market participants by offering them the most efficient regulatory environment in which to operate."[160] Regarding disclosure regulation and competition, issuers will expect a higher price for their securities in jurisdictions with more stringent disclosure requirements. At the same time, investors will pay more for the securities given the increased protection from fraud and manipulation derived from strict disclosure standards.[161] Conversely, investors will pay less for securities offered in jurisdictions with lax disclosure requirements to account for the higher risk of fraud and deceit.[162]

Information costs, however, significantly limit the operation of regulatory competition.[163] The process of gathering and evaluating information about the disclosure standards of various jurisdictions costs a substantial amount of money. The steps involved in identifying the most efficient jurisdiction include obtaining, translating, analyzing, assessing, and comparing information on various markets throughout the world.[164] The complexity of this process can prevent issuers from conducting any cost-benefit analysis. Without analysis, issuers regard all regimes as equally inefficient and suppose that all capital markets contain the same risk for fraud and manipulation. The cost of this risk reduces the price issuers are willing to pay for stringent disclosure rules specifically and registration generally.

As issuers prefer not to have to analyze each jurisdiction's disclosure regulations in order to lower information costs, investors and regimes will follow suit by preferring low costs and lenient disclosure standards.[165]

Accordingly, investors will assume lax disclosure standards and demand low prices.[166] Investors will discount the price of all securities for the risk associated with fraudulent, manipulative, and deceitful behavior by issuers.[167] Higher-quality securities will sell at prices lower than they would if the information-gathering process was costless.[168] On the other hand, low-quality securities will draw more money than they would in a world without information costs.[169] There will be too little investment in good ventures and an abundance of overcompensated low-quality ventures.[170] In other words, a market for "lemons" will prevail.[171]

Issuers will prefer the low costs accompanying reduced disclosure standards, especially issuers structured by separated ownership and control.[172] Minimized

disclosure requirements make it easy for managers to achieve the short-term goal of issuing a security, while owners suffer the long-term consequences as the value of their shares remains discounted for the risk associated with fraud and deceit.[173] Regimes will thus supply lax standards to attract issuers and retain a competitive advantage via their capital markets.[174] According to this line of logic, a race to the bottom will occur as poor quality, low-disclosure markets will prevail and regimes will compete to offer the least stringent disclosure regulations.[175]

This race to the bottom is similar to the prisoners' dilemma in game theory.[176] If all countries cooperate, then the most efficient and socially beneficial rules will result, i.e. strict disclosure standards that optimally protect investors and correctly charge issuers.[177] Each country has an incentive to act individually, however, and opt for the suboptimal solution of lax disclosure standards and minimal investor protection.[178] Individual countries will choose to cater to the interests of managers who decide where to issue securities and prefer lenient and inexpensive disclosure rules.[179] Lax disclosure rules will abound and a race to the bottom will occur. Each country will choose the road of inefficient disclosure rules based on a lack of trust in the willingness of other countries to cooperate.[180] Without an enforcement mechanism, any individual country can opt for cooperation but renege and reap the benefits of collective activity without significant costs.[181] For example, if countries decide to adopt collective disclosure standards to ensure the most efficient and protective system, issuers will have to pay the high costs associated with the stringent rules. If one country chooses to deviate from the collective agreement by adopting lenient, inexpensive, and inefficient standards, then that country will capture all of the profits of attracting foreign issuers.[182] To avoid this manipulation, countries opt to act individually and compete for the most lenient and inexpensive disclosure standards. This race to the bottom scenario favors the most inefficient and least protective disclosure rules and thus allows fraudulent and deceptive behavior to go undetected.[183]

Does this scenario sound familiar? The U.S. hit rock bottom in 2001–2002 with the flurry of corporate collapses stemming from questionable disclosure practices. Congress passed Sarbanes-Oxley to prevent corporate accounting scandals from further obliterating investor trust and confidence in the markets. The legislation applies equally to domestic and foreign firms to ensure maximum investor protection. In the atmosphere of global regulatory competition, however, the U.S. faces a dilemma. By supporting the stricter and more costly regulation alone, the U.S. risks losing the business of foreign issuers to regimes offering cheaper, more lax disclosure regulations. Even though Congress supports a seemingly efficient and socially beneficial regulation, other countries see an opportunity to capture the lost business of the U.S. by continuing to engage in the competition for the cheapest and most lenient disclosure standards. Put more simply, the race to the bottom will

continue with or without participation by the U.S. For the U.S. capital markets to retain a global competitive advantage, this country must cooperate with other regimes in regulating corporate disclosure. By adopting international accounting standards, the U.S. can shift the global environment away from regulatory competition to convergence. International cooperation will allow the most efficient and protective rules to prevail.

3.2. Convergence

To reduce the inefficiencies associated with domestic regulatory frameworks, regulators generally have two options. Regulators can choose to converge rules through either the reciprocity or the commonality approach.[184] Reciprocity entails deference to the rules of a foreign jurisdiction.[185] Commonality involves the adoption by many jurisdictions of a universal rule.[186] International Accounting Standards follow the convergence approach. Discussion of both methods, however, lends insight via comparison and aids in the evaluation of the International Accounting Standards platform.

3.2.1. Reciprocity

With respect to disclosure standards, the U.S. can enter into reciprocal disclosure agreements with other regimes whereby the U.S. agrees to accept the securities disclosure requirements of foreign jurisdictions and those jurisdictions similarly accept the rules of the U.S. Since the reciprocity approach centers on deference to the standards of another jurisdiction, it is limited to situations in which the countries share strong economic bonds and follow similar disclosure rules.[187] This method makes sense on a regional basis where economies share the same essential rules and characteristics. A clear example of the reciprocity approach involves the Multi-Jurisdictional Disclosure System between the U.S. and Canada. Canadian issuers offering securities in the U.S. can use an offering document prepared under Canadian law and file it with the SEC.[188] In the U.S., the SEC will rely largely on the document review conducted in Canada.[189] Similarly, the U.S. firms issuing securities in Canada can submit documents prepared under U.S. law.[190] The regulatory authorities in Canada review the documents to assess compliance with the MJDS rules, but for the most part do not review for substance. The U.S. SEC treats MJDS filings the same as domestic offerings.[191] Issuers in both countries must meet certain qualifications regarding market capitalization and reporting history.[192] This system of reciprocity works based on the similarity between U.S. and Canadian regulatory systems and auditing and accounting standards.[193] The world, however, encompasses various sets of regulatory systems and auditing and

accounting standards making it too difficult to follow the reciprocity approach on a global scale.

3.2.2. Commonality

Alternatively, the U.S. can adopt the commonality approach by changing its disclosure standards to reflect a universal approach. The commonality approach is based on the production of a uniform standard to govern specific situations.[194] The commonality approach corresponds appropriately with the issue of securities disclosure given the international nature of the economy. Economic issues began to lose ties to geographic boundaries with the era of internationalization. At this point, the international character of business calls for the adoption of universal standards. The U.S. must therefore adopt international accounting standards to remain competitive via its capital markets and provide investors with a trustworthy and transparent system.

International accounting standards will provide minimum universal standards and prevent a race to the bottom from occurring.[195] Since the world has witnessed the horrors stemming from accounting scandals and suboptimal disclosure standards, international standards will develop at an efficient and appropriately protective level. Harmonized legal rules, however costly to develop, will ultimately lower transaction costs for issuers of securities.[196] Transparency will also increase if all companies on the international market disclose their financial information according to the same standards.[197] Lower costs will foster growth in economic trade and development.[198] Since practitioners, investors, and issuers will have to learn only one set of rules, international accounting standards will facilitate the realization of economies of scale.[199] A uniform set of international standards will also ease comparison of investments across countries for purposes of analyzing risk and return.[200]

4. INTERNATIONAL ACCOUNTING STANDARDS

Securities regulators need to strike a balance between adequately regulating for the protection of investors, properly easing the process to raise capital, and maintaining acceptable levels of risk.[201] In response, international organizations such as the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Committee (IASC) have developed to shape international agreements on certain key issues, such as disclosure and insider trading.[202] IOSCO recommends minimum standards of conduct to deter the promotion of unchecked regulatory competition in a race to the bottom.[203] The IASC works toward the realization of a universal set of accounting standards.

The International Accounting Standards Committee (IASC) began in 1973 to develop and promote a set of core international accounting standards.[204] The group started with professional representatives from ten countries and grew to include ninety-one countries in 2000. The group also includes all professional organizations that maintain membership in the International Federation of Accountants, totaling 142 members in 103 countries.[205] In 2000, a restructuring plan called for the formation of the International Accounting Standards Board, and Sir David Tweedie became the first Chairman of the IASB responsible for the implementation of international accounting standards.[206] The IASB mission statement reads: "The Board is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements."[207]

IOSCO works to ensure the efficient operation of global markets.[208] IOSCO comprises securities regulators from around the world.[209] Several countries in the Western Hemisphere founded IOSCO in 1974 to provide a forum for regulators across nations to discuss securities issues and to aid capital formation in the West.[210]

The SEC is a prominent member in both IOSCO and IASC. For example, the SEC serves on IOSCO's Technical Committee in charge of reviewing regulatory issues related to international securities and issuing recommendations.[211] In 1987, the Technical Committee began a study to investigate issues related to the increased levels of transnational securities offerings. IOSCO published a report following the study in which it encouraged regulators "to facilitate the use of single disclosure documents, whether by harmonization of standards, reciprocity or otherwise."[212] In May 2000, the IASC unanimously approved a restructuring plan to organize the group and form the International Accounting Standards Board (IASB) in preparation for the future implementation of international standards.[213] The SEC significantly contributed to the plan by offering suggestions to aid in the success of the IASC, the implementation of international accounting standards (IAS). Also in May 2000, the International Organization of Securities Commissions recommended that its members adopt the IAS generated by the IASC for cross-border filings by foreign issuers.[214] The SEC currently requires foreign issuers to reconcile the accounting principles used on their financial statements with U.S. GAAP.[215] In a speech concerning the global landscape of securities regulation, former SEC Chairman, Harvey Pitt explained:

> Having most European issuers use a single set of accounting standards by 2005 provides an interesting target date for us as we reform our financial disclosure and auditing processes. If, by 2005, there has been sufficient progress in the improvement and short-term convergence of

> accounting standards, in the development of a process and structure for consistent interpretation and application of IAS, and in the enhancement of financial reporting infrastructure, then it may be appropriate for us to reconsider the need for foreign private issuers from EU countries to continue to reconcile from IAS to U.S. GAAP.[216]

Given a deadline for the adoption of international accounting standards by the European Union, the U.S. must move quickly to implement the standards in order to remain competitive. A first mover advantage exists in the global capital markets whereas the market that moves first wins the global competitive advantage.[217] If the U.S. fails to cooperate with other countries in the acceptance of international accounting standards, capital markets outside the U.S. will rise to the occasion in supplying the global standards demanded by investors and helpful to issuers. The U.S. thus risks losing its competitive position by avoiding the adoption of international accounting standards. If the U.S., however, cooperates and accepts international accounting standards, then it will retain its position as the home of the pre-eminent capital markets.

5. CONCLUSION

The past two decades have witnessed a large-scale process of internationalization. This process has affected social, political and economic landscapes throughout the globe. Economically speaking, American citizens have a bigger interest in foreign investments, while foreign firms have increasingly sought to issue shares in capital markets abroad. Even though foreign firms experience transaction costs when listing on a foreign exchange, firms opt to list because the benefits exceed the costs. Capital markets across the globe compete for foreign issuers to list on their exchanges. The U.S. has fared relatively well in the competition because its capital markets offer liquidity and prestige unavailable in many areas. The U.S. loosened disclosure regulations for foreign issuers throughout the period of internationalization to maintain a competitive advantage in attracting participants from the emerging markets.

The loosening of disclosure rules for foreign issuers signals the environment of regulatory competition that permeated national regimes. Countries competed for the business of foreign issuers via their regulatory disclosure systems. Since compliance with high disclosure rules costs a substantial amount of money, countries loosened disclosure rules to win the business. Regulatory competition often results in a "race to the bottom" because lax disclosure standards fail to protect investors and diminish trust in capital markets. The U.S. participated in the game of regulatory competition and hit rock bottom with the string of bankruptcies and corporate scandals in 2001–2002.

Congress passed the Sarbanes-Oxley Act in 2002 to protect investors and restore trust in the U.S. capital markets. Sarbanes-Oxley also reverses the trend of loosened standards for foreign private issuers by applying relatively equally to domestic and foreign firms. Since the passage of the Sarbanes-Oxley Act in 2002, the cost-benefit analysis has therefore changed for foreign firms seeking access to U.S. capital markets. The costs associated with a U.S. listing may now seem overly cumbersome and disproportionate to the benefits. Since foreign firms can choose to list in other capital markets such as London or Frankfurt, the U.S. may witness a decline in the number of foreign firms listing on its national securities exchanges. To remain competitive in the landscape of the global capital market system, the U.S. must take steps to level the international playing field. The adoption of international accounting standards will allow the most efficient and protective disclosure rules to dominate the international landscape. If the U.S. acts quickly in implementing international accounting standards it will enjoy a competitive advantage via its capital markets.

NOTES

1. Harvey L. Pitt, Remarks at the Financial Times' conference on regulation and integration of the international capital markets (October 8, 2002), in http://www.edgar.sec.gov/news/speech/spch588.htm.
2. *Id*.
3. John C. Coffee, Jr., Racing toward the top? The impact of cross-listings and stock market competition on international corporate governance. *Colum. L. Rev.*, *102*, 1757, 1771 (2002) [hereinafter Coffee 2002].
4. Uri Geiger, The case for the harmonization of securities disclosure rules in the global market, 1997. *Colum. Bus. L. Rev.*, 241, 250.
5. *Id*. at 253–254.
6. *Id*. at 250–253. Portfolio theory developed by Henry Markovitz in the 1950s found application to international investing in the 1980s with the realization that an internationally diversified portfolio provides greater risk reduction than purely domestic investments due to the low correlation between returns on foreign and domestic securities. See also Trig R. Smith, The S. E. C. and regulation of foreign private issuers: Another missed opportunity at meaningful regulatory change. *Brooklyn J. Int'l L.*, 765, 780–781 (2000).
7. Geiger, *supra* Note 4, at 253.
8. Smith, *supra* Note 6, at 765.
9. Andreas J. Roquette, New developments relating to the internationalization of the capital markets: A comparison of legislative reforms in the United States, the European Community, and Germany. *U. Pa. J. Int'l Bus. L.*, *14*, 565, 567 (1994).
10. Coffee, *supra* Note 3, at 1779–1783.
11. *Id*. at 1815.
12. Larger public companies located in countries with transitional economies choose to list in the U.S., London, or Frankfurt. "At the end of 1999, some seventy-two companies from

transitional economies have listed on the NYSE or Nasdaq, and sixty-one such companies had listed in London. Smaller public firms in transitional economies, which would not qualify for a NYSE listing, have also begun listing on German exchanges, most commonly in Frankfurt." Coffee 2002, *supra* Note 3, at 1802.

13. A foreign private issuer includes all foreign issuers other than foreign governments, excluding any foreign company with: (i) more than 50% of its shares are directly or indirectly owned of record by U.S. residents; and (ii) the majority of its directors or executive officers are U.S. residents or citizens, its business is principally administered in the U.S., or more than 50% of its assets are located in the U.S. 17 C. F. R. § 230.405, § 240.3b-4 (2000).

14. See Coffee 2002, *supra* Note 3 (discussing both regulatory competition and corporate governance standards).

15. Recognizing that countries organize based on varying economic, political, and social conditions, the adoption and implementation of international accounting standards lie with the developed countries of the world. The developed countries retain the resources necessary for the efficient operation of capital markets. For example, developed countries have the economic and legal structures in place to provide the liquidity, transparency, and integrity required by investors in equity markets. Many developing countries deal with unique struggles that consume their attention and drain their resources, leaving their economic and legal systems inefficient and lacking. Companies from developing countries, however, look to the markets of the developed nations to provide strong disclosure and corporate governance regulations. Companies enter the established capital markets of the developed countries to "bond" their commitment to full disclosure and governance standards that protect minority shareholders attached to such established capital market systems. The developed nations therefore act as suppliers via capital markets and are in the best position to standardize the language of disclosure through the adoption and implementation of international accounting standards. See Coffee 2002, *supra* Note 3, at 1780–1783.

16. http://www.sec.gov/about/whatwedo.shtml.

17. *Id*.

18. Securities Act of 1933, 15 U. S. C. § 77a-aa (2000). See also Roberta S. Karmel, Will convergence of financial disclosure standards change SEC regulation of foreign issuers? *Brooklyn J. Int'l L.*, *26*, 485, 488–489 (2000).

19. Report of the Senate Committee on Banking and Currency, *S. Rep. No*. 73-47 at **??** (1933).

20. Securities Exchange Act of 1934, 15 U. S. C. § 78a-mm (2000).

21. *S. Rep. No*. 73-1445, at Note 34 (June 16, 1934) (statement of Richard Whitney, Feb. 28, 1933, National City, pt. 6, pp. 2233–2234).

22. Smith, *supra* Note 6, at 768.

23. Exchange Act Release No. 34-412 (Nov. 6, 1935). See also Bevis Longstreth, A look at the SEC's adaptation to global market pressures, *Colum. J. Transnat'l L.*, *33*, 319, 320–324 (1995).

24. Securities Act Release No. 6962 (Oct. 15, 1992).

25. 15 U. S. C. § 78l (2003).

26. Longstreth, *supra* Note 23, at 323–324.

27. 17 C. F. R. § 239.31-.34,.36 (2003) (with reference to the following forms: F-1, F-2, F-3, F-4, and F-6). See also Smith, *supra* Note 6, at 770.

28. 17 C. F. R. § 249.220f (2003).

29. Smith, *supra* Note 6, at 770.

30. *Id*. at 772. See also Geiger, *supra* Note 4, at 256–262.
31. 17 C. F. R. § 230.901-05 (2003).
32. 17 C. F. R. § 230.144A (a)(1) (2003).
33. Geiger, *supra* Note 4, at 261–262.
34. *Id*.
35. 17 C. F. R. § 210.4-01(a)(2) (2003).
36. Securities Act Release No. 6902 (July 1, 1991).
37. Smith, *supra* Note 6, at 774.
38. *Id*.
39. Simplification of registration and reporting requirements for foreign companies; Safe harbors for public announcements of unregistered offerings and broker-dealer reports, Securities Act Release No. 7,053, [1993–1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,331, at 85,206 (Apr. 19, 1994).
40. Exchange Act Release No. 34-41014 (Feb. 2, 1999); Securities Act Release No. 33-7637 (Feb. 2, 1999). See also Smith, *supra* Note 6, at 776.
41. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) [hereinafter Sarbanes-Oxley].
42. The role of the board of directors in Enron's collapse, S. Rep. No. 107-70, at 1–2 (2002) at http://www.senate.gov/%7Egov_affairs/070902enronboardreport.pdf.
43. Global to restate most 2001 results, *L. A. Times*, Oct. 22, 2002 pt. 3 at 2.
44. Elizabeth Douglass, Firm says move would erase $19 million in revenue. Analyst calls news "anticlimactic," *L. A. Times*, Oct. 22, 2002, pt. 3 at 2.
45. WorldCom, *The bankruptcy data source*, Oct. 25, 2002, at 1.
46. Monica Roman, WorldCom: The rot keeps spreading, *Bus. Week*, Nov. 18, 2002, at 47.
47. SEC charges WorldCom with $3.8 billion fraud commission action seeks injunction, money penalties, prohibitions on destroying documents and making extraordinary payments to WorldCom affiliates, and the appointment of a corporate monitor, Litigation Release No. 17,588 (June 27, 2002) at http://www.sec.gov/litigation/litreleases/lr17588.htm.
48. Bankruptcy filing rise to a record, *Newsday*, Dec. 31, 2002, at A55.
49. *Id*.
50. Roel C. Campos, Remarks at the International Institute for Enforcement and Market Oversight, (Nov. 4, 2002) in http://www.sec.gov/news/speech/spch110402rcc.htm.
51. *Id*.
52. Sarbanes-Oxley, *supra* Note 41, §§ 101–109.
53. *Id*. §§ 201–209.
54. *Id*. §§ 301–308.
55. *Id*. §§401–409.
56. *Id*. §§ 802–807, 902–905.
57. *Id*. § 306 (a "blackout period" refers to a time of more than three consecutive business days during which the ability of certain individuals to transfer the companies securities is temporarily suspended).
58. *Id*. § 806.
59. *Id*. §§ 701–705.
60. Wayne Kirk, Sarbanes-Oxley Act of 2002: Application to Foreign private issuers with securities registered under the 1934 Act, August 8, 2002 at http://www.thelenreId.com/articles/article/art_135.htm.

61. Andrew Hill & Andrew Parker, Tyco considers HQ move to "end doubts," *Financial Times*, Oct. 7, 2002, at 18.
62. *Id*.
63. Canute James, Home from home: Corporate inversions: Offshore incorporation is a delicate issue, *Financial Times*, Nov. 22, 2002, at 5.
64. Hill & Parker, *supra* Note 61.
65. Moreover, Congress will likely modify the U.S. tax laws that currently create an incentive for corporate inversion. See Edward Alden, Congress wrestles with corporate rules, *Financial Times*, Jan. 6, 2003, at 5.
66. S. Rep. 148-103, July 25, 2002 (comments of Senator Enzi).
67. Campos *supra* Note 50.
68. See Leasco Data Processing Equip. vs. Maxwell, 468 F. 2d 1326, 1335–1337 (2d Cir. 1972). See also John C. Coffee, The future as history: The prospects for global convergence in corporate governance and its implications, 93 *Nw. U. L. Rev*., 641, 690 (1999) [hereinafter Coffee 1999].
69. Schoenbaum vs. Firstbrook, 405 F.2d 200 (2d Cir. 1968).
70. *Id*.
71. *Id*. at 205. See also Stephen J. Choi & Andrew T. Guzman, The dangerous extraterritoriality of American Securities Law, 17 *Nw. J. Int'l L. & Bus*., 207, 216–222 (1996).
72. Schoenbaum, 405 F. 2d at 205.
73. *Id*. at 206.
74. *Id*.
75. *Id*.
76. See generally Choi & Guzman, *supra* Note 71.
77. See Coffee 1999, *supra* Note 68, at 690.
78. See SEC roundtables on the international impact of proposed auditor independence and attorney conduct rules, Dec. 17, 2002 at http://www.connectlive.com/events/secroundtables/ (roundtable discussions sponsored by the SEC including comments by representatives of foreign countries on the conflicts arising from imposition of Sarbanes-Oxley on foreign issuers); Sarah Laitner & Bob Sherwood, SEC to Hear Foreign Groups' Concerns on Sarbanes-Oxley, *Financial Times*, Dec. 17, 2002 at 12 (explaining some of the comments by international lawyers and auditors at the roundtable discussion regarding the application of Sarbanes-Oxley to foreign firms); Japanese Business Federation, Comments on the proposed rules for implementing Section 407 of the Sarbanes-Oxley Act of 2002, File No. S7-40-02, Nov. 29, 2002 at http://www.sec.gov/rules/proposed/s74002/hendo1.htm (calling for reexamination of the application of certain provisions of Sarbanes-Oxley to foreign firms and including an appendix calling for exemption for Japanese corporations from provisions of Sarbanes-Oxley); United Breweries Company, Inc., Comments on Securities and Exchange Commission proposed rule: Disclosure required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002, Nov. 28, 2002, in http://www.sec.gov/rules/proposed/s74002/dltimmermann1.htm; Organization for International Investment, Comments of organization for international investment on S7-39-02, November 27, 2002 in http://www.sec.gov/rules/proposed/s73902/tmmalan1.htm (outlining the conflicts of law arising from the imposition of Sarbanes-Oxley on Chilean corporations).
79. *Cong. Rec*., *148*, 103 (2002) (statement of Sen. Enzi).

80. Final Rule: Standards relating to listed company audit committees, Securities Exchange Release No. 33-8220, 17 C. F. R. Parts 228, 229, 240, 249 and 274 (Apr. 9, 2003) available at http://www.sec.gov/rules/final/33-8220.htm.

81. SEC proposes listing standards rule, adopts investment company exemptive provisions at 3 Jan. 8, 2003 at http://www.sec.gov/news/press/2003-1.htm.

82. See *Id*.

83. Sarbanes-Oxley Act § 106.

84. *Id*. § 106 (a) (2).

85. *Id*. § 106 (b)(1).

86. *Id*. § 106 (b) (2).

87. *Id*. § 106 (c).

88. *Id*. § 301(1)–(2).

89. *Id*. § 301(3).

90. *Id*. § 301(4).

91. *Id*. § 301(3)(B).

92. *Id*. § 301(3)(C).

93. See *supra* Note 78 and accompanying text.

94. See *supra* Note 80, at 26–31.

95. *Id*.

96. *Id*.

97. Sarbanes-Oxley Act § 302(a).

98. See *Id*. § 302(a)(1)-(6) and final rule: Management's reports on internal control over financial reporting and certification of disclosure in Exchange Act periodic reports, SEC Release Nos. 33-8238, 34-47986 (June 5, 2003).

99. 18 U. S. C. §1350 (Supp. II 2002).

100. Sarbanes-Oxley Act § 302 (b).

101. *Id*. § 306 (a)(1).

102. *Id*. § 306 (a)(4).

103. Wayne Kirk, Sarbanes-Oxley Act of 2002: Application to foreign private issuers with securities registered under the 1934 Act, at 6 (Aug. 8, 2002) at http://www.thelenreId.com/articles/article/art_135.htm. See also Sarbanes-Oxley Act § 306 (a)(5).

104. Sarbanes-Oxley Act § 306 (a)(2).

105. Kirk, *supra* Note 103, at 6.

106. Final rule: Insider trades during pension fund blackout periods, Securities Act Release No. 33-47225, 17 C. F. R. §§ 240, 245, 249 (Jan. 22, 2003) available at http://www.sec.gov/rules/final/34-47225.htm. The final rule outlines the following conditions to initiate international application:

(1) If the number of participants and beneficiaries located in the United States in individual account plans maintained by a foreign private issuer who are subject to a temporary trading suspension in issuer equity securities exceeds 15% of the number of employees of the issuer worldwide (and the concurrent 50% test is satisfied), the issuer will be considered to have a sufficient presence in the United States for purposes of applying the Section 306(a) trading prohibition to the issuer's directors and executive officers.

(2) If the number of participants and beneficiaries located in the United States in individual account plans maintained by a foreign private issuer who are subject to a

temporary trading suspension in issuer equity securities does not exceed 15% of the number of employees of the issuer worldwide but exceeds 50,000 participants and beneficiaries (and the concurrent 50% test is satisfied), the issuer will be considered to have a sufficient presence in the United States for purposes of applying the Section 306(a) trading prohibition to the issuer's directors and executive officers.

(3) If the number of participants and beneficiaries located in the United States in individual account plans maintained by a foreign private issuer who are subject to a temporary trading suspension in issuer equity securities does not exceed 15% of the issuer's employees worldwide and is 50,000 or less participants and beneficiaries (even if the concurrent 50% test is satisfied), the issuer's presence in the United States will be considered sufficiently small so that its directors and executive officers will not be subject to the Section 306(a) trading prohibition.

107. See SEC roundtables on the international impact of proposed auditor independence and attorney conduct rules, Dec. 17, 2002 available at http://www.connectlive.com/events/secroundtables/

108. See *supra* Notes 78–81 and accompanying text.

109. Sarbanes-Oxley, *supra* Note 41, § 201 (g).

110. *Id*.

111. Final rule: Strengthening the Commission's requirements regarding auditor independence, Securities Act Release No. 33-8183, 17 C. F. R. §§ 210, 240, 274 (Jan. 29, 2003) available at http://www.sec.gov/rules/final/33-8183.htm, [hereinafter Final rule: Auditor independence].

112. *Id*.

113. *Id*.

114. Sarbanes-Oxley Act § 201(b).

115. *Id*. § 202 (1)(A).

116. *Id*. § 202 (1)(B).

117. *Id*. § 202(3).

118. *Id*. § 203.

119. *Id*.

120. Final rule: Auditor independence, *supra* Note 111.

121. *Id*.

122. *Id*.

123. *Id*.

124. Sarbanes-Oxley Act § 203.

125. Final rule: Auditor independence, *supra* Note 111.

126. *Id*.

127. *Id*.

128. Sarbanes-Oxley Act § 206.

129. See *Id*.

130. Final rule: Auditor independence, *supra* Note 111.

131. *Id*.

132. *Id*.

133. Sarbanes-Oxley Act § 307.

134. *Id*.

135. Final rule: Implementation of standards of professional conduct for attorneys, Securities Act Release No. 33-8185, 17 C. F. R. § 205 (Jan. 29, 2003) available at http://www.sec.gov/rules/final/33-8185.htm.

136. *Id*.

137. *Id*.

138. See SEC roundtables on the international impact of proposed auditor independence and attorney conduct rules, Dec. 17, 2002 available at http://www.connectlive.com/events/secroundtables/.

139. Vincent Boland & Andrei Postelnicu, LSE hopes to take business from New York, *Financial Times*, Dec. 5, 2002 at 21.

140. See *Id*. (pointing to Benfield Group, a reinsurance company that switched its plans for an initial public offering from New York to London due to the "unattractive environment" in the U.S.); Vincent Boland & Andrei Postelnicu, NYSE fears loss of foreign listings, *Financial Times*, Dec. 5, 2002 at 16.

141. Sarbanes-Oxley Act § 401 (a). This provision applies to all Form 20-F and Form 40-F reports. It also applies to any foreign issuer that chooses to file financial statements on Form 10-K, Form 10-Q, and Form 8-K reports. Since firms "submit" Form 6-K to the SEC, rather than "file" the form, this provision does not apply to financial statements furnished under cover Form 6-K.

142. *Id*.

143. *Id*. § 401(b)(1). Pro forma financial information highlights the important areas of a company's financial reports, and is communicated by the company usually through a press release. According to a warning by the SEC, " 'pro forma' financial results aren't prepared using GAAP, and they may not convey a true and accurate picture of a company's financial well-being. They often highlight only positive information. And because 'pro forma' information doesn't have to follow established accounting rules, it can be very difficult to compare a company's 'pro forma' financial information to prior periods or to other companies." Securities and Exchange Commission, Pro-forma financial information: Tips for investors (Dec. 4, 2001), available at http://www.sec.gov/investor/pubs/proforma12–4.htm.

144. Sarbanes-Oxley Act §401 (b)(2).

145. See id §401.

146. See final rule: Conditions for use of non-GAAP financial measures, Securities Act Release No. 33-8176, 17 C. F. R. §§ 228, 229, 244, 249 (Jan. 22, 2003) available at http://www.sec.gov/rules/final/33-8176.htm. The SEC final rules included the adoption of a new disclosure regulation, Regulation G, as well as an amendment to Item 10 of Regulation S-K. Regulation G requires public companies that disclose or release non-GAAP financial measures to include a presentation and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. Foreign firms qualify for exemption from Regulation G under the following conditions: (1) the securities of the foreign private issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States; (2) the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with generally accepted accounting principles in the United States; and (3) the disclosure is made by or on behalf of the foreign private issuer outside the United States, or is included in a written communication that is released by or on behalf of the foreign private issuer outside the United States. Correspondingly, foreign private issuers will be subject to the same requirements as domestic issuers

with respect to Regulation S-K and the use of non-GAAP financial measures in filings with the Commission on Form 20-F. Filers on Form 40-F under the MJDS, however, are not subject to compliance with the new requirements of Regulation S-K. The SEC acknowledged possible conflict of laws by permitting a non-GAAP financial measure in a Form 20-F that would otherwise be prohibited as long as the measure is: (1) required or expressly permitted by the standard-setter that establishes the generally accepted accounting principles used in the foreign private issuer's primary financial statements and (2) included in the foreign private issuer's annual report or financial statements used in its home country jurisdiction or market. *Id*.

147. Final rule: Disclosure in management's discussion and analysis about off-balance sheet arrangements and aggregate contractual obligation, Exchange Act Release No. 33-8182, 17 C. F. R. §§ 228, 229, 249 (Jan. 27, 2003) available at http://www.sec.gov/rules/final/33-8182.htm#IIIG.

148. *Id*.

149. *Id*.

150. *Id*.

151. Geiger, *supra* Note 4, at 262.

152. *Id*. at 265.

153. *Id*. at 266.

154. *Id*. at 259.

155. Coffee 1999, *supra* Note 68, at 674.

156. *Id*. at 673–74.

157. *Id*. at 675–76.

158. *Id*. at 676.

159. *Id*. at 679.

160. Geiger, *supra* Note 4, at 269.

161. *Id*. at 270.

162. *Id*. at 271.

163. *Id*. at 273.

164. *Id*. at 274.

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166. *Id*. at 274–275.

167. See *Id*.

168. Frank H. Easterbrook & Daniel R. Fischel, Mandatory disclosure and the protection of investors, *Va. L. Rev*., *70*, 669, 673–674 (1984).

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176. *Id*. at 290.

177. *Id*.

178. *Id*. at 291.

179. *Id*. at 290–291.
180. See *Id*.
181. *Id*. at 291.
182. *Id*.
183. See *Id*. at 290–292.
184. Smith, *supra* Note 6, at 773–774.
185. Geiger, *supra* Note 4, at 271.
186. *Id*.
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188. Marc I. Steinberg & Lee E. Michaels, Disclosure in global securities offerings: Analysis of jurisdictional approaches, commonality and reciprocity, *Mich. J. Int'l L.*, *20*, 207, 254 (1999).
189. *Id*.
190. *Id*. at 252.
191. *Id*.
192. See *Id*. at 253–255.
193. *Id*. at 255.
194. Smith, *supra* Note 6, at 774.
195. See Pistor, *supra* Note 174, at 103–105 (discussing the debate on competition vs. convergence and including some arguments for convergence through International Accounting Standards).
196. *Id*.
197. *Id*.
198. *Id*.
199. Smith, *supra* Note 6, at 777.
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210. Smith, *supra* Note 6, at 775.
211. *Id*.
212. *Id*.
213. Grossfield, *supra* Note 208, at 332.
214. *Id*. at 315.
215. King, *supra* Note 202, at 316–317.

216. Harvey L. Pitt, Remarks at the Financial Times' conference on regulation and integration of the international capital markets (Oct. 8, 2002), available at http://www.edgar.sec.gov/news/speech/spch588.htm.

217. See Luis E. Lopez & Edward B. Roberts, First-mover advantages in regimes of weak appropriability: The case of financial services innovations, *J. B.* Research, *55*, 997 (2002) (finding important market share advantages to early entry in financial services innovations).

PART III:
PERSPECTIVES

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THE ECONOMIC ROLE OF THE AUDIT IN FREE AND REGULATED MARKETS: A LOOK BACK AND A LOOK FORWARD

Wanda A. Wallace

ABSTRACT

In 1980, The Economic Role of the Audit in Free and Regulated Markets *described market evidence, how the demand for auditing services can be explained and predicted by agency, information, and insurance dimensions, by-products of the audit, the nature of the audit process, and the effects of regulation. In 1987, research since 1980 was described and discussed as to implications for future research. In 2004, the time has arrived to look back and look forward to reassess the body of evidence accumulated since 1987 regarding key sources of demand for the audit, supply issues, and regulatory activities, while offering a roadmap for future inquiry.*

INTRODUCTION

The Economic Role of the Audit in Free and Regulated Markets was written over two decades ago to articulate the theoretical framework in which demand, supply, and regulation have influenced the audit. In 1987, in the inaugural issue of *Research in Accounting Regulation*, I revisited the original work in light of subsequent developments in my article entitled "The Economic Role of the Audit in Free and Regulated Markets: A Review" (Vol. 1, 1987, pp. 7–34). I am pleased to have the

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opportunity to do so once again. Other than the 1930s, there may be no other time in history that has accorded such attention to our accounting profession. One might suggest that during the 1990s, a combination of technological advances, a hot market, and scarce human resources combined in a manner that clouded traditional demarcations between public accounting firms and consulting firms. Demand for information systems predictably "reached out" to the information specialists who speak the language of business – accounting – to help in the design and implementation of technological resources that would be relied upon to manage the business and prepare financial statements and information required by generally accepted accounting principles, securities regulators, and other third parties. As they did so, the public accounting firms began hiring professionals who had not followed the traditional educational track of an accounting major, which had always included an understanding of the professional obligations of a certified public accountant. A "bright line" had always existed between a client relationship and a public obligation. Indeed, the attractiveness of public accounting firms to purchasers of information system and consulting services was acknowledged, in part, to be their candor, directness, objectivity, independence, and long-term accountability. Unfortunately, as the technological and market-related demand functions grew, the public accounting firms blurred into consulting firms through hiring, training, promotion, and compensation practices that apparently could and should have accorded more attention to the traditional hallmarks of the profession throughout their practice.

Individually, many of us recoiled as we heard assertions made that "auditing was a commodity" or that "auditing was a loss leader" and that the only manner in which the "best and brightest" would be attracted was via other professional endeavors beyond the attestation services. All of those assertions were signs of a problem that should and could have been corrected by the profession on a timely basis that might have avoided the high profile debacles that have been attributed, in part, to shortcomings of the audit community. The fact of the matter is that auditing is a profession that is highly tailored to context by necessity. It ought to be priced to reflect risk and to ensure effective audit scope. Any individual who fails to find an audit both interesting and challenging simply fails to understand the essence of the audit process. The reality is that an auditor must understand the economic entity being audited, be able to explain the information systems and technological infrastructure in which information is generated, recorded, aggregated, and interpreted, and skeptically consider the interplay of inherent, control, and detection risk factors that involve a combination of controllable and uncontrollable elements including the ingenuity of the human race. The eclectic nature of the typical professional's portfolio of audit clients, the ability to bring to bear industry experiences from a cross-section of client settings, and the number

one obligation to the public combine to make the profession both admirable and fulfilling. Recent events have proven once again the importance and value of the attestation function. The steps taken by the public accounting firms toward the audit function also clearly speak to the central role, importance, and primary product position of the audit.

The objective of this analysis is to provide added perspective on the auditing research that has taken place since 1987, to reflect once again on how the Wallace (1980) monograph could be updated to describe more effectively our current understanding of the audit function. In like manner to my earlier review, to facilitate the integration of this update into the materials developed in the original monograph and in Wallace (1987), this analysis is organized into ten parts corresponding to the ten chapters of the monograph. In other words, familiarity by the reader with the original monograph (available on the Internet) or the concepts developed therein is assumed, although care is taken to make this treatment lucid as a stand-alone contribution. Particular focus is placed on lines of inquiry for future research and the manner in which the sections can be linked to provide an integrated picture of the auditing environment.

THE MARKET EVIDENCE

Regulatory change in Canada permitted an investigation (Rennie et al., 2003) of the question: what happens when previously required audits are no longer mandated? Specifically, on June 14, 1996, mandatory filing of audited financial statements for large private corporations was removed. The proportion of companies choosing to continue the audit (73%) is consistent with that of earlier research looking at the demand for auditing in other contexts that permitted choice. The complement of approximately one-quarter of the deregulated companies either purchased lesser levels of assurance services or no assurance services after the change in legislation. Most reached for a review engagement rather than an audit; these former auditees and others referred to materiality, internal auditors, role of the parent company audit, and cost savings as considerations in their choices. Of interest is the observation that the explanations for continuing audits tied to lenders' requirements (over a third), parent company requirements or that of owners (about 30%), and information credibility (about 17%). These clearly dovetail with agency and information theory, as well as the insurance hypothesis. Importantly, the message is loud and clear that the elimination of regulation in no way eliminates demand for audits. Yet, the elimination of a "one size fits all" regulation does result in market adjustments of the package of monitoring and bonding mechanisms used by entities. The public good loss from the private savings is

evidenced by the result that the financial statements are no longer on public record and stakeholders such as employees, labor unions, special interest groups, and members of the public no longer can readily access financial statement information for these economically significant companies.

Future research should explore whether alternative public information sources evolve for such entities and whether any of these entities migrate back toward attestation services. For example, we could hypothesize that an elimination of a regulation may result in rewriting of future contracts to invoke certain requirements at a transaction level. Of related interest is the observation that the number of public company registrants in the United States has declined from approximately 10,500 in 1999 to below 9,000 by the end of 2002 (Huron, 2003). Movement overseas has likewise been reported (Zielenziger, 2003), at a time when corporate governance questions are being raised globally (*The Economist*, 2003).

Beyond the market evidence pre-regulation, in unregulated sectors (Abdel-Khalik, 1993; Barefield et al., 1993), and in the international community (Chow et al., 1988; Roussey, 1992), a new strain of evidence on demand for audits has emerged, associated with transaction-based contracts and pools of investors. In particular, special-purpose entities (SPEs) and what have been dubbed "variable interest entities" (VIEs) by the Financial Accounting Standards Board are legal entities that may not be consolidated into a single company's financial statements (see Batson, 2003 for a discussion of those involved in the Enron debacle). As a result, these economic entities in which various parties have risks and returns have been a testament to free-market demands by capital providers for varied attestation services. The SPE type of organization often isolates certain cash flow streams with fiduciaries' involvement and contractual specification of controls and property rights. The scope of reporting and control, as well as related discretion, is tailored to the special-purpose nature of the entity (Beckett, 2003). The use of multiple funds has evolved in the investment management industry – with a single holding company often having over 100 funds. The investment management industry decentralizes its funds and often uses third-party entities for numerous operating responsibilities. They have decentralized boards and managers.

Outsourcing of services of these organizations as well as diverse governmental units from local to federal levels has grown. Attendant to this phenomenon has been attestation of third-party providers – service organizations – and negotiation of diverse "rights to audit" clauses.

Anecdotal accounts of control practices, fiduciary responsibilities, tailored legal letters and attestations merit systematic inquiry to assess the degree to which audits, reviews, compilations, or other CPA services are accessed in the comparatively unregulated sector that has evolved from outsourcing, SPEs, VIEs,

and similar financing/hedging vehicles. The parent company's audit role identified in the Canadian research raises questions of materiality assessment relative to private company ownership, as well as related to unconsolidated entities such as VIEs. Manry et al. (2003) provide evidence that timely quarterly reviews increase the likelihood that accounting earnings reflect economic events contemporaneously with returns. Such research suggests that both the review engagement – distinct from the audit – and the timing thereof influence the market for attestation services.

AGENCY THEORY: THE STEWARDSHIP (MONITORING) HYPOTHESIS

Price protection by principals was arguably undercut by stock options' lack of measurement through the 1990s (Bear Stearns, 2003; Fraser et al., 1998). A combination of diverse compensation committee practices and composition, non-shareholder-approved option plans, large dilutive grant practices, and repricing reactions to stock price erosion has been cited as reflecting the adage "unmeasured is unmonitored." The millennium has embraced corporate governance reform as essential to stewardship.

The relationship of the independent audit and entities' boards of directors historically has been seen as a means of monitoring management. Yet, both the U.S. and other countries have struggled with the definition of independent directors, the pros and cons of financial interests by directors, the distinction between external and internal as well as independent and non-independent, and the definition of so-called gray directors (Byrd & Hickman, 1992; Vicknair & Carnes, 1993). The form of corporate governance such as use of audit committees varies as a joint product of practice and regulation (Cravens & Wallace, 2001; Deloitte, 2003). Bradbury (1990) reports that New Zealand voluntary audit committee formation is related to directors' incentives and in particular the number of directors on the board and intercorporate ownership. Of interest, is an absence of relationship with either auditor incentive variables (defined as a Big Eight auditor) or agency cost variables – note that audit committees were not a political issue in New Zealand and the country has a low litigation environment with neither contingency-based legal fees nor class action privileges. Yet even with favorable home country legal environments, research suggests that foreign companies are named in class action suits: 15 in 2001, 22 in 2002, and 13 through November 3, 2003 (PricewaterhouseCoopers Foreign Securities Litigation Study, 2003).

Ng and Tan (2003) design an experiment and find that precise standards and effective audit committees may be compensating mechanisms that enhance

auditor effectiveness, bolstering auditors' positions during negotiations with clients (also see Beattie et al., 2001; Gibbins et al., 2001; Libby & Kinney, 2000). Internal control and bribery associated legislation and international guidance likewise varies (Heimann, 1996; Internal Control Working Group, 1993; Vanasco, 1999). Williamson (2002) has extended his work in transaction economics, providing ideas on how to use the lens of contract to understand economic phenomena. Specifically, private ordering "entails efforts by the immediate parties to a transaction to align incentives and to craft governance structures that are better attuned to their exchange needs" (Williamson, 2002, p. 172). Literatures on property rights, mechanism design, agency theory, transaction cost economics, and incomplete contracting are all cited as relevant. He explains that adaptation to the unforeseen, strategic behavior and opportunism, mitigation of prospective contractual impasses, and breakdowns including refusals of cooperation, maladaptation, and demands for renegotiation (p. 174) are dimensions of transactions. Needs exist to evaluate verifiability or the lack thereof in light of potentially idiosyncratic knowledge, and to be aware that agents are not passive but rather react to controls, creating both intended and unintended consequences, and at times leading to costly and uncertain dispute resolutions in alternative forms. The issue of verifiability ties directly to the role of attestation and control processes and incentives relate to system design and monitoring, as well as their influence on behavior. How these practices can serve to facilitate contracting, mitigate disputes, and adapt to change merit both analytical and empirical study.

A key assertion has been a need for greater expertise on boards, particularly on audit committees. Moreover, mandated internal control reports (an idea debated since 1979) and certifications by CEOs, CFOs, and various members of the Wall Street community have been adopted as monitoring and bonding requirements for certain public companies. Future research will doubtless explore whether expertise in the form of a CPA differs in effect from that of CEOs – a controversial synonym for financial acumen adopted at the last phase of the reform. Whether certifications will be an effective bonding mechanism – given their boilerplate form lacks information – is an unanswered question. A plethora of research questions can be posed as to whether such required boilerplates have unintended consequences: risk-taking deterrence, shifting of decision making from full-time managers to part-time directors, liability imposition that affects the pool of talent accessible, or excessive reliance by users who may liken such representations to audit certification by independent third parties (Schroeder, 2003; see McDaniel et al., 2002 for related experimental evidence). The evolution of "best practices" and various proposals merit study (e.g. Breeden, 2003). Of particular interest is whether they influence monitoring effectiveness, including interactions with the auditor.

Depending on how such bonding interrelates with incentives, stewardship could be enhanced. For example, information reports via an assortment of 1099s are provided to the Internal Revenue Service by businesses and their mere existence appears to motivate greater taxpayer compliance (Wallace & Wolfe, 1995; also see Davis et al., 2003 for modeling of the interaction of enforcement practices and compliance). Baber (1990) proposes that use of municipal accounting and auditing practices derive from relationships between incumbents and their prospective competitors rather than with their constituents. Essentially, game theory is used to model the idea that if competition exists, an incumbent able to costlessly and perfectly disclose his or her pre-election actions can resolve uncertainties affecting a competitor's decision to compete. The premise of the essay is that political markets differ from other markets since political entrepreneurs profit only by attracting a coalition of interest groups that is sufficient to win an election, whereas in profit settings, appealing to a small segment of a market can be sufficient. A coalition is deemed likely to expect post-election actions of an incumbent to be predictable from pre-election, meaning transparency is achieved through voluntary disclosure practices. Note that the actions being communicated may not map to constituencies at large but instead be focused on interest groups. The implication is that the agency theory characterization of politicians and their constituents does not map from the profit sector, due to the peculiarities of political markets. Yet, similar to price protection being averted by agents through bonding and committing to monitoring activities, competition can be averted through release of information by the incumbent.

THE INFORMATION HYPOTHESIS

Information theory contends positive reputation, signaling, and homogeneity of service quality can help to address asymmetry of information concerns by capital providers (Elliott & Jacobson, 1994; Moore & Ronen, 1990). Evidence on the interplay of information and cost of capital is provided in Conover and Wallace (1995). Evidence has been reported, consistent with lower interest cost being incurred by those entities in six countries – Italy, Spain, Australia, Germany, France, and the United Kingdom (as well as a hold-out sample from Canada) – that have selected Big 5 auditors (Wallace, 2002). Examples of trademark and reputation effects on markets are observable in initial public offerings (Beatty, 1989; Simunic & Stein, 1987 – both cited in working paper form in my 1987 review; Balvers et al., 1988; Beatty, 1993; Datar et al., 1991; Feltham et al., 1991; Jang & Lin, 1993; Menon & Williams, 1991 – focusing on trading volume; Clarkson & Simunic, 1994; Hogan, 1997) and bankruptcy (Menon & Williams, 1994).

Auditors' reports that are modified before bankruptcy provide protection from litigation. The idea is that timely modified reporting has a defensive role for auditors, suggesting an interaction between information content and legal exposure (Carcello & Palmrose, 1994). Frost (1997) finds evidence that firms' managements are forthcoming about adverse developments when receiving first-time modified audit reports during the 1982–1990 time frame in the United Kingdom. Yet, these same managers are reported to be overly optimistic on the future, although the markets discount such positive tones. Skinner (1994) likewise explores incentives for bad news voluntary disclosure practices. An interesting wrinkle stemming from Sarbanes-Oxley is the report that in April 2003, 14% of 89 surveyed Fortune 1000 companies were considering no longer providing earnings guidance to analysts (Schroeder, 2003, p. C7). The absence of such alternative sources of information may affect the content and timeliness of attestation-associated reporting mechanisms and their related demand function. Becker et al. (1998) explain that regulators and financial statement users appear more concerned with aggressive application of GAAP than with conservative application, meaning that the former – characterized as opportunistic – has more signaling problems with auditor independence. Such skewness has tension with the stated neutrality intent of reporting and interacts with auditors' loss functions. Additional research on the implications for signaling is warranted.

Beattie and Fearnley (1995) identify eight uncorrelated audit firm dimensions of importance to companies selecting their auditor, with the top four being reputation/quality, acceptability by third parties, value for money, and ability to provide non-audit services. Such research raises the question of whether proscription of certain non-audit services will alter the competitive edge of particular firms and thereby affect their demand function. In a sense, information demands by clients reach far beyond financial statement presentations, yet they are increasingly constrained from accessing their auditor's firm to address such needs if they are public companies. The American Institute of Certified Public Accountants (AICPA, 2003) is at work on the earlier Jenkins report initiative to explore nonfinancial information: how it should be reported, its quality, transparency, usefulness, and overall reliability, and linkage to attestation services. The Special Committee on Enhanced Business Reporting is addressing what it describes as the five elements of enhanced business reporting: system reliability, corporate accountability, understandable disclosures, information dissemination, and financial and non-financial measures. The issue of recurring earnings reports in the form of pro forma announcements has been the focus of debate (Wallace, 2002) and regulation. Researchers can assist in exploring these questions as well as the consequences of past and future practices (e.g. Young, 2003 discusses how "net debt" language – debt minus cash and cash equivalents on hand – has replaced total debt in companies' discussion of their debt load).

THE INSURANCE HYPOTHESIS

Insurance theory posits that stewardship considerations of agents and "deep pocket" advantages (i.e. potential loss recovery) of larger firms combine to create demand for Big 5 auditors (Lennox, 1999; Melumad & Thoman, 1990). The legal framework for audit liability as evolving in recent cases is discussed by Gormley et al. (2003) who observe that the incidence of $100,000,000 and greater pre-trial settlements negotiated by CPA firms may affect future liability. Researchers ought to identify means of systematically exploring this growing set of "black boxes" to sort out determinants of the "fight or settle" decision of firms (extending such work as Palmrose, 1991, 1994 and Lys & Watts, 1994 who investigate whether joint and several liability encourages settlements of non-meritorious cases; also see Latham & Linville, 1998). Data bases such as that provided in Palmrose (1999) can inform such future analyses. Many argue that the environment engendered by the Enron debacle has deterred fighting, as have the "David and Goliath" odds faced when government resources are unleashed.

The advent of enforcement actions involving audits by large public accounting firms citing a single auditor as culpable (SEC, 2003a) may influence the nature of professional partnerships' operations in the future. For example, how will partners be comfortable relying on their colleagues and professional staff, if at the end of the day, they are held solely responsible for debacles? How can an engagement partner be seen as culpable for missing that which was likewise missed by a concurring partner? In what sense does an audit team *share* responsibility, if at all? Such considerations can influence incentives and behavior, meriting future research attention.

A dimension of the insurance hypothesis relates to "insurance from blame" by the political sector. The Congressional creation of the Public Companies Accounting Oversight Board, under the auspices of the Securities and Exchange Commission (SEC), but independent in structure is indeed a shift from self-regulation of the profession. Yet, the requirement of no voting CPA members and acknowledgment that advisory groups of professionals will be needed to prescribe auditing guidance permits the shifting of blame, should another debacle arise. Indeed, the retention of the Financial Accounting Standards Board as the independent promulgator of generally accepted accounting principles (GAAP) likewise permits politicians to retain a "trump card." An interesting development in the Department of Treasury (2003) has been the promulgation of a final rule that authorizes Agencies, if there is good cause to do so, to remove, suspend, or debar accountants from performing audit services under its Section 36 requirements that insured depository institutions with total assets of $500 million or more obtain both an audit and an attestation concerning internal controls. This creates a similar "trump card" for these agencies in terms of shifting blame, but

likewise changes the market enforcement mechanisms that can sanction public accounting firms.

Much debate has occurred as to how Sarbanes-Oxley (2002) will affect capital markets, global competition, information quality, and legal liability. Predictable reactions to the tort reform of 1995 were addressed by further reform in 1998, and debate continues on means of limiting unintended consequences of malpractice litigation and alternative legislative solutions. Research suggests that U.K. firms cross-listed on U.S. markets incur audit fees reflecting risk differences across liability regimes, i.e. higher fees than non-U.S. capital market firms (Seetharaman et al., 2002) – in contrast to evidence in Canada (Anderson & Zeghal, 1993), Hong Kong (Gul & Tsui, 1998), New Zealand (Johnson et al., 1995) and Norway (Firth, 1997a, b) of little or no support for litigation-adjusted audit fees. Also see Gietzmann and Quick (1998) and Taylor and Simon (1999). The consequences of both the Treasury ruling and Congressional legislation of the past and related actions in the future merit monitoring and analysis by the research community.

Analytical models consider the relationship of auditing standards, legal liability, auditor wealth (Dye, 1993; Schwartz, 1997) and incorporation (Dye, 1995). Strategic auditor behavior in terms of effort exerted and its association with strategic errors is considered in Lee and Gu (1998) who consider low balling, liability, and auditor independence. Auditor choice has been modeled as a signal of audit quality in valuing new issues (Datar et al., 1991). Experimental markets research has explored how institutional settings, such as alternative negligence liability rules and reputation formation, can affect the quality of audit services (Dopuch et al., 1997; King, 1996; Wallin, 1992 – who report the lowest settlement frequencies in joint and several allocation settings and the most adverse effects on defendants' wealth; Dopuch et al., 1994; Gramling et al., 1998; King & Schwartz, 1998, 2000; Zhang & Thoman, 1999 – who explore pre-trial settlement dimensions; Pae & Yoo, 2001 – who also consider internal controls). Grant et al. (1996) find that voluntary self regulation in multi-person coalitions can provide incentives for sustaining high quality services. Such research must continue, hopefully informing legislators *before the fact* of likely outcomes of proposed changes.

PRODUCT ATTRIBUTES OF THE AUDIT

Covaleski et al. (2003) use latent content analysis to explore how competing factions legitimated a transformation of jurisdictions toward outsourcing of internal auditing services. These factions included exchanges among the Big Five, the AICPA, the IIA, the SEC, and the U.S. Congress. Lemon and Wallace (2000)

discuss the ethical issues associated with internal auditing – particularly outsourcing. An unanswered question includes: why did the profession not circumscribe its own involvement in outsourced internal audits for its own audit clients? No dearth of warning signals existed, yet even the SEC stopped short of such proscriptions until Sarbanes-Oxley. Reportedly, internal auditing has become involved in the review of the Form 10-Q in 40% of a survey of 89 of the Fortune 1000 sized companies in April of 2003, relative to the September 2002 level of involvement reported of 27% (Schroeder, 2003, p. C7). This portends a shift of internal auditing resources toward the financial reporting function, implying less operational audit emphasis – the traditional focus. This apparent change, in tandem with the newly created internal audit departments across corporate America, call for further research as to their costs and benefits. Product attributes may likewise be altered by the increased attention to internal control, stemming in part from widely publicized shortcomings associated with high-profile debacles (Kirkpatrick & Lockhart, 2003).

How auditor independence is affected by the provision of varied non-audit services is considered in experimental research by Mauldin (2003) as a basis for concluding that the General Accounting Office's principles-based approach to limiting non-audit services may be preferable to the standards-based approach used by Congress and the SEC. Chung and Kallapur (2003) find no statistically significant association between abnormal accruals and any client importance measures that consider nonaudit fees and firm revenues, including tests of samples partitioned based on corporate governance and auditor expertise considerations. Past research reports no association exists between firms' going concern opinions and the magnitude of nonaudit services; however, a positive association is observed between the likelihood of issuing a going concern opinion and audit fees (DeFond et al., 2002 – see Chen & Church, 1992, for a description of the relationship of going concern opinions to default). Carcello and Neal (2003) find that audit committees with greater independence and governance expertise – as well as lower stockholdings – are more effective in shielding auditors from dismissal after a going-concern modification is initially issued. Future research will have a new environment to explore certain expectations: will the Big Four merely "trade" client portfolios, will rotation of auditors prescribed by the SEC as reaching to "other auditors" affect CPA firm cultures and/or performance, and how will audit committee approval requirements influence usual product attributes? Will synergies be lost to clients from unavailability of certain services? All of the Big Four continue to offer certain consulting services, although three have sold or divested portions of their consulting businesses – PricewaterhouseCoopers to International Business Machines Corp. and Ernst and Young to Cap Gemini Group SA, with KPMG becoming BearingPoint (GAO, 2003b, p. 9). The effects

of such firm changes and the comparison of these firms' strategies to that of Deloitte and Touche will provide a research opportunity to better understand the interplay of consulting services with the provision of the audit.

The manner in which the audit is performed may have implications for legal liability. In an experiment, Lowe et al. (2002) find that jurors' propensity to hold auditors liable decreases when such auditors rely on decision aids (Scott & Wallace, 1993) thought to be highly reliable, even when they were ineffective in the particular circumstances (also see Anderson et al., 1995; Eining et al., 1997).

INFORMATION ECONOMICS

A key vein of research has considered the quality of information and its association with enforcement actions and audit practices. The accruals research has attempted to define discretionary accruals and distinctions between expected and unexpected accruals in a manner that proxied quality (Bartov et al., 2000; Beneish & Press, 1997; Dechow et al., 1995, 1996; DeFond & Subramanyam, 1998; Francis et al., 1999; Francis & Krishnan, 1999; Geiger & Raghunandan, 2002; Heninger, 2001; Jiambalvo, 1996). Others have considered the relationship of specific types of adjustments to reported earnings, comparing recurring items to nonrecurring components (UBS, 2003). Yet, real challenges arise in the empirical proxies, including their meaning within industry and specific company settings. The empirical complexities of the questions posed have begun to be explored, such as the apparent preferability of cash flow inputs, relative to balance sheet measures. Future research should study reliability measured more finely, with attention to the overall effects of rapidly changing accounting measures and business practices. Audits reduce measurement error in information used in monitoring (Eilifsen & Messier, 2000; Kinney & Martin, 1994). Fineness, bias, and noise are elements of proxies that require like attention to ensure the information quality of research findings (Ashbaugh et al., 2003 explain that reported results by others are sensitive to research design choices, leading to erroneous inferences; also see Kinney & Libby, 2002 and Klein, 2002; Bell & Wright, 1995, describe examples of effective collaboration of practice with research and education).

Assertions that preparers have gamed accounting standards has posed questions of whether auditors are permitted to focus on substance rather than form. Kadous et al. (2003) through experimental research suggest that changes in regulation requiring auditors to make quality assessments of accounting methods will lower objectivity of auditors, thereby having the opposite effect to that intended. Recent changes to accounting for variable interest entities (VIEs) may offer an

example of how the standards, when revised, nonetheless, fail to achieve their described purpose. Many view the FIN 46 as a move to place onto balance sheets what would otherwise be off-balance sheet financing vehicles, such as special purpose entities (SPEs). FASB (2003) states "The objective of this Interpretation is not to restrict the use of variable interest entities but to improve financial reporting by enterprises involved with variable interest entities." Yet, the media has explained that banking entities with as much as $55 billion in SPEs are working to restructure with additional outside investors' dollars in order to maintain off-balance-sheet arrangements (Goldstein, 2003; also see Bryan-Low, 2003). Future inquiry is needed as to how the principles and rules distinction in standard setting (Burns, 2003; SEC, 2003b) has influenced the auditability of financial statements in line with substance relative to form (Schuetze, 2003 – see Nelson et al., 2002). Moreover, the emphasis on intent within certain standards (Wallace, 1999) has been cited as precluding an ability to independently audit certain facets of management representations (Wallace, 1992). How information quality has been affected by standards that have auditing implications merits study.

Pricing of audits has continued to be explored. Smieliauskas (1996) points out the inconsistency of archival findings on individual countries' experiences to date regarding litigation risk and audit pricing (Simunic & Stein, 1996). Most of that literature has focused on a single country at a time (e.g. Woo & Koh, 2001). Big 5 brand name premium over non-Big 5 auditors averages around 30% (a finding inconsistent with an analysis of UK fees in 1900 (Matthews & Peel, 2003)); audit fee literature is reviewed and the agency cost basis for expecting quality-differentiated audits is described, as is the cost-benefit framework for determining optimal audit quality choice from among monitoring mechanisms (Craswell et al., 1995). Banker et al. (2003) explain that merger and acquisition activities among accounting firms increased profitability in the last half of the 1990s – attributing this to favorable economies of scale and pointing out that partners contribute nine times more to generating revenues than professionals and about 20 times more than other employees. The relationship of partner compensation to judgments by partners is explored by Trompeter (1994).

Copley and Doucet (1993) find a negative association between competitive bidding and audit fees, as do Raman and Wilson (1992) and Ward et al. (1994). Low-balling's association with independence is explored by Schatzberg and Sevcik (1994) – also see Craswell and Francis (1999). Raman and Wilson (1992) do not observe lower fees in the initial audit engagement or the two years following, but do find that independent auditor reports on legal compliance (internal controls) significantly affect audit fees. Hackenbrack et al. (2000) find audit fees in Florida cities exceed fees of municipalities in seven other southeastern states

and characterize the evidence as consistent with better auditor performance in the Florida government setting. They point to the audit restriction on bidding creating an emphasis on auditors' qualifications, thereby enhancing audit quality in the local government audit market. Deis and Giroux (1992) report a direct relationship between oversight agency quality review and audit effort as measured by hours. Deis and Giroux (1996) explore the relationship of auditor changes (also see Eichenseher et al., 1989), audit fees, audit hours, and audit quality. Johnson et al. (2003) report that audit hours and fees are higher for audits of local governments in Florida than in other states and draw the inference that the quality of local government audits in Florida is greater, though at higher cost. They likewise find similar effort on government clients by Big Six and non-Big Six firms. Audit pricing and its relationship to independence is modeled by Magee and Tseng (1990) – also see Beck et al. (1988) for a treatment of audit tenure and management advisory services.

The interaction of fees and risk is further explored by Pratt and Stice (1994) who examine their relationship with likelihood of litigation. Walker and Casterella (2000 – also see Ettredge & Greenberg, 1990) find that discounting of new engagements continues in 1993, similar to the earlier 1980 evidence and that profitability influences fees, with loss clients not provided discounting. They infer that firms change their business practices in response to risk through portfolio management.

THE SUPPLY OF AUDITS

Audits can be supplied by diverse firms, at differential prices, reflecting distinctive risk profiles, and having unique adaptations to regulatory processes. An example of one characteristic explored in past research relates to industry specialization (Hogan & Jeter, 1999). Gramling and Stone (2001) reviews archival research into the industry specialist characteristics of auditing firms. Velury (2003) finds that the quality of the audit is partly a function of auditor industry expertise, although context-specific. Beasley and Petroni (2001) report that industry specialists perform better audits and other researchers link industry-specialist audit firms to higher fees in Australia (Craswell et al., 1995) and Hong Kong (DeFond et al., 2000). Ferguson et al. (2003) demonstrate that the pricing of industry expertise in Australia is primarily based on office-level industry leadership in city-specific audit markets (24%), rather than being driven by national standing (also see Francis et al., 1999). Stein et al. (1994) describe industry differences in the production of audit services. The nature of how audits are performed has received vast attention (see Wallace, 1995 for extensive citations, as well as Anderson & Koonce, 1998; Elder & Allen, 2003; Kreutzfeldt & Wallace, 1995).

Client acceptance decisions are described by Asare et al. (1994) and Johnstone (2000), as simultaneously affected by client business risk, audit risk, auditor business risk, and risk adaptation behavior (also see Johnstone & Bedard, 2003; Walo, 1995). O'Keefe et al. (1994) explain that a client's financial condition can affect audit risk and vice versa. The relationship of pre-engagement factors with lawsuits is described by Stice (1991). Bloomfield (1995) investigates strategic interactions and audit reliance. Kinney and McDaniel (1993) empirically describe the delay that accompanies firms' correction of quarterly earnings. Wallace (2000) discusses lessons from Cendant. These types of research contributions explain how key events of a client interact with both risk and the audit process (GAO, 2002; Kreutzfeldt & Wallace, 2000 – this analysis of restatements has spawned numerous working papers and will add insight as to how such events interact with the market and the attestation process; as one example, see Wallace, 2004).

One of the regulations to which firms have adapted is required "cold reviews." Matsumura and Tucker (1995) report an economic rationale for concurring partner reviews with an analytical model and, in turn, test the implications using experimental economics in Tucker and Matsumura (1997) to find a reduction in reporting bias when a concurring partner is involved. Schneider et al. (2003) find that the degree of concurring partners' agreement with an engagement team's conclusion was unaffected by prior involvement in audit planning; in other words, the objectivity of the concurring partner appears unaffected, suggesting that such consultation does not detract and might be beneficial. Leuhlfing et al. (1995) report a lack of agreement as to the second partners' role in the review process, as well as significant differences in their extent among the large CPA firms. Evidence regarding workpaper preparation and reviewers' responses is reported by Tan and Trotman (2003; also see Tan & Jamal, 2001, regarding the interaction of perceived competence with the evaluation of subordinates' work).

The profession's responsibilities to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, increasingly broaden attention to sources of information, particularly to fraud risk factors. The Committee of Sponsoring Organizations (COSO, 1999) provides archival evidence as to the profile of entities identified as fraudulent reporters, including the nature of more common problems – also see Bonner et al. (1998). These permit a debriefing process that can enhance the audit process (*Report and Recommendations*, 2000) – however, consideration of auditor and auditee interaction is also essential (Newman et al., 2001).

Domestic auditing standards can vary in terms of the requirements for achieving certification and performing an audit (Magill et al., 1998), as well as the steps

required by the auditor regarding such primary aspects of the audit as planning materiality (Price & Wallace, 2001) and risk assessment (COSO, 2003). Krogstad and Smith (2003) provide evidence that research has continued to build on core inquiries concerning error characteristics, litigation, audit methods, and auditors' reasoning in such areas as materiality and risk assessment. With the advent of the Public Companies Accounting Oversight Board (PCAOB), it is possible that a public/private generally accepted auditing standard (GAAS) dichotomy will be created, with standards being promulgated by multiple bodies – creating complexity and a lack of comparability as two apparent by-products (e.g. PCAOB, 2003). McEnroe and Pitman (2003) argue that a jurisdictional claim – the claim before the public for the legitimate control of a particular work – by the Auditing Standards Board has resulted in standards being promulgated that define the services over which the profession has been granted a monopoly, and likewise result in a legal defense. They propose a reorganization toward an independently funded, full-time board and argue that past concurrent membership by firm representatives had resulted in firm rather than individual points of view driving voting patterns, in order to legitimize respective audit firm approaches. Research should evaluate the theoretical, analytical, and empirical ramifications for markets of a proliferation of diverse auditing standards for private and public markets, as well as the potential alternative of a single standards setter being recognized to design a single GAAS framework. The role of international auditing standards should likewise be integrated with that research agenda. The advent of Parmalat – an Italian dairy-foods giant – debacle, apparently involving $12 billion in missing assets, $4.9 billion of which was supposedly held in a bank account determined nonexistent, has raised numerous questions about the manner in which primary auditors work with other firms, outside of their home country. In addition, questions have been raised as to the actual execution of such core audit procedures as the confirmation process (Edmondson & Cohn, 2004; Norris, 2003) – see Wallace (1998) for a relevant earlier discussion.

Not only must firms adapt their audit technology (Manson et al., 1998) to changing standards and regulatory processes, the entire labor market must likewise adapt (Mian, 2000). Provisions of quality reviews, limited liability and continuing class (whereby a second class of licensed accountants is recognized beyond the CPA license, easing entry to the services sector) appear to have induced entry of accountants into the professional services sector, while quality review and limited liability appear to be positively associated with self-employment (Schaefer & Zimmer, 2003). Laboratory market experiments suggest that audit quality and pricing are associated with the timing of the peer review process, suggesting that such timing affects an auditor's willingness to provide consistent high quality services (Payne, 2003). State Boards' regulation of the profession is discussed by

Colbert and Murray (2003), suggesting that a relation exists between an outcome of a Colorado sunset review and the political ideology of the governor, as well as the interaction between the regulated profession and the regulators. A description of the profession, its legal, regulatory, and social environment, as well as the marketplace for CPA services is provided by Magill et al. (1997). Peer reviews do not appear to affect the amount or price of credit that loan officers extend to potential borrowers (Schneider & Ramsay, 2000), although their confidence in both the auditor's report and the financial statements is enhanced. A number of measures of audit quality are reported to be associated with peer reviewed firms (Deis & Giroux, 1992; Krishnan & Schauer, 2000).

As with any time of change and debate, a number of proposals for change have appeared in the literature, such as the Healy and Palepu (2003) suggestion that the stock exchanges take over the contracting of auditors for all public companies listed. There is a certain irony to such a proposal, in light of the later call by Securities and Exchange Commission Chairman William Donaldson for the New York Stock Exchange to provide "full and complete" details on its $140 million pay package to New York Stock Exchange Chairman Richard Grasso, and his subsequent resignation, as it has raised questions about the way in which the exchange is governed and how funding and operations of its regulatory program might be affected (Reuters, 2003). Nonetheless, the research community should be vigilant to appraise proposals as they appear, carefully analyze their respective benefits and costs, and inform decision makers, lest hasty change create larger problems themselves than they are intended to address.

A LOOK AT REGULATION

Legitimacy theory describes a systems orientation that permits the enterprise to be influenced by and, in turn, to influence the society in which it operates (Taylor et al., 2001). Legitimacy theory recognizes an implicit social contract between enterprises and their broad constituency in society, including community expectations embracing ethical norms, informed consent ideas buttressed by the right of exit, and widely acknowledged rights (Taylor et al., 2001). The aim of enterprises has been described as legitimizing behavior through managing perceptions of stakeholders through educational efforts as well as information exchange. Sheikh and Wallace (2003) describe the comment letter process of the certification requirement associated with Sarbanes-Oxley – as an illustration of one type of information exchange common in today's regulatory setting. The implications of legislative and SEC rulings such as the prohibition on misleading auditors, new "buckets" for disclosure of fees paid to the auditor, prohibitions on compensation

of audit team partners based on non-audit services, prohibitions on employment of audit team members by clients, working paper retention guidance, and required rotation of the audit engagement team members have been discussed theoretically, but an empirical pre/post setting now exists for researching actual consequences – similar to early evidence concerning Regulation FD (Fair Disclosure) (Heflin et al., 2003). Myers et al. (2003) find prior to the Sarbanes-Oxley legislation, longer auditor tenure, on average, was associated with higher earnings quality, suggesting auditors placed greater constraints on extreme management decisions in the reporting of financial performance. Such results are consistent with the role of expertise in continuing audit engagements and should cause regulators to pause as to the advisability of further expansion of the rotation concept (GAO, 2003d). Indeed, the "bare-bones" audit term that evolved in the governmental sector as a real cost that led to less effective controls in public entities has been attributed to mandatory auditor rotation in that sector of the economy. Earlier analysis of voluntary auditor changes suggested that audit quality can be enhanced by permitting clients to switch to more efficient providers (Johnson & Lys, 1990 – also see Francis & Wilson, 1988); historical evidence on early policies on rotation of auditors is provided by Zeff (2003). Learning from history and considering ill effects of well-intentioned proposals are important domains for the research community.

Wallace (2000) articulates China's regulation and development of the profession. Wallace (1997) addresses multiple auditors' use in Scandinavia. Monsen and Wallace (1995) describe the harmonization effort in Nordic countries, associated with both accounting and auditing developments. An important metamorphosis in the market place is toward international harmonization. Efforts to describe, understand, anticipate, and analyze consequences of such change are important research tracks. In understanding challenges to harmonization, a research question of interest is why has the National Association of State Boards of Accountancy (NASBA) not yet achieved alignment of state standards for certification, and will recent changes by some of these Boards make such nationalization of the certification more difficult? The Sarbanes-Oxley Act has a number of provisions involving foreign registrants that raise questions about whether the Commission's historical deference to the home countries of foreign private issuers still apply and what effects on the market the apparent changes might have.

In addition to diverse standards across borders, differing standards exist across sectors of the economy. The GAO (2003a) Government Auditing Standards expand the definition of performance auditing to include prospective analysis and add attestation as a separate type of audit, and adopt what has been characterized as a substance over form and principles over rule guidance on independence – explaining that "Auditors should avoid situations that could lead reasonable third

parties with knowledge of the relevant facts and circumstances to conclude that the auditors are not able to maintain independence and, thus, are not capable of exercising objective and impartial judgment on all issues associated with conducting and reporting on the work." (p. 15, para. 3.04). Government auditors have expressed some concern as to how to proceed with operational audits and yet respect the essence of para. 3.04, suggesting that the effects of such evolving standards warrant evaluation, as to their consequences. A look backward may also be informative: why did the Public Oversight Board choose to disband, in what ways is the PCAOB similar or dissimilar from this former body, what are the implications of the PricewaterhouseCoopers independence-associated SEC censure and did the firm's clients experience a market penalty, how have clients of Andersen been affected by the elimination of that firm's auditing services, and were the tax-related services to executives as well as those involving tax shelters by auditors' firms examples of advocacy and/or imprudence?

Campbell and Parker (1992, p. 297) analyzed the 415 SEC releases associated with enforcement actions from 1972 to 1989 and found a consistent SEC conclusion "that the primary purpose of the independent audit is to enhance the efficiency of the capital markets and help protect the investing public by providing reasonable assurance concerning the integrity of the financial statements and related disclosures." Audit failures asserted were tied to auditors' judgments and the gathering of audit evidence, as well as the relationship with management – either over-reliance on management or deception by management. Related party transactions were cited in 37% of the actions examined. This likewise permeates the international scene (Landler, 2003 observes Parmalat is not unusual in that Germany, France, and other countries' companies are often controlled by families or have close ties to the state). A line exists between allegations and reality, and research must recognize the import of settlement practices that "neither admit nor deny." Future research ought to consider exploring how initial complaints compare to legal outcomes as a means of improving understanding of regulators' enforcement actions.

Fines are ordered for violations of securities and futures laws, to help ensure the accountability of violators and to deter future violations. The GAO (2003c) describes the 1997 to August 2002 fines imposed and collection rates – for example, open and closed cases involve levies by the SEC of $480,375,353 (p. 21, Table 2), 40% of which was reported to have been collected. The magnitude of such fines creates questions of their role in deterrence and the incentive effects linked not merely to violators but likewise to regulators (Bayot, 2003; Jones & Wallace, 2003; Maremont & Solomon, 2003). For example, if a problem is permitted to fester and lead to a large debacle, such as Enron and WorldCom, is it the case that much larger fines can be imposed as a revenue source for government

regulators? Could such a scenario create a conflict of interest in the discharge of day-to-day responsibilities such as the timely review of 10-K filings? If governmental funding relies on such sanctions (Wallace, 2003), what mechanisms exist to ensure some fairness in computing penalties and disgorgement amounts? These questions merit consideration.

Regulators have also made demands that accounting firms be penalized by banning them from accepting new audit clients for a period of time, such as six months (Glater, 2003). In a market with four remaining worldwide public accounting firms (GAO, 2003b – four firms audit more than 78% of all public companies and 99% of all public company sales, p. 25) this type of sanction may have unintended consequences for the larger market. The Sarbanes-Oxley Act increased the maximum penalty for mail and wire fraud to ten years, making the tampering with corporate records a crime. Moreover, any officer certifying a report that does not conform to the requirements of the Act faces a fine of not more than $1 million and a sentence of not more than 10 years in jail or both (Schroeder, 2003). How these adjustments of available penalties will affect behavior and the market place are important subjects for inquiry.

SUMMARY

Williamson (2002) calls for the development of a theory capable of prediction that incorporates asset specificity, disturbances, frequency considerations, associated costs and competency of alternative governance structures including reputation effects and contract law regime, and when hierarchies are used. Such hierarchies are described to weaken incentives, yet extend controls, facilitating the exercise of fiat that cannot be achieved in markets. Increasingly, our economy involves bilateral dependencies, meaning that the identity of parties matter, as does the continuing of the relationship; this departs from the concept that an instantaneous exchange (MacKie-Mason & Varian, 1994) at equilibrium price between faceless buyers and sellers is the primary market of interest. Indeed, the result of recognizing that simple market exchanges have been transformed into multiple-party long-term strategic alliances in diverse settings helps to explain the role of "credible contracting, which includes penalties for premature termination, mechanisms for information disclosure and verification, specialized dispute settlement procedures and the like." (Williamson, 2002, p. 176). The entire phenomenon of "partnering" has been at the heart of many controversies. The independence of auditors, the meaning of "arm's length transactions," the import of barter transactions, the asymmetry of accounting treatments among parties to a transaction, the assumption of risks and returns among such parties, and the nature

of the relationship between auditor and client are examples. A comprehensive predictive theory for when certain forms of governance, controls, auditing, and varied contractual mechanisms will be used – particularly in multiple-party settings – merits development and testing.

The depth and breadth of research since 1987 are impressive. Support for the market demand for auditing, ill effects of barriers to price protection, variations of political markets from economic markets, information attributes' influence on relevance, reliability, objectivity, and legal consequences, and the changing nature of attestation and nonaudit services have been evidenced. Joint consequences of legal, regulatory, and market forces are apparent. Yet, greater integration of the literature (as was suggested in my 1987 review, Exhibit 1) is required in order to effectively predict and explain.

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LAWYERS AS WHISTLE-BLOWERS IN A POST ENRON WORLD

Robert P. Lawry

ABSTRACT

A lawyer's claim that the principle of client confidentiality overrides the public's right to know in the wake of wide-spread and deep corporate malfeasance has raised new awareness and concern. The latest round of this debate began with the passage of the Sarbanes-Oxley Act of 2002. Section 307 of the Act required the Securities and Exchange Commission (SEC) to set forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission. The debate reached at least a temporary resolution in August, 2003, when the American Bar Association (ABA) amended key provisions of its Model Rules of Professional Conduct, conceding after a long and bitter battle, that its own rules had not been helpful in thwarting corporate greed – and that lawyers needed to play a more significant role when their clients defrauded the public out of countless millions of dollars. This review provides perspective on the issue and notes the various options and conditions involving client confidentiality in financial markets and other legal settings.

In the wake of the ENRON corporate scandals, and the others that followed in late 2001 and 2002, the popular press excoriated accountants, executives and boards of directors. Nevertheless, lawyers did not entirely escape criticism, at least from those who thought the silence of lawyers to be shameful in light of the

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vast economic harm done to the public. The lawyers' claim that the principle of confidentiality overrode the public's right to know about such wide-spread and deep corporate malfeasance was not convincing. Paradoxically, the smallish public debate about lawyer's ethics re-ignited a large and long-simmering debate within the profession concerning its role as whistle-blower in the public interest. The latest round of this debate began with the passage of the Sarbanes-Oxley Act of 2002. Section 307 of the Act required the Securities and Exchange Commission (SEC) to set forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission. The debate reached at least a temporary resolution in August, 2003, when the American Bar Association (ABA) amended key provisions of its Model Rules of Professional Conduct, conceding after a long and bitter battle, that its own rules had not been helpful in thwarting corporate greed – and that lawyers needed to play a more significant role when their clients defrauded the public out of countless millions of dollars. In what follows, I shall try to tell the story succinctly, but with some nod to the history of the often fractious debate among lawyers.

Sarbanes-Oxley also directed the SEC to promulgate two specific rules regarding lawyers. The first required an attorney to report evidence of a material violation of securities law or breach of fiduciary duty to the chief legal counsel or chief executive officer of the company. The second required the attorney to report the evidence of a violation of law or breach of duty to a designated committee of the board of directors or to the full board, if the counsel or officer does not appropriately respond to the evidence. Note that both specific rules dealt with disclosures within the corporation itself. Historically, the organized profession had not been very helpful to lawyers in matters of entity representation, and Congress, at least, thought more was needed. Notice, too, however, that Sarbanes-Oxley was silent about disclosures outside the corporation, except to direct the SEC to think about "minimum standards," which may or may not include true "whistle-blowing" provisions. Let me take up these two issues of inside and outside disclosures seriatim.

DISCLOSURES WITHIN THE ENTITY

Although the American Bar Association (ABA) passed its first code of ethics in 1908 (CANONS), and made a complete overhaul and format change in 1969 (CODE), it was not until the third substantial revision in 1983 (RULES) that drafters paid more than superficial attention to the special problems lawyers face in representing an organization rather than an individual person. Rule 1.13 of the RULES provided a variety of options for lawyers who knew that a person internal

to the corporation "is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization." One of the options provided was to take the information to a "higher authority" in the organization, even to the "highest authority that can act on behalf of the organization." If that "highest authority" (presumably the Board of Directors) illegally acts or refuses to act, thus causing "substantial injury to the organization," the lawyer "may resign." A lot is packed into this rule. Because lawyers often deal most directly with middle management or members of the in-house counsel staff, it was something of a jolt to be told they might seek to push beyond the level of reporting they were accustomed to, even to the CEO or the Board itself. Yes, they were at least technically aware their client was the organization, not any individual officer or other employee; however, they were often hired (or fired) by lesser folk, and they felt uncomfortable in going beyond the authority of those with whom they worked most directly. Nevertheless, it made sense to remind lawyers in no uncertain terms that going to the "highest authority" was an option, at least before resigning, presumably because there were some uncontrolled or uncontrollable illegalities going on "below." Although not specifically required to go up-the-ladder by their ethics rules, lawyers were criticized by judges in the Savings and Loan scandal cases of the 1980s for not moving beyond sometimes powerful CEOs to Boards of Directors in the face of suspected problems of fraud or mis-management.

The new SEC rules have changed this state of affairs for lawyers "appearing and practicing" before the SEC. When any of these covered lawyers become "aware of evidence of a material violation" of the securities laws, that lawyer is required to report such information to the chief legal officer of the organization or to the CEO or to both. If an appropriate response to the problem is not made, the lawyer is mandated to then report the matter to the audit committee or other independent committee of the Board or to the full Board itself. In the alternative, if the organization has set up a special "qualified legal compliance committee" under SEC rules, the lawyer has fully complied with his or her reporting mandate by reporting to that committee. These SEC rules will now force lawyers doing securities work to go up-the-ladder in a way not required before. Whether this will change the culture of lawyering more generally remains to be seen. It is likely to do so, especially given the historic changes to Model Rule 1.13, passed in August, 2003, by the ABA. It must be understood that the ABA Model Rules are not binding on lawyers. Each state passes its own set of ethics rules, but historically, the ABA's leadership has had an enormous effect on the state's rules. Under the new Rule 1.13, when the lawyer is faced with a problem of the kind described above, the lawyer is now required to go up-the-ladder, except in matters that can readily be handled below.

As the official comment has it, "ordinarily, referral to a higher authority would be necessary."

This amounts to a huge change in corporate culture for lawyers. The new dispensation calls for a new era of communication between lawyers and board members. Whether corporate executives will be pleased with this change is open to doubt. Some fear lawyers will consequently be squeezed out of the inner sanctum of corporate decision-making. Still, if the expectations of board members is that counsel is to be a "player," and a confidant to them as well as to management, it may be very difficult for even powerful CEOs to exclude lawyers. At least CEOs will have to think hard before attempting to exclude lawyers from key decision-making communications.

DISCLOSURES OUTSIDE THE ENTITY

Confidentiality is one of the core values for lawyers. Many believe it to be the most important value of all. Generally speaking, unless there is an explicit exception, all information that the lawyer obtains in representing a client is required to be kept in confidence by the lawyer. Justification for a strong rule in favor of confidentiality stems from the belief that clients will not be forthcoming in talking about sometimes delicate personal or important matters unless they are assured the lawyer will keep such information confidential. Unless they are forthcoming, clients cannot be helped. Law is an important public good; and access to law comes through lawyers. Therefore, a strong rule assuring clients of confidentiality is necessary. All the helping professions espouse a similar justification for their confidentiality rules. It is based on the need to help and client unwillingness to disclose necessary information without the promise of confidentiality. Despite this need for professional secrets, there are standard exceptions to the rule of confidentiality, which apply generally across professions. Philosopher Sissela Bok lists three: (1) when the client is incompetent, i.e. when the client is a child or someone mentally ill; (2) when the client's actions may be injurious to the client himself, i.e. when the client wants to commit suicide; or (3) when the client's actions may be injurious to others, i.e. when the client wants to physically assault someone. It is the third general exception which plagues the client fraud cases. More on that later. First, it is useful to point out that unique exceptions may also apply to client confidences because of the nature of the profession itself. For example, since the early days of the common law in England, there has always been an exception for the lawyer to disclose confidences to rectify the effects of perjury in a trial. This was because of the centrality of lawyers in preparing witnesses to testify; and because of the importance of the trial process itself in maintaining the integrity

of the legal system. The idea that a lawyer may not remain silent, when he or she knows perjury has occurred, is thus a long-standing ethical norm for lawyers – even if maintaining the norm requires a breach of confidence. This particular norm was challenged in the late 1960s by a brash young criminal defense lawyer and law professor, Monroe Freedman.

Freedman raised hackles on the necks of traditional lawyers by proclaiming that the lawyer's obligation of confidentiality took precedent over any obligation the lawyer had to any court to expose or to rectify client perjury. Then Circuit Court Judge, later Supreme Court Chief Justice, Warren Burger, wanted Freedman disbarred for espousing this position. There had been a consistent ethical tradition that forbade lawyers from allowing perjury to remain as a pollutant in any trial. Now Freedman said the tradition was wrong, and that most lawyers ignored it anyway, silently allowing perjured testimony to stand. As the dust of the debate settled over the draft of the 1969 MODEL CODE, the traditionalists seemed to have won. The CODE provided four discretionary exceptions to the normal obligation of the lawyer to maintain the confidences of his client "inviolate." These exceptions were also traditional:

(1) If the client consents.
(2) If a law or court order required disclosure.
(3) If the client intends to commit a crime.
(4) To allow the lawyer to defend against allegations of ethical or legal impropriety.

All of these exceptions were permitted, not mandated by the CODE. In other words, the lawyer was not bound by confidentiality in any of the situations described, but could exercise his or her unfettered discretion to disclose or not to disclose, as a matter of personal ethical judgment. It was assumed that most lawyers would disclose only in the most egregious cases, i.e. a felony involving serious bodily injury or substantial financial harm. However, the Code gave the lawyer complete discretion within the broad categories enumerated.

There was one more exception. This one was mandated. The relevant provision was DR7-102(B)(1), which stated the following:

> A lawyer who receives information clearly establishing that:
>
> His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal, shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal.

As widely understood, this provision captured both frauds before a tribunal (perjury) and any other fraud in matters wherein the lawyers' professional services were used. The policy reasons for such a rule were clear: (1) lawyers may not assist their clients in fraudulent activities; (2) if the client tries to engage

in fraud, the lawyer must refuse to help, either by remonstrating with the client, or, failing a change of heart by the client, by resigning from the representation; and (3) if the lawyer himself or herself was duped by the client too, or used by the client to dupe another, the lawyer, as a special officer of the law, had a mandatory duty to disclose the fraud to appropriate people in order to rectify the abuse of the legal system itself by the abuse of the lawyer's professional services.

Soon after the CODE was passed, it was amended in a confusing way. The following language was added to the end of the previously quoted DR7-102(B)(1) ". . . except when the information is protected as a privileged communication."

Despite awkward drafting and word choice, the ABA interpreted this except clause to negate not only the duty to disclose client fraud, but to prohibit the lawyer in most cases from disclosing client fraud, period. Since the original rule was written in the past tense, the idea was that the misuse of the lawyer's service by the client was an insufficient reason to breach the confidences of that client. Of course, if the fraud were criminal and were to occur in the future, the lawyer still had the discretion to disclose. The distinction between past and future criminal acts had deep roots in professional tradition. Moreover, the idea that perjury before a tribunal must not be allowed to stand also had deep roots. What was new and troubling to the bar was the idea explicitly introduced in the CODE that any fraud, accomplished through the use or misuse of the lawyer by a client, must be reported, even "past" frauds. Lawyer's services were equated with the trial process as fundamental to the effective working of the system of justice itself. It was argued that those services as well as that process should not be allowed to be corrupted. Rectification of the effects of the fraud on the court or on the persons affected must be made to assure the continued integrity of the system. Against this argument was a deeply held belief that confidentiality is so central to the lawyer-client relationship that even "lawyer abuse" could not support any additional exception to the confidentiality rules. Thus, the issue was joined.

Securities lawyers had been at the forefront of pushing for the 1974 amendment to DR7-102(B)(1). Fraud is a major concern in the securities industry, and throughout the 1970s, the battle raged. In the *NATIONAL STUDENT MARKETING* case (1978) a federal court upheld the SEC's claim that lawyers had violated the law in allowing a merger to be consummated when the lawyers knew that financial disclosures previously made and relied upon were inaccurate. The lawyers claimed that it was the client's decision whether or not to complete the merger under those circumstances; and the lawyer's ethical obligation was to respect client confidential information and permit the now fraudulent transaction to go forward. It was Monroe Freedman's position on perjury transferred to the world of transactions: even if fraud is discovered before the transaction is completed, client confidentiality trumps disclosure, despite the fact that silence allows substantial financial harm

to occur. Like Freedman's argument in the context of client perjury, however, the effort to privilege lawyer-client confidentiality over financial harm to third parties largely failed. This was not just because of cases like *STUDENT MARKETING*. The 1974 "except clause" was not accepted by most states. Thus, lawyers in most states were still mandated under the original version of DR7-102(B)(1) to disclose client fraud even after the fact. Nevertheless, there was a fallout because of the debate and the passage by the ABA and a few states of the 1974 "except clause." That fallout was incipient confusion. Suddenly, even the original version of DR7-102(B)(1) was re-interpreted, casting doubt on the obligation of lawyers to disclose in a variety of contexts. A need for clarification was widely felt.

A momentary clarification came after the debate intensified during the efforts of the ABA to change its ethics code once again. After acrimonious debate on many issues, the ABA passed its MODEL RULES in 1983, establishing very narrow exceptions to Rule 1.6, which, like its predecessor in the MODEL CODE, generally required confidentiality of all information relating to the representation of a client. Under Rule 1.6, the lawyer was permitted to reveal confidences:

(1) to prevent the client from committing a criminal act reasonably likely to result in imminent death or substantial bodily harm; or
(2) to establish a claim or defense on behalf of a lawyer is a controversy with the client or in any proceeding where the lawyer's conduct is an issue.

Under Rule 3.3 perjury was singled out as needing special treatment. The rule required the lawyer to disclose perjury when necessary to prevent a fraud on the tribunal even if it requires a breach of confidentiality. The duty lasts until "the conclusion of the proceeding." The narrowing of the number and the scope of the exceptions to confidentiality from CODE to RULES is stunning. Even future crimes of the client – a traditional exception – were not permitted to be disclosed, unless the crime involved "death or substantial bodily harm." Future crimes involving financial harm or fraud of any kind, other than perjury, were not permitted to be disclosed at all. A bone of an odd sort was thrown to defeated traditionists by a comment to Rule 1.6, which allowed a lawyer who withdrew from a representation to disclose "the fact of withdrawal" and to "withdraw or disaffirm any opinion, document, affirmation, or the like." This so-called "noisy withdrawal" provision allows a lawyer to distance himself or herself from any work done for a client that might be tainted by client fraud. It does not require disclosure as the original DR7-102(B)(1) did. In fact, it does not allow actual disclosure at all. It merely allows the lawyer to refuse to be used by a client in defrauding third parties. Of course, in one sense, the lawyer has already been mis-used by the client; but, at least, the lawyer can re-claim some lost integrity by distancing the lawyer's work product (and services rendered) from the client's fraudulent scheme. This

approach walks a fine line. It does not permit actual disclosure. It just refuses to force the lawyer to stand by and be mis-used for the client's illegal purposes.

What happened after the 1983 MODEL RULES were passed was very different from what had happened after the passage of the 1908 CANONS and the 1969 CODE. Previously, the states had acted quickly to adopt the document, and to adopt it nearly always as passed by the ABA. The road to the adoption of the MODEL RULES was longer and considerably rockier. First of all, state-by-state acceptance of the RULES went slowly. Even now, twenty years later, a handful of states have still not adopted the RULES. Most importantly, the confidentiality provisions were attacked and seriously modified in most states from the beginning of the adoption process. Very few kept the narrow exceptions to confidentiality provided by Rule 1.6. Most allowed for a more traditional "future crimes" exceptions. Many, too, permitted or required disclosure when the lawyer's professional services were misused. The result of this process is the astonishing fact that there is more diversity in the rules governing exceptions to confidentiality state-by-state than has ever been the case before. The situation is a disaster for lawyers who are licensed to practice in different states when they try to work together. It has undermined the idea of a unified profession, maybe undermined the idea of law as a profession altogether.

Fast forward to the aftermath of the ENRON scandal. With respect to exceptions to confidentiality generally, the SEC has adopted a rule which will permit (but not require) a lawyer to reveal information to the SEC itself to prevent fraud or perjury or to rectify the consequences of a material violation of securities laws in which the lawyer's services had been used. This comports with the ethics rules in many states after they rejected the narrowing of exceptions in the RULES. The SEC is presently still debating whether or not to require outside lawyers to resign and issue a "noisy withdrawal" if they reasonably believe fraud is on-going or will occur; or to have discretion to resign and issue a "noisy withdrawal" for past occurrences.

More significantly, the ABA has now fallen in line. In August, 2003, Rule 1.6 was amended to permit lawyers to disclose confidential information to outsiders either to prevent client crime or fraud or "to prevent, mitigate or rectify substantial injury to the financial interests or property of another" that has resulted from the client's improper behavior. In a draft report, a blue-ribbon ABA Task Force on Corporate Responsibility recommended that the disclosures be made mandatory, not permissive. That recommendation was reversed in its final report, and the ABA passed the permissive version. Thus, the debate seems to have been concluded with the ABA joining the majority of states in at least permitting lawyers to disclose crimes or frauds of their clients, which threaten sessions financial harm to the public. However the 1969 Code contained a mandatory disclosure

provision when clients defrauded persons or tribunals. How far have the lawyers actually come?

CONCLUSION

Since the “whistle-blowing” provisions are permissive, not mandatory, cynics will suggest nothing significant has happened. That may be true, but I think not for two reasons. First, the debate has now concluded with an overwhelming endorsement of the proposition that lawyer confidentiality cannot be used as an ethical principle that requires lawyer silence in the face of serious corporate wrong doing. Second, even if lawyers remain reluctant to disclose confidences to outsiders, the SEC rules and amended Model Rule 1.13 push lawyers into the board room of the corporation, where they are to be heard in the interests of the client itself. Of course boards of directors can also be corrupt, or can continue to be un-involved. There are signs that will not be the case, though others are more competent to speak to that issue than I am.

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PART IV:
BOOK REVIEWS

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ENRON: A Professional's Guide to the Events, Ethical Issues and Proposed Reforms

By Arthur L. Berkowitz. CCH Inc., Chicago, Illinois, 2002,
268 pages, $49.50. ISBN 0-8080-0825-0

Reviewed by Larry M. Parker
Case Western Reserve University

This book provides a quick overview of key facts and ethical issues related to the bankruptcy of Enron and the demise of Arthur Andersen (Andersen). The author's main purpose is to have the reader consider ethical issues and implications related to the Enron/Andersen collapse. The author is a CPA who often conducts ethics workshops, and the last part of the book provides the reader an opportunity to earn CPE credit. Each chapter of the book is followed by several multiple choice questions and a brief discussion question.

The book is organized into five sections. Section one describes the Enron/ Andersen scandal. The next section discusses various possibilities for change. The third section is devoted to ethical lessons to be learned. The fourth section consists of three Appendices provided documents from Enron, Andersen and ethics issues. The final section consists of CPE materials.

The first section contains three chapters that briefly describe the people of Enron, Andersen and Vinson & Elkins (the chief legal counsel firm for Enron) who were players in the scandal, and the sequence of key events. Generally, these chapters contain only very short discussions and analysis, but the coverage seems thorough. For example, this reviewer did not really understand why the Enron Treasurer, Ben Glisan, Jr., had not received the scrutiny of the other Enron executives. According the author, this is because Glisan has agreed to cooperate with the FBI and other criminal investigators. A short but interesting portion, titled "The Enablers," of the third chapter describes the political connections and influence enjoyed by Enron. Brief discussions of the Enron connections to the White House, Vice President Cheney and Senator Phil Gramm are included. This reviewer also found the discussion on the role of regulators interesting.

The second section contains three chapters that discuss possibilities for reforms related to the accounting profession, corporate governance, legal entities, the securities industry and broad social and political settings. This section was written

prior to the passage of the Sarbanes/Oxley Act, which could be a weakness of the book. However, the author provides a very succinct, thorough discussion of all the key issues related to the Sarbanes/Oxley Act. This is in contrast to most writings after Sarbanes/Oxley, which focus mainly on the implications of the act, not the broad range of underlying problems. Generally, the author avoids a preaching tone in this section, though he is certainly critical. For example, though Berkowitz is hard on the accounting profession, he states on page 62 that the profession consists of serious and honest people in search of serious and honest solutions, and cautions about solutions that invoke the Law of Unintended Consequences.

The third section contains the last two chapters of the book which discuss directly the ethical lessons related to Enron/Andersen. The author provides very brief, basic, applied ethical analysis. Those who desire deep, thoughtful analysis and ethical discussion are likely to be disappointed in this section. The author is focused directly on the specific, practical issues at hand. He concludes with his Seven Steps to Greater Ethical Behavior.

The fourth section has three appendices of documents related to Enron, Andersen and ethics. The warning memo from Sherron Watkins to Ken Lay and the memo from Nancy Temple to David Duncan are among the documents included. The CPE materials comprise the last section. Fifty multiple choice questions can be completed and mailed (with a fee) to receive CPE credit.

This is a no frills book that quickly provides the basic events and issues around the failure of Enron and Andersen. Discussion is broad and comprehensive, but does not provide much depth. It would be difficult to delve deeply into so many topics, since some topics could be (and often are) books in themselves. Fraud, for example, is presented in little more than a page of print (parts of pages 54 and 55). The timing of the book may seem unfortunate (prior to Sarbanes/Oxley), but the issues discussed in the book are extremely fundamental, have existed for a very long time, and are not likely to go away in the foreseeable future. I recommend this book to those who would like a good introduction to the Enron/Andersen events and issues, and particularly to those interested in ethical implications.

Financial Statement Fraud: Prevention and Detection

By Zabihollah Rezaee. John Wiley and Sons, Inc., New York,
2002, 315 pages, $65.00. ISBN 0-471-09216-9

Reviewed by Larry M. Parker
Case Western Reserve University

Professor Rezaee provides a very comprehensive discussion of financial statement fraud. The purpose of the book is to educate a broad audience about financial statement fraud and how to improve the quality, integrity and reliability of financial reports. The desire to reach a broad audience requires discussion of issues that may seem basic to readers who are already familiar with financial statement reporting and financial statement fraud. However, the book is very well organized, and provides a blend of conceptual and practical discussions that most readers will likely find very informative. All discussions are thoroughly referenced, and provide the reader with an extensive and useful list of relevant speeches, authoritative pronouncements, news articles and research papers.

The first two chapters provide the setting for the rest of the book by discussing financial statement fraud and financial reporting. All categories of fraud are presented, and financial statement fraud is clearly defined and distinguished from other types of fraud in the first chapter. The first chapter also presents the various estimates of costs of fraud (at least $400 billion a year), and estimates of the percentage of fraud detected (about 30%). The second chapter discusses the financial reporting process, including corporate social responsibilities related to financial reporting, and difficulties and deficiencies in reporting. The author also provides the "six legged stool" for quality financial reporting – top management, board of directors, audit committee, external auditors, internal auditors, and governing bodies. These six legs are the basis for most of the remaining chapters of the books, and are specifically addressed in detail in Chapters 6 through 12.

Chapters 3, 4 and 5 explain the general nature of financial statement fraud, the multitude of reasons for fraud, conditions that correlate to fraud, categories (taxonomy) of fraud, and specific methods (schemas) of fraud. Extensive use of charts, diagrams and other organizing tools (e.g. the 3Cs model – conditions, corporate structure/culture and choice) help summarize the multitude of topics. An excellent summation of important red flags adapted from the National Commission on

Fraudulent Financial Reporting (Treadway), SASs, and various research papers is presented in Chapter 5. The author also discusses prevention, detection and correction strategies, including conditions that can encourage whistle blowing.

The next seven chapters treats of general corporate governance and the six legs of the stool (mentioned in paragraph two above) as the essential components of corporate governance. Definitions, importance, roles, responsibilities, interrelationships, deficiencies/issues, and suggestions for improvements for all aspects of corporate governance are discussed in well organized detail. The juxtaposition of thorough analysis of all six areas helps the reader see how these areas check and balance each other when functioning well. Chapter 12, which covers governing bodies, is out of date since the book was completed before the Public Companies Accounting Oversight Board was established. However, the chapter is otherwise very informative.

Chapter 13 may be one of the most interesting chapters in the book for many readers. It presents issues for financial reporting in a digital environment. E-Commerce and its strategies (including possible effects on globalization) are discussed. Many difficulties and implications of EDGAR and XBRL, such as trust, security, and the possibility of continuous auditing are also included. The final chapter, fourteen, informs readers of the basics of fraud examination, including forensic accounting, and the role and education of Certified Fraud Examiners.

I believe this is an excellent book for those who wish to understand the breadth and depth of financial statement fraud. It also seems likely to be useful as a textbook or supplemental text for a course, such as advanced auditing, in which financial statement fraud and fraud detection are a component of the course.

Gangs of America

By Ted Nace. Berrett-Koehler Publishers, San Francisco, 2003, 285 pages, $24.95

Reviewed by Timothy J. Fogarty
Case Western Reserve University

The modern world would be distinguished from prior periods in many ways. One very important dimension of distinction is the advent of the corporation and the trajectory that this means of business organization has established for the economy and society. Ted Nance offers a monograph that through its subtitle, "The Rise of Corporate Power and the Disabling of Democracy" strongly signals its priorities and its normative positioning.

The basic objective of the book is quite straightforward. It seeks to explain how modern corporations got their power. In order to motivate this question, the extent of corporate power is documented in historical and present day perspective. The basic mechanism of the narrative is to show how corporations become embedded in the legal framework and the political infrastructure of the United States. As such it invites the reader to problematize that which most accept as a natural and necessary cornerstone of our current economic lives.

Students of the history of capitalism should enjoy this book. The author traces the medieval origins of the corporation to the guilds of the Middle Age and the colonial efforts of the European powers. As the stage moves to the U.S., the reader is treated to the tension that existed between the founding fathers' suspicions of chartered monopolies and the gradual increase in scale for economic enterprise. The railroads play a large role in this drama. The action comes to a head in the backdrop of the age of robber barons and continues to play out in the first few decades of the Twentieth Century as the modern framework of labor relations and economic regulations was formed. This is then telescoped to the very recent past with some treatment of the post-millennium crisis in corporate confidence and the backlash against globalization that will be very recognizable to most readers. The history is a worthwhile blend of the very familiar, the vaguely known, and the completely obscure.

In all likelihood, readers will find that this book adds more to their legal knowledge than anything else. The achievement of power that we witness today required the broad-based recognition of the premise that corporations

were persons under the constitution. This status allowed them to exercise their economic power in ways that could not be easily controlled by state and local regulation. This argument requires the author to offer an assessment of the key law cases that created an important turnaround. This ranges from "the story behind the story" that features the people who were instrumental in shaping the law to brief reproductions of the actual language of the legal opinions that had lasting impact. Compared to the shifting of the law, the economic and the managerial dimensions are not well developed. Readers will not find much economic determinism (a la Karl Marx) or captains of industry (the "great men" histories) here. Nonetheless, the author's choices are good. Since a fine line exists between economic crime and business as usual, the law requires serious attention.

No review of the book would be complete without mentioning the author's effort to explore the moral issues. Why is that corporations, comprised of honorable people, persist in immoral actions that harm people and the world? The author suggests that the answer lies close to the way that we define what a corporation is, with inconsistent notions about its ability to form intentions and to have a conscience comparable with human beings. I do not think that the author achieves complete success in nailing the accountability question. Yet, most readers will appreciate the effort, and what they find might stimulate more work on this quite neglected point.

The organization of the book is mostly chronological. This makes it easy to read strategically if one's purpose is limited. I found the middle chapters to be the best work. In this area, the author provides an analytical assessment of the primary dimensions of the regulation over corporations that had to be relaxed or destroyed for them to achieve their current stature. In a chapter entitled "Judicial Yoga" the author very successfully uses legal precedent to show how the legal person issue was turned upon its head. The last few chapters are the least successful. A foray into Enron et al. territory and into the current globalization debates seemed ill-advised. The book does not really offer any coherent ideas for reform, and therefore ends on a disappointing note.

In addition to text that runs slightly over 220 pages, the book provides several other features. One paragraph summaries of about a dozen legal cases are provided for easy reference. The 14th Amendment to the Constitution is reproduced in its entirety for those that have dim memories of high school civics. The book also provides a bibliography and about fifteen pages of notes to the text. The author has wisely eschewed the heavy footnoting so typical of legal writing.

Although many readers will find the implications of this book controversial, the discourse is not polemical nor is the analysis what most would consider radical. The author does not appear to have an implicit "ax to grind" in asking us to reexamine where we find ourselves. The author has worked in the regulatory apparatus of the federal government, but also spent many years as a successful

petty capitalist, prior to becoming a freelance author. The book possesses an evenhanded tone that is not designed to inflame a reasonable person, although it is a bit too light to convince a die-hard skeptic.

The book is recommended to a very general audience. The author does not demand that the reader come to the book with a much more than a basic appreciation of U.S. institutions. One does not have to be a lawyer to understand the author's treatment of the law, nor does one have to be a social philosopher to appreciate the larger picture that the author occasionally draws upon. In fact, I suspect that the deeper the reader's expertise, the less they would benefit from reading this book. For example, a historian might dismiss the book as lightweight. Nonetheless, the book is a quick read that adds value for the rest of us that are so fascinated with the current day that we have allowed the past to recede into the dimness.

The Mind of Wall Street

By Leon Levy with Eugene Linden. Public Affairs, New York,
2002, 221 pages. $26.00. ISBN 1-58648-103-7

Reviewed by Timothy J. Fogarty
Case Western Reserve University

If you are like most of us, you are still trying to make sense out of the recent stock market bubble and burst. You might try reading *The Mind of Wall Street* to ease the trauma caused by the most recent report of your declining market portfolio. Leon Levy has contributed a very enjoyable, very approachable memoir of his life as a trading professional.

The book is only partly an autobiography. It uses many of the facts of the life to illustrate points about the markets and the financial institutions. Leon Levy documents his early climb on Wall Street, overcoming his lack of a college degree and the prejudice against his religion. Leveraging astute research and side investing, Leon became a partner of Oppenheimer and Co. in 1951. We learn of the many struggles over the next forty years to build and nurture the partnership. The firm's participation in many of the great financing and investing trends of these decades is revealed. We are also treated to briefer glimpses of Leon Levy the philanthropist and hedge fund manager.

From an historical perspective, this book provides worthwhile insight into the Wall Street of bygone days. From the vantage of today it is difficult to appreciate an era when the New York markets were not at the center of the world, and when work on the street was as much a reflection of the class structure as capitalism. Levy's stories tell us about a time when stocks were often undervalued, and when risk was at least as important as return to traders. In these tales, we see the pre-history of equity research, the birth of mutual funds and the legacy of great companies, many of which are long gone. Throughout, Wall Street has struggled with the forces of growth and the constraint of ethics.

Levy's book advocates the importance of a psychological approach to the market. He does not believe that economics provides an exclusive way to predict market swings and trading trajectories. In fact, he attributes most of his trading success to the missing psychological component in economics. Levy's dependence on psychological concepts runs the gamut from the collective irrationality of

certain periods (like to late 1990s) to the investor's mental processing of the temporary swings of individual issues. The author uses psychological analysis to select the right employees and to distinguish capable managers. Although he never asserts that nothing else matter, Levy is keen on bringing psychology to the forefront. Levy also contributes sustained efforts to link societal and world events to stock prices. He understands the connection between governmental activity, demographic transitions and social unrest with valuation. The reader is treated to historical accounts of the twists and turns of the 1960s and 1970s, as well as the current situation.

The author believes that equity markets are profoundly cyclical, as well as surprisingly irrational. He lampoons those that believe in an efficient market. He illustrates with well-turned anecdotes how markets are fascinated with new technologies and with new types of transactions, but that such infatuations never last. He asserts that the recent bubble has not yet run its course.

The book contains a systematic approach to investing. Levy's philosophy is a contrarian one that focuses on the identification of hidden value over the long run. He advocates courage, perseverance and imagination, exploiting those whose anxiety blinds them to investing opportunities. Levy is profoundly "old school" in his idea, contradicting advocates of a new economy and skewering some of the persistent myths of get rich quick investing. Throughout, Levy is modest, being willing to recognize that "you don't know what you don't know."

Although not the focus of Levy's attention, the recent scandals in corporate America do get some treatment. Levy is unapologetic in characterizing the people involved in these events as overreachers and cheaters. He explores how the success of these schemes required the collaboration of many, including firms like his former employer He is particularly keen on his illustrations of how stock market analysts failed. It appears that Levy himself lost money in Enron off-balance sheet participations. The contribution that the book makes may be in helping us put the events of 2001–2002 in historical perspective. Towards this end, Levy does not let us forget the savings & loan crisis of the 1980s or the mutual fund crises of the early 1970s.

The book is exceptionally well-written. Reading it is a pleasure! The text is peppered with pithy quotes as well as literary/historical references. Mr. Levy is a bit of a Renaissance Man. Along the way, we are introduced to a large cast of characters that has played a part in the financial dramas that Levy witnessed or participated in. A good deal of the book is anecdotal, but these stories are never too long or uninteresting. Levy is very effective at reducing technical scenarios to their essentials so that they can be appreciated even by those without extensive backgrounds. One of the best parts of the book is the fictional Dimbulb.com that Levy creates to describe the internet company mania of the late 1990s.

Readers that come to this book will not find many things that might get implied by its ambiguous title or by the timing of its publication. There is not much about accounting or accountants beyond parenthetical observations about recent ethical lapses. You will not find much about the contributions of the academy to an understanding of market mechanisms. In fact, Levy states that following the advice of Nobel Prize winners is a good way to go broke. Even though there is some consideration of income taxes, most of this is historical in nature and not very systematic. A reader will not find much that is new in Levy's assessment of the recent run-up and crash of the equity markets. Although this section is well-conceived and communicated, most of the ideas have been previously circulated. Finally, no one should come to this book expecting specific stock recommendations or the outlines of an actual investing plan. As Levy reminds us, the world is not that simple.

The book is recommended for anyone interested in financial history or current economic events. Levy does not have an ideological ax to grind about governments or regulation. Although the book may be accused of oversimplifying with the benefit of "Monday morning" clarity, *The Mind of Wall Street* delivers on its ambitions.

Regulation of Corporate Accounting and Reporting in India

By Bhabatosh Banerjee, The World Press Private Limited,
Calcutta, India, 2002

Reviewed by Nandini Chandar
Rutgers University

Bhabatosh Banerjee's timely book is a descriptive, analytical, empirical, and normative study of corporate financial reporting and regulation in India. The largest democracy in the world has been undergoing dramatic political, economic and social transformation just in the past decade. Starting with a new industrial policy adopted by its government in 1991, India is rapidly evolving from a centralized, closed economy to one that is increasingly liberalized and deregulated. As a consequence, issues relating to corporate reporting and regulation have taken center stage. Improving financial reporting is not only important to local participants in Indian capital markets, but also to the world financial community as India becomes an important partner in global trade and finance. This book therefore addresses an important and timely issue.

The book is organized around key issues. First, the author provides a background on accounting regulation and argues for the need for regulation of financial reporting in India. Next, he provides a historical description of corporate legislation and accounting regulation including detailed comparisons of the various stages of corporate legislation embodied in the Companies Acts starting with the original 1865 Act. Chapter 4 discusses issues relating to professional regulation including the role of the Institute of Chartered Accountants of India (ICAI), which is the primary professional and standard-setting organization. The chapter also includes an interesting discussion comparing Indian standards with international accounting standards, followed by a detailed description of several key standards issues by the ICAI. Chapter 5 explores the roles of governmental entities like the Department of Public Enterprises, the Securities and Exchange Board of India, and the Stock Exchanges, financial institutions like banks and investment companies and voluntary bodies like the Indian Chamber of Commerce, Indian Commerce Association and the Indian Accounting Association in the standard setting process.

The focus then shifts to the international context with a comparative study of financial reporting in the U.K., U.S. and Japan. As Banerjee argues, with

increasing integration of capital markets and the resulting call for harmonization of accounting standards, it is useful to place the discussion of Indian financial reporting in a global context. Following a fairly detailed description of financial reporting regulation in the U.K., U.S. and Japan, Banerjee analyzes the reasons for international differences including legal systems, financing and tax structures and the development of an accounting profession. The author then attempts to place these observed differences in financial reporting in a theoretical framework using well-known social and cultural models.

Banerjee also presents descriptive empirical evidence on financial reporting practices in the Indian corporate sector in the form of a case study. The sample used in the case study consists of 50 companies, divided into two groups – 25 companies that form part of the Mumbai Stock Exchange SENSEX (the index of some of the largest "blue chip" companies in India, including 3 companies that are in the public sector) and 25 private sector companies that are listed on one of the Indian stock exchanges but not included among the top 500 companies in terms of market capitalization. The author's rationale for selecting these two extreme groups for analysis is not entirely clear. It does not appear that the sample of 25 smaller sample companies is a random sample or is a sample that is industry-matched with the companies in the larger sample. While the study does not lend itself, as a consequence, to a scientific analysis of the variation in financial reporting practices, it does nevertheless provide some interesting descriptive details about these practices by large and small companies.

Following the descriptive evidence on the current state of financial reporting, Banerjee presents what he terms the "User's Perspective," the results of survey responses from 39 academics and 14 professionals to normative questions relating to issues such as the need to better clarify the objective of financial reporting, improving enforcement of accounting standards, and structural independence of the standard setting process from the accounting profession. The survey is very limited in sample size and does not appear to follow a scientific process in terms of both its design and execution including the sample selection process. It cannot, therefore, be construed as a scientific study of user perspectives. In any case, a study of user perspectives that ignores the most important user segments – the individual investors, security analysts and professional fund managers – is handicapped in its ability to shed even a little light on user needs with respect to financial reporting. The summary of findings (p. 187) is therefore not strongly supported.

The study concludes by providing recommendations on key issues such as the nature and structure of accounting regulations, objectives of financial statements, standard-setting process and enforcement. These recommendations again do not appear to be grounded in theory or strongly related to the nature of evidence and analyses presented in the book, but reflect the author's personal ideas.

Banerjee's book is an ambitious undertaking. It seeks to provide large brush strokes of descriptive history, theory, analyses, international comparisons, empirical evidence and recommendations relating to Indian financial reporting on a limited canvas. The most interesting part of the book is the detailed description of the evolution of financial reporting in India in a historical context. Less successful are the author's attempts to place Indian accounting in a theoretical framework, provide empirical results and make recommendations. In choosing to provide a very broad analysis, the author has to necessarily sacrifice depth of research and analysis. This has also resulted in many loosely used terms and constructs, as for example "self-regulation," and "social accounting." Banerjee might have been better served to limit his attention in the book to a smaller set of issues.

Banerjee's book is a useful starting point for academics who are interested in financial reporting in India, and international accounting issues, particularly accounting in emerging market countries, and practitioners and policymakers who are seeking to reform financial reporting regulation in developing countries. Its usefulness, however, is largely due to its wealth of descriptive details about the evolution of the Indian accounting system rather than its analytical insights or normative prescriptions.

The Number: How the Drive for Quarterly Earnings Corrupted Wall Street and Corporate America

By Alex Berenson. Random House, New York, 2003, 274 pages, $24.95. ISBN 0-375-50880-5

Reviewed by Julia Grant
Case Western Reserve University

In the current state of the economy, and given the conditions in the financial markets over the past several years, determining causes and/or blame for the outcomes we observe is compelling. This entertainingly written book does a reasonably thorough job of identifying a set of possible culprits, and attempts to trace the historical events that tipped the markets, first toward the late ’90s bubble, then toward the subsequent burst. The author, Alex Berenson, is a financial investigative reporter who has written for TheStreet.com and, currently, *The New York Times*. The book’s title indicates the author’s underlying thesis – he has decided that the market’s focus on quarterly earnings numbers is at the root of the problems.

He identifies a number of possible reasons for the situations that occurred. They include greedy corporate executives who were getting rich on stock options as the stock market responded to their manipulated numbers, a lax accounting profession (captured by its consulting clients), an overburdened and ineffective SEC, and inadequate work by financial analysts.

In spite of the book’s title, the complexity of the issues defies identification of a single cause, and Berenson does not clarify this. Is the root cause the number itself? Its frequency (does he want only annual reports)? Its imprecision (the author’s own appendices illustrate the source of accrual accounting’s imprecision)? Its production as an outcome of lax accounting standards? The market’s and analyst’s stubborn focus on only that number, even though it is accompanied by other disclosures? If the information users were using incomplete information leading to bad decisions, then executives were making rational, albeit unethical, decisions. The fact that these decisions led to outright fraud is a greater indictment of the business ethics of the corporate world and its auditors than of the number itself. If the author means to imply that a better earnings number would solve the problems and allow truth to prevail, then the standard setters of the accounting profession and its oversight body, the SEC, are the clear villains. The author does not make

this distinction for the reader, perhaps appropriately given the complex, interactive nature of the problems. But the book's concluding sentences point to fraud as the problem – "A healthy skepticism is the best defense against fraud; only when investors demand honesty about good news *and* bad will companies respond with the truth" (p. 225).

Berenson's discussions of the accounting profession's shortcomings are scattered throughout the book. He identifies the development of a Big Eight (Six, Four) mindset toward lax auditing as consulting relationships developed. He discusses the hubris of some of the leaders of the profession. He describes some of the standard setting efforts that have led to weaker standards than desirable. He discusses the SEC's lack of oversight, linking that to both its inadequate budgets and its dominance by business-biased leaders.

However, he does not make the link between the SEC and standard setting as completely as it should be made to allow the reader a fuller understanding of this process. Yes, the FASB backed down on the options reporting issue, but it would have needed the full, public backing of the SEC to have withstood the political pressures brought to bear. This backing was lacking. In some details of the history of the accounting profession, the author appropriately critiques the APB, but neglects to mention an analogous situation that contributed to its demise, its unpopular move to require successful efforts accounting for oil firms, an attempt that was firmly resisted by and finally defeated, thanks to the lobbying efforts of political campaign contributors. Berenson does not fully acknowledge the political realities of the standard-setting structure, wherein the profession's franchise has a direct link to the SEC, which is highly subject to political pressures.

The book more fully develops its accusations against some players, such as the accounting profession and the SEC, while giving inadequate treatment to other factors. One example is the issue of pro forma earnings (EBITDA and other acronyms), which receives only a cursory discussion. These measures do not arise from the use of accounting principles, and in the opinion of many in the profession, they have been widely misused. Yet the focus on that number, even in important national publications, contradicts the author's thesis that the problem lies only in the accounting-produced quarterly earnings number. Corporations used pro forma numbers to make themselves look better, but some financial writers picked up the conventions as well, and these non-GAAP disclosures appeared in national news articles that lent legitimacy to their status as a useful metric. Perhaps the corporations' presentations of pro forma earnings had fraudulent intent. Additionally, their ready acceptance, publication and use for valuation purposes amounted to a pronounced lack of willingness on the part of analysts, reporters and investors to evaluate disclosures critically.

Berenson does incorporate and critique the role of sell-side analysts. He notes the predominance of their buy recommendations at the height of the market's frenzy, and he recounts some of the sleazier recommendations that have come to light in the aftermath. He does not, however, develop the apparent unwillingness or inability of many sell-side analysts to understand the accounting or to do in-depth research on the firms they cover. And he does not address the role of buy-side analysts in all this. After all, these "inside" analysts are supposed to be the most informed, and they are arguably the ones setting the market's prices since the trades that occur as a result of their work often involve large numbers of shares.

The author identifies some market players who seem to be able to detect problems. He identifies his preference for, and relationships with, the short-sellers of the market, who make it their business to ferret out potential corporate weaknesses. The "shorts" come out looking best in this work, and the reader wonders why informed investors do not pay more attention to their signals if they are right as much of the time as implied herein.

This entertaining treatment of how we got to the current state of U.S. capital markets provides a handy, brief historical review of U.S. capital markets, with a heroic attempt to extend this understanding and historical perspective to what has happened in the last ten years. This book is worthwhile for its early perspective on our current state, but it will require some time and a less biased historian (who was not writing about the events as they happened) to sort out more clearly some of the cause and effect issues.

60 Years of Progress Through Sharing: 10-Year Supplement to 50 Years of Progress Through Sharing 1991–2001

By Dale L. Flesher and Elaine R. McIntosh. The Institute of Internal Auditors, Altamonte Springs, FL, 2002, 166 pages; $10.00 for IIA members, $15.00 non-members through the IIA Bookstore

Reviewed by Reed A. Roig
Case Western Reserve University

After a previously inconsistent record of documented histories of the organization, The Institute of Internal Auditors (IIA) has followed up its 1991 comprehensive history celebrating the 50-year anniversary of the organization (hereafter, *50 Year History*) with this 10-year supplement (hereafter, *Supplement*). Published in spiral bound paperback form and written by the same author (although this time with assistance from Elaine McIntosh, former IIA Manager of Educational Products), this *Supplement* continues the story of the IIA from 1991 to 2001.

Whereas the *50 Year History* was organized first by topic and then chronologically, the *Supplement* follows a reverse pattern – first chronologically, then by topic. Following an introduction that highlights the significant achievements of the IIA during the decade, there are eleven chronological chapters detailing each year's activities and achievements. Starting with 1990–1991, which was incomplete at the time the *50 Year History* was written, each chapter represents a "Chairperson Year" of the IIA, taking the theme chosen by each Chairperson as its title. As seems to always be the case, there is an exception to the one-year rule, as Chapter 8 covers the 1997–1999 period, which includes the tenures of two Chairpersons due to a change in the IIA's fiscal year-end.

Each chapter begins by detailing the membership of the Executive Committee and then summarizes "The Year at a Glance," with highlights quoted from the Chairperson's message from that year's annual report, significant events of the year, and a brief chronicle of that year's Chairperson and his/her activities. This is followed by sections devoted to the leadership and activities of The IIA Research Foundation, Professional Development, Professional Services, Professional Practices, and if present, IIA Advisory Councils. Those familiar with the *50 Year History* will recognize that Professional Development, Professional

Services, and Professional Practices are consistent with the topic areas developed chronologically there. Within these sections, significant activities and events are detailed covering publications, research, seminars, professional and international conferences, educational products, advanced technology, editorial policy, membership, Board of Regents, professional issues, Internal Auditing Standards Board, Committee on Quality, ethics, and government, academic, international, business & industry relations.

Three appendices included with the *Supplement* continue the listings of the IIA Awards Winners, the locations and themes of International Conferences, and the names and themes of the Chairpersons begun in the *50 Year History*. In addition, there is an appendix devoted to the significant contributions of Victor Z. Brink and Lawrence B. Sawyer to the practice of internal auditing and to the IIA. Brink, one of the founders of the IIA died during the term of the *Supplement*. Finally, the chronological timeline begun in the *50 Year History* is included and extended for the 10 year period of the *Supplement*.

The *50 Year History* and this *Supplement* begin and end the same way. They begin with a quote attributed to Robert Milne, 1945:

> The Institute is the outgrowth of the belief on the part of internal auditors that an organization was needed in the structure of American business to develop the true professional status of internal auditing . . . Although its roots are in accountancy, its key purpose lies in the area of management control. It comprises a complete intracompany financial and operational review (p. v).

and end with a final chapter titled “A Look to the Future.” However, in between these end-points, their tone and focus diverge. While the *50 Year History* remains more true to Milne’s quote in describing the foundations of the IIA’s formation and initial growth, the *Supplement* documents an organization “looking to the future.” It describes the IIA adapting to meet membership needs in the face of higher public acceptance and scrutiny, increasingly rapid technological change, market incursion, rapid growth, and globalization.

In the final chapter of the *50 Year History*, A. J. Hans Spoel, the first IIA Chairperson from other than North America, describes his proposed “12 strategic thrusts for the 1990s.” Their principle focus is to exploit the IIA’s status as a truly international organization through membership, CIA certification, standard setting, involvement and promotion, technology, and re-organization on a global scale. The *Supplement* describes an organization that relentlessly pursued and implemented this strategy. Membership grew more than 61% and CIA designations doubled over the decade. By the end of the decade, half of the membership is located in 141 countries other than the United States and the CIA exam is given in 62 countries in 10 languages. More importantly, the *Supplement* describes the

development process and publication of the *Competency Framework for Internal Auditing* and *Vision for the Future: Professional Practices Framework for Internal Auditing* during the later stages of the decade. These lead to a broadened definition of internal auditing, revisions to both the standards of ethics and practice, and a more globally oriented organization structure, which secure the IIA's international status.

Although the book stands on its own, it is probably best considered as it is advertised – as a supplement to be enjoyed in conjunction with the original *50 Year History*. While necessarily full of detailed facts, names, and figures, it still manages to tell a compelling story. The authors suggest at the end that "the best years in the history of The Institute of Internal Auditors and the profession may be yet to come" (p. 135). We'll probably have to wait another 10 years for the sequel to find that out.

Final Accounting, Ambition, Greed, and the Fall of Arthur Andersen

By Barbara Ley Toffler with Jennifer Reingold. Published by Broadway Books, 2003, 288 pages. Price $24.95

Review Essay by Leon W. Blazey Jr.
Case Western Reserve University

As Dan Lee said in his review of this book in the *Houston Chronicle*:

"Barbara Ley Toffler's former job title at Arthur Andersen – partner-in-charge of ethics and responsible business practices for consulting services – now has an almost laughable ring to it."

Since this is a text about ethics and greed, as well as an author's ethical confession – I must note that I was associated with Arthur Andersen from 1967 until 1998, when I retired from the firm after 23 years as an equity partner. I started and supervised a specialty practice in two offices, just as the author was hired to do, as a non-equity partner. I retired in the last part of the author's four year career with Andersen.

The writing style compels the reader to believe that in Ms. Toffler's time with the firm as a non-equity partner, she knew intimate secrets of the firm and had discussions with the principals mentioned, if they were old friends, or at least close business associates. The following from Page 5, about Lou Salvatore, the New York City, managing partner: "He favored elegant suits, was a major contributor to George W. Bush's presidential campaign, and was very active in Catholic community groups. He'd even hired a nun to work full time in Andersen's New York offices. I knew him well." It is only when the reader gets to the final chapter, and wonders what could possibly be contained in the many pages left unread, that you discover 129 sources, listed as footnotes, although not so noted in the text. While the text reads like a "tell all" written by an insider, it's really not; its more of a compendium, made out of the many reports of others, and thus not one who had integrated herself into an organization.

My heart began racing at certain points, because at times passages read like a "pulp fiction" as on Page 2: "As Robert loomed over me, linebacker-broad shoulders flexing ominously, he reminded me of nothing so much as Zero

Moestel's transformation into a rhinoceros in the Ionesco play of that name . . . This is big time young lady. What kind of consultant are you?"

While every organization has a few boorish individuals, what is described here was not typical behavior, although the reader is led to believe that it was. During my 35 year career, I never used, nor heard others use, the term, "young lady" or "young man," and I served in three offices, including Houston, now reviled as the seventh level of Dante's Inferno.

The book is a chronicle of the author's inability to understand the organization she joined.

The author complains about the firm's fee accounting system. I admit it was a constant concern because it was designed for an 800 partner firm. Just because it didn't tell management how much one accomplished, was not a problem. The author's several mentions of "fee f- - - - - -" is evidence of her naiveté or departure from reality. Every partner knew the fee and billing system was in a ditch, and kept their own records of accomplishments for use at review meetings with superiors. If she didn't know this, she didn't talk to her peers on a one to one basis. Could it be that the "fee f- - - - - -" and other billing travails were of her own making?

When challenged with a revenue goal, the author protests that greed was afoot. If one has no goal, how does an organization grow? Did she have a goal beyond the six figure salary she was being paid?

My review noted over thirty tabs with similar misunderstandings or issues of good sense. The author makes several ethical pleas that accountants should adopt, which show her complete misunderstanding of the business. Her first dictum is that accountants should not be involved in the political process. Her second prohibits business entertainment.

The political issue – Page 251: "If certified public accountants are to be independent and responsible to the public, they must remain absolutely clear of the political process in every way." Ergo, accountants must forego their constitutional rights, but it's O.K. for lawyers, officers of the court, to maintain theirs? How well thought out is this?

The business entertainment issue: If the author's prescriptions regarding business entertainment were ever adopted, and if these ethics are good for accountants they should be good for all in all professional business . . . including journalism. And thereby 75% of the restaurants in New York, Washington, DC, Chicago, Los Angeles and San Francisco would likely be at risk of becoming bankrupt; not to mention golf clubs; sports teams; and the theater and entertainment industry. To take their position, would lead one to believe that somehow, accountants are malleable beasts while attorneys, doctors, architects, journalists and executives aren't. I never had the experience of my personal ethics being overwhelmed by a dinner. Rather, professional relationships developed at dinner often allowed the

presentation and subsequent adoption by the entertainee of the correct ethical thing to do. Streets run two ways, not just one!

The last two pages reveal an personal epiphany . . . The author confesses a desire for dollars and shunning of "ethics" for those dollars. "Ambition, Greed and the Fall" . . . Hmmmm While I don't intend to delve into psychological issues, what we have is a performance and communications issue, common in professional failings.

We are all thinkers, feelers, sensors, or intuitors, or a blend of all four. Those with whom we come in contact are similarly endowed. If you understand this, you'll not need to write a "tell all" book in your professional future.

Conclusion? If you wish a road map of what not to do as a mature professional, when joining a professional services firm, buy the book and do the opposite of what the author did.

Alternative Conclusion? If you already believe Andersen is Satan, buy the book. If you want reality and not "True Confessions," then don't spend the $25 [Ah, yes. The "devil" made me write this alternative!]

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