A Market Proposal for Auditing the Financial Statements of Public Companies*

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Abstract

Recent corporate financial information frauds such as the Enron case, as well as those involving WorldCom, Qwest, Sunbeam, Tyco, Parmalat and others, show the systemic weakness of accounting regulations in the capital market. This paper presents a market proposal to improve the quality of information provided in the financial statements of public companies. The proposal establishes the necessary incentives to make external auditors more independent in their approach. It also aims to strengthen the monitoring mechanism, thus reducing the residual loss caused by the agency relationship existing in all firms.

The year 2001 witnessed a series of financial information frauds[1] involving Enron Corporation, auditing firm Arthur Andersen, the telecommunications company WorldCom, Qwest and Sunbeam, among other well-known corporations. These problems highlighted the need to review the effectiveness of accounting standards, auditing regulations and corporate governance principles. In some cases, management manipulated the figures shown in financial reports to indicate a better economic performance. In others, tax and regulatory incentives encouraged over-leveraging of companies and decisions to bear extraordinary and unjustified risk.

The Enron scandal deeply influenced the development of new regulations to improve the reliability of financial reporting, and increased public awareness about the importance of having accounting standards that show the financial reality of companies and the objectivity and independence of

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* In this article, public companies are companies that have offered their stock to the public. They are companies that have already made an initial public offering (IPO).

1 Financial information-related frauds are caused by the deliberate distortion or misreporting of submitted figures or by omissions in financial statement items. Therefore, they do not show all relevant aspects for investors.

auditing firms. The question has also been raised as to whether it would be advisable to apply international accounting standards (IAS) instead of U.S. GAAP (generally accepted accounting principles).

Financial frauds give rise to many concerns. Who is mainly responsible for these scandals? Are U.S. GAAP standards sufficient? Or was it simply that these standards were not observed? If accounting standards were not applied, why did independent auditors report that they were? Do auditors' goals match those of the users of financial reports? Why did the United States Securities and Exchange Commission (SEC) fail to protect investors? Does management have the right incentives to show the company's real economic performance in its financial statements? Is the creation of more regulations the solution to or are the regulations themselves the cause of this systemic problem? Is it an ethical problem or one of incentives?

This paper examines some of the factors that contributed to these crises and were behind the failure of independent auditing companies and of board members to carry out their responsibilities. The scope of this study is limited; for example, it does not take into consideration the distortions caused by inequitable and casuistic[2] tax policies. Indeed, the main focus of this paper is stock market regulation in the United States, as this is the largest market in trading volumes. Finally, we put forward a market proposal designed to improve the quality of the information provided in public companies' financial statements. This proposal encourages an objective attitude on the part of external auditors, as it reduces the possibility of their review and opinion being influenced by a corporation's management.

Background

The Significance of Financial Statements and Generally Accepted Accounting Principles

Accounting is a technique designed to record, classify and summarize a company's business operations, with the aim of providing information for

2 For example, as Eric Stern states in *The Value Mindset: Returning to the First Principles of Capitalist Enterprise* (New Jersey: John Wiley & Sons, Inc., 2004), President Bill Clinton's administration attempted to reform corporate governance by limiting the tax deductibility of cash payments to executives. This tax regulation was aimed at limiting the income of top executives but the plan backfired spectacularly. To avoid this tax inconvenience, companies replaced part of their officials' cash payments with stock options. This changed management's incentives and led them to overvalue profits. The new tax regulation unaligned the goals of managers and investors and harmed investors. As stock options offer potentially unlimited profits and only limited losses for their holders, some managers assumed greater risk or engaged in creative accounting to increase profits, with the aim of raising stock prices and obtaining personal benefits. When shares were overvalued, managers were encouraged to keep them that way until the market corrected the situation. This example shows how a tax regulation can destroy shareholder value.

decision-making purposes. Accounting standards appeared spontaneously in the market, not as a set of centralized decisions but as a result of an infinite number of decentralized decisions taken at different times and in different places. These rules evolved on the premise that man's memory is limited and important information needs to be recorded. In Greece, Egypt and the Mesopotamia valleys, the records of companies' financial operations were kept on clay tablets; and in ancient Rome a forerunner of the double entry system was developed.

In 1487 Luca Pacioli published the *Summa de arithmetica, geometria, proportioni et proportionalità*, which explained the double entry system already widely used at that time. In the 15th century, the Venetian method of bookkeeping was similarly well-known. This system consisted of two books, the forerunners of the journal and the ledger currently used.[3]

After the Industrial Revolution, accounting principles appeared as standards that companies used to produce financial information. In 1854, the Institute of Chartered Accountants of Scotland was created, followed by the Institute of Chartered Accountants of England and Wales in 1880, and the American Association of Public Accountants in 1887. All these institutions are self-regulating organizations of the public accounting profession.

"Generally accepted accounting principles" are a set of accounting rules and criteria developed as a frame of reference for the production of financial information. These principles require accounting reports to be: 1) useful regarding the information they contain (the information must be relevant, truthful, comparable and timely); 2) reliable, so that financial reports are consistent and verifiable; 3) provisional, so that financial statements contain all relevant information up to the moment they are produced.

When referring to "generally accepted accounting principles" it should be remembered that these are standard rules that should capture the substance of business transactions. Accounting standards are not made up first and applied later; they are discovered over the course of the transactions carried out by economic agents.

The accounting process generates the financial statements, which are fundamental for analyzing a company and assessing its historical performance. Accounting information has a number of flaws; for example, it shows historical values and not economic values.[4] However, traditional accounting is still the starting point for the development of a more detailed and accurate financial analysis.

3 Gerardo Guajardo Cantú, *Contabilidad financiera* (México: McGraw-Hill, 2004), pp. 2–3.

The benefits of financial statements are:

- They provide financial measurements to make economic calculations and allocate resources efficiently. In order to determine whether a company has made an economic profit or not, adjustments have to be made to the conventional financial statements. That is to say, the accounting information allows us to establish the real return by making the necessary corrections to show the income, costs, expenses and operating capital.

  In addition, the cost of financing—or capital cost—must be established, using accounting and extra-accounting information. If the return on the invested capital exceeds the capital cost, economic or extraordinary profits have been produced. It can be said, then, that accounting figures are a necessary element to calculate economic profit or loss, but not the only one.

- The correct analysis of financial statements and forecasting specific variables allows us to establish whether the current market price of the stock shows, from the investor's point of view, the company's real value, or whether the stock is overvalued or undervalued. In order to determine the intrinsic value of a stock, historical financial statements can be taken as the frame of reference to forecast future cash flows.[5]

- Reliable financial information can show whether managers are pursuing goals that are aligned with the interests of the shareholders. As Myddelton states: "The main purpose of company accounts is to enable shareholders to monitor the stewardship of managers."[6]

- Financial reports verify statements made by managers regarding the company's financial position and earnings.

The question, then, is this: can traditional financial statements reflect objective accounting profits? Because different accounting criteria exist, financial statements are merely the subjective opinion of a company's financial position and the results of its operations. For example, very different accounting profits may be obtained simply by changing the inventory valuation method. However, changing the inventory valuation method does not change the eco-

4 According to GAAP, goods and rights (assets) must be valued at their acquisition or manufacturing cost (original historical value). For example, if a company owns real estate with a purchase cost of US$100,000 and a current market value of US$500,000, it must be booked at its purchase cost even though the asset may be sold for US$500,000. This historical value postulate distorts certain performance measures, such as the return on invested capital, which is obtained by dividing the after tax operating earnings by the invested capital (the invested capital is formed by all the resources invested in the project). If the invested capital includes assets at historical value, the return will be higher than if the assets are included at their economic or market value due to the fact that the value of these assets will have appreciated.

5 The intrinsic value is the present value of a company's cash flow that may be withdrawn in the future. See Lawrence A. Cunningham, *Los ensayos de Warren Buffett: Lecciones para inversionistas y gerentes* (Guatemala: Giancarlo Ibárgüen S., 2000).

6 David Myddelton, *Unshackling Accountants* (London: The Institute of Economic Affairs, 2004), p. 28.

nomic profit. Herein lies the difference between accounting profit and economic, or extraordinary, profit.

Also, financial statements may show the company's past performance, but they will not provide all the information necessary to assess its future performance and value, because companies operate in a competitive and highly dynamic environment. In order to determine the value of a company, valuation methods such as the discounted cash flow (DCF) and aggregate economic value methods are normally used. These methods take some historical data into account, but also forecast the behavior of the critical variables that affect a company's value.

Users must recognize the limitations of accounting information and with these limitations in mind make an analysis based on fundamental aspects, rather than on just a few indicators, such as EPS[7] or P/E.

The SEC's Mission

The stock market boom in the 1920s was driven by the inflationary monetary policy adopted by the United States Federal Reserve. The reality of this inflationary mirage became apparent with the dramatic stock market crash in October 1929. As a result, the Federal Reserve implemented an aggressive monetary tightening policy that brought about the collapse of the world financial system. Unemployment and poverty increased worldwide.[8] As few people understood the real causes of the crash and the Depression, public confidence in the capitalist system plummeted. Public opinion turned in favor of government intervention in the economy in the mistaken belief that capitalism was the fundamental cause of the economic depression.[9] After the Great Crash of 1929, the U.S. Congress passed the 1933 Securities Act (regulating the issuance of stock) and the Securities Exchange Act of 1934 (governing the periodic reporting of financial information). These laws were designed to restore investor confidence in capi-

7 EPS refers to earnings per share.

8 See Murray Rothbard, *America's Great Depression*; Hans Sennholz, *The Great Depression*; Milton Friedman and Anna Schwartz, *Monetary History of the United States.*

9 This mistake about the origins of the economic depression can be seen in the debate that raged between Friedrich Hayek and John Maynard Keynes from 1931 to 1946. Keynes attributed economic cycles to free market deficiencies. Keynes proposed government intervention through an active tax and monetary policy to extend the period of economic growth and prevent recession. Hayek, in turn, thought that economic cycles were not caused by the free market, but were the consequence of a credit economy. Hayek viewed the market as a spontaneous, unplanned order that resulted from evolution, and considered recessions to be caused by an increase in the central bank money supply, which artificially reduces interest rates and distorts the business cycle. In Hayek's opinion, recession is the way the market corrects the overvaluation that results from the performance of these investments, which otherwise would not have existed. Hayek explains how the intervention policies suggested by Keynes cause inflation, and increasingly complicate the economy. Keynes' argument suggests that through monetary and credit expansion, government can establish a zero interest rate so that capital is no longer considered

tal markets, by providing greater government supervision of public transactions and companies. The main purposes of these laws were:

- to make public companies provide reliable financial information on a timely basis;
- to ensure that people and/or organizations that traded and sold securities would treat investors fairly and honestly.

In 1934, Congress also established the Securities and Exchange Commission (SEC) to enforce the newly passed securities laws, to promote stability in the markets and, most importantly, to protect investors. Thus, the investor felt he no longer needed to worry about making a careful analysis of the stock he was going to buy, and thereby assumed greater risks.

To protect investors and the public, the SEC requires public companies to make a full report of their financial information. When the SEC was established, the Commission was entrusted with the responsibility of ensuring that the financial statements filed by companies followed the "generally accepted accounting principles." This is why the SEC requires an independent auditor's examination and opinion. We could say the SEC has been a major user of audited financial statements.

At present, the SEC requires public companies with more than $10 million in assets and more than 500 shareholders to publish quarterly and annual financial statements. These financial statements are prepared by the company's management based on U.S. GAAP and must be audited by accounting firms.

Two questions arise here. First, would public companies still submit their quarterly and annual financial statements if the SEC did not require them to do so? Second, is regulation by an institution such as the SEC necessary for capital markets to work?

Public Accountants and Regulatory Organizations

The term *auditor* originally meant a "person who hears." During the Middle Ages and the Industrial Revolution, audits were conducted to detect errors or frauds committed by government or private company offi-

an economic asset (in the sense that an economic asset is a scarce resource). If this were true, it would be very easy to solve the economic problem of capital shortage. However, Keynes ignores the fact that higher inflation increases interest rates, which in turn reduces the efficiency of marginal capital. According to Hayek, crises result from the poor investment of productive resources because of distortions in the interest rate—the market signal that indicates the level of saving and investment to be made. Summing up, according to Hayek, Keynes confuses consequences with causes. Keynes' theory opened the doors to increased government intervention with the aim of providing stability to the market and preventing recessions.

cials. In the 20th century, auditing focused on establishing whether financial statements reasonably showed a company's financial position, operating results and cash flow. This shift occurred because of the increasing number of shareholders and corporations in existence. The focus of the audit also changed when sampling began to be used for testing, and when internal control became important as a mechanism for preventing errors and irregularities in the management of company resources and in the information submitted to financial statement users.[10]

During an audit, public accountants undertake to gather evidence and reasonably ensure that financial statements follow generally accepted accounting principles or other proper accounting standards. The independent auditor provides credibility to the figures submitted, that is to say, reduces the information risk.[11] This is a key factor, as credible financial information allows for the efficient allocation of a company's resources. In other words, if financial reports are truthful, their users (shareholders, creditors, clients and others) can then make informed economic decisions.

We could say that public accountants represent investors in the process of generating financial reports. However, management is responsible for issuing the financial statements. The auditor's responsibility is to make an examination based on generally accepted auditing standards to determine whether the figures submitted are reasonable, and to issue an opinion.

Audits can validate the figures included in financial statements, or establish the existence of errors or irregularities, such as overestimation of income or assets, or underestimation of expenses or liabilities. For example, income should not be recorded unless the transaction has already taken place (that is to say, been completed) and the right to the future cash flow secured.[12] An audit review makes it possible to identify the presence or absence of conflicts of interest and proper or improper use of a company's resources.

As we mention above, the traditional accounting method for measuring net profit is based on specific premises and subjective criteria. This provides managers with the opportunity to change the net profit they report. For

10 O. Ray Whittington and Kart Pany, *Auditoría: un enfoque integral* (Colombia: McGraw-Hill, 2000), p. 7.

11 Information risk refers to the risk of making decisions based on inaccurate information. Information risk includes the possibility that financial statements do not show the financial position and operating results of a company reasonably, or that they depart substantially from generally accepted accounting principles.

12 An example of booking unrealized income would be a company that has received an advance payment by clients and books this payment as income when the service has not yet been rendered. In this case, there would be no relation between income and cost, and a greater return would be shown.

example, the management may ignore depreciation during a certain period and report higher profits. It may also use alternative procedures for recognizing income and cost provisioning. The independent auditor must determine if criteria are being used that show the company's real financial position.

The self-regulatory organization of public accountants in the United States is the AICPA (American Institute of Certified Public Accountants). The main functions of this organization are:

- to establish professional standards for public accountants;
- to develop an ongoing research and publications program;
- to promote continued professional training.

The AICPA has established ten generally accepted accounting standards. One of the most important is that, in discharging auditing services, public accountants must keep an independent state of mind. For example, an auditor's opinion may be biased if he holds shares in a company he is auditing, or if he is a member of the board of directors.

Independence is therefore one of the most essential criteria in public accounting, as autonomy strengthens credibility and increases diligence in any job, but especially that of public accountants.

The AICPA has also issued a Code of Professional Conduct. This code states that auditors must act in the public interest; i.e., in the interest of financial statement users. It also highlights the objectivity and independence necessary to discharge their professional responsibilities. The principles included in the Code of Professional Conduct[13] are listed below.

- Responsibilities. In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
- The Public Interest. Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
- Integrity. To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.
- Objectivity and Independence. A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibil-

13 American Institute of Certified Public Accountants (AICPA), *Code of Professional Conduct,* http://aicpa.org.

ities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

- Due Care. A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.

- Scope and Nature of Services. A member in public practice should observe the principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

Taking these principles into account, we take a closer look at objectivity and independence. According to the Code of Professional Conduct, independence is weakened when: 1) a direct or indirect financial interest is held in the audited company; 2) a significant investment is held jointly with the company or with any official, director or major shareholder of the company; or 3) when the auditing firm has granted a loan to the company, or to any official, director or shareholder.[14]

The Code of Professional Conduct also states that an auditor shall not accept contingency fees during audits or financial statement reviews, or when preparing tax returns.

Moreover, the SEC requires that financial statements be audited by independent certified public accountants. The SEC also forbids auditors discharging accounting services from offering external auditing services to the same client.

It is interesting to note that the rules of the Code of Professional Conduct and the SEC provisions do not mention the conflict of interest that arises when the audited company pays for the auditing services, which in our opinion is vital. Moreover, before these corporate crises occurred, nobody questioned the conflict of interest that arose from providing financial or tax consulting services as well as external auditing services to the same company.

The Enron Case and its Implications

The 2001 corporate crises destabilized the U.S. capital market. These crises were the result of deficiencies in a number of areas: corporate gov-

14 The *Code of Professional Conduct* considers there to be a direct interest when the auditor holds an investment in the client's business; for example, the auditor owns company shares or has provided a loan to the company. An indirect interest is deemed to exist if the investment is not a significant part of the auditor's net worth.

ernance, conflicts of interest, misleading accounting information and illegal practices. One of the main effects of these financial frauds was the decline in public trust in institutions, a trust vital for reducing transaction costs and achieving an efficient allocation of resources.

Of all the financial frauds, the bankruptcy of Enron drew the greatest public attention. This fraud prompted the authorities to consider reviewing U.S. GAAP and GAAS (generally accepted auditing standards), and was one of the main reasons for the Sarbanes-Oxley Act of 2002.

Enron was a broker in the purchase and sale of gas and, at the end of 2000, it had become the seventh largest corporation in the United States in terms of sales. Enron developed complex agreements to reduce market risk.[15] We could say it contributed to the creation of the gas derivatives market. Unfortunately, not all of Enron's investments were good ones. The group suffered economic losses and its directors started misreporting financial information to maintain its credit rating.

Enron officials focused on increasing EPS, and manipulated accounting data to favorably influence the stock price. As mentioned in a Stern Stewart & Co. article: "Tempting management to under-invest in research is only one of the problems brought about by a myopic focus on EPS. Others include *over-investment*, *over-leverage*, and *over-the-top accounting*, and Enron fell prey to them all . . . EPS is the opium of the executive suite . . ." [16]

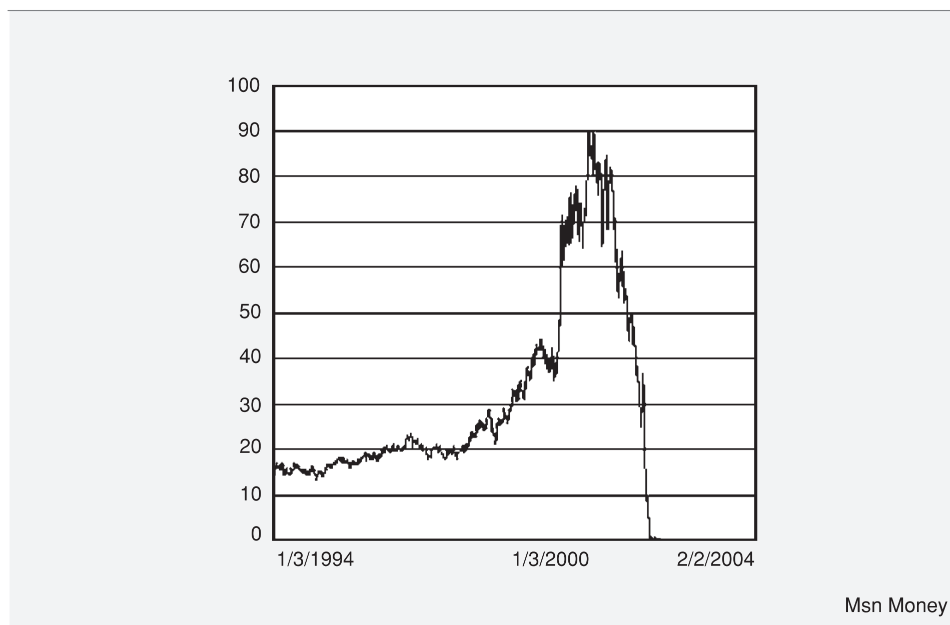
This approach led the company to hide the debt it was using to finance EPS growth. Investors, however, are more interested in a company's capacity to generate substantial and positive cash flow than in EPS, which depends on the subjective accounting criteria applied when preparing financial statements.

Enron's stock price, which hit a high of $90 per share in mid-2000, fell to below $1 by year-end 2001. On October 16, 2001, Enron reduced its net income after taxes by $544 million, and adjusted its retained earnings by $1.2 billion, bringing the company's stockholders' equity down $1.7 billion. The drop in Enron's stock price is estimated to have caused its stock-

15 Market risk refers to the risk that variations in the prices of economic variables may affect the value of cash flow or profits. Enron offered contracts so that its clients were insured against variations in the price of commodities, interest rates, failure to meet debts, etc. Enron diverted from its core business (broker in the purchase and sale of gas) and started offering specialized financial services.

16 G. Bennett Stewart, "Enron Signals the End of the Earnings Management Game," *EVAluation* 4 (April 2002).

holders to lose $11 billion. On December 2, 2001, Enron filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code, one of the largest ever U.S. corporate bankruptcies (its assets amounted to $63 million and liabilities to $30 million).[17] Around 15,000 employees held 62% of their savings in Enron stock, purchased at $83.13 in early 2001; when it went bankrupt in October 2001, Enron's stock plummeted to $0.10.[18]



Enron Corporation Price History - ENRNQ (1/1/1994 - 1/31/2004)

When auditing Enron's financial statements, Arthur Andersen failed to meet GAAS guidelines. In March 2002, the U.S. Department of Justice accused this firm of independent auditors of shredding documentation and obstructing justice. After this accusation, Arthur Andersen disappeared as an auditing firm.

About half a dozen of the generally accepted accounting principles had been breached, including failure to consolidate "special purpose entities"[19]

17 George J. Benston, "The Quality of Corporate Financial Statements and Their Auditors before and after Enron," *Policy Analysis*, no. 497 (November 2003): p. 12.

18 Rafael Termes, "Las irregularidades financieras y la economía de mercado" (speech delivered to the Royal Academy of Moral and Political Sciences, Madrid, November 5, 2002).

19 "Special purpose entities" (SPE) are independent entities created by third parties to develop specific projects. These SPEs were created without Enron investment and were used to transfer assets, liabilities and losses the company did not want to reflect in its financial statements. Enron did not consolidate the SPEs, because a third party held 3% of the entity's total assets. Enron used more than 3,000 SPEs, which it controlled indirectly (Rafael Termes, "Las irregularidades financieras y la economía de mercado").

and to book contingencies for the insurance of these entities' debt. Financial statements also showed wash sales or round trip sales (Enron increased its income and assets artificially by booking transactions the company carried out with itself). The transfer of assets made by *special purpose entities* were also booked as sales. The increase in the Enron stock price was also booked as realized income (around $1 billion). Another breach of U.S. GAAP was that financial statements did not show related-party transactions.

It was not only Enron that engaged in financial engineering and creative accounting to overvalue income and earnings and undervalue losses and debts. Similar problems have been found in the financial statements of companies such as Global Crossing, WorldCom and Quest. Most of them are violations of generally accepted accounting principles. The main types of fraudulent accounting practices are the premature recognition of profit, the overvaluation of existing assets (for example, not showing the loss resulting from deteriorated or obsolete inventory, or bad debt), and the hiding of losses, which are shown as assets.

We must not forget, however, that most accounting complexities stem from tax policies and capital market regulations. Income tax encourages profit or loss recognition practices that are far removed from the company's economic reality. Income from long-term contracts, transactions between affiliates, valuation of foreign assets, asset depreciation, etc. are booked according to subjective management criteria, frequently influenced by tax strategies. Enron was no exception.[20]

The increasing number of public companies that have had problems as a result of accounting irregularities is alarming. According to surveys carried out by the General Accounting Office, the number grew from 83 in 1997 to 195 in 2001, and to 110 in the first 6 months of 2002.[21] These surveys assert that the main reason for modifying previously filed financial statements was the erroneous recognition of income. The second reason was the erroneous capitalization of costs and expenses.

These financial crises were one of the main factors that caused the SEC to design new rules for the issuance of quarterly and annual reports. The

20 Richard Bassett and Mark Storrie, "Accounting at Energy Firms after Enron: Is the 'Cure' Worse Than the 'Disease'?," *Policy Analysis*, no. 469 (February 2003).

21 George J. Benston, "The Quality of Corporate Financial Statements and Their Auditors before and after Enron," *Policy Analysis*, no. 497 (November 2003).

European Union announced that its members would adopt the *international accounting standards* (IAS) issued by the International Accounting Standards Board (IASB) as of January 2005. This is aimed at unifying the accounting standards used when issuing financial reports and at improving European capital market integration by making it easier to compare financial reports submitted in European Union countries. The European Parliament also intends to impose more regulations on the auditing profession, such as making it compulsory for public companies to have independent auditing committees, requirements related to the rotation of auditors, severe penalties and others. An important change is that stock options will be booked as an expense for executive remuneration, and will, thus, affect the results for the period.

Accounting Standards

As mentioned above, accounting principles have evolved spontaneously as a result of the need to show in figures the results of business transactions carried out by economic agents. Things have changed recently, however. In the 20th century, for example, the United States government became involved in the drafting of accounting principles, and this has limited the creative capacity to develop new standards that might provide a better picture of a company's financial position. The SEC delegated the development of U.S. GAAP to public accountants. This is the origin of the Financial Accounting Standards Board (FASB), created in 1973 as a self-regulatory organization, which defines the standards and practices that must be followed by public accountants and public companies.

Although most irregularities resulted from non-compliance with generally accepted accounting principles, the latter have faced serious criticism. As we have already seen, some experts have even begun to question seriously whether it would be advisable to use international accounting standards (IAS) instead of U.S. GAAP.

Another proposal is to allow competition between accounting standards. If this idea prospered, the SEC would have to allow public companies to issue their reports using either U.S. GAAP or IAS. This, however, could pose a problem for investors comparing investment options prepared with different accounting criteria, and who do not, under current circumstances, have enough information to make the necessary adjustments to compare financial statements prepared under two different sets of standards.

At present, a foreign company registered with the SEC may file its financial statements based on IAS or on local accounting principles so long as a reconciliation of the period's results and of its net worth with U.S. GAAP[22] is included.

These proposals, however, would not address the main problem. There are many companies, such as Parmalat and Royal Ahold, that use IAS to file their financial reports and have also committed fraud, filing misleading financial information backed by auditing firms.

Regardless of the accounting standards used, Warren Buffett's words go straight to the point: "In reality, however, earnings can be as pliable as putty when a charlatan heads the company reporting them. Eventually truth will surface, but in the meantime a lot of money can change hands."[23]

Aligning Management and Shareholder Goals

The separation between ownership and control in corporations where ownership is diluted[24] (shareholder-manager dichotomy) brings in the need for effective corporate governance. We must remember that managers act in their own interests. The problem arises when the goals of the managers are different from those of the owners. What steps can be taken to align the goals of shareholders with those of managers?

One solution could be for managers to own a significant part of companies as well. If managers hold part of their equity in company shares or stock options, they will, conceivably, tend to promote the economic interests of shareholders. However, with stock options, for instance, interests might not be aligned, as company officials would not be bearing the same risks as shareholders.

Another option could be for the compensation system to depend on the profitability managers generate for shareholders. But again the question of how to determine profitability would arise. Which unit of measurement should be used: accounting profits, economic profits, dividends paid or stock price appreciation?

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22 Deloitte, *Guía Rapida IAS* (España: Publicaciones Deloitte, 2003), p. 20.

23 Lawrence A. Cunningham, *Los ensayos de Warren Buffett: Lecciones para inversionistas y gerentes* (Guatemala: Giancarlo Ibárgüen S., 2000), p. 38.

24 The problem of ownership and control separation in modern companies will be discussed in greater detail in our "Changing Incentives" section.

A hostile takeover [25] may also encourage the proper management of company resources. A hostile takeover occurs when a company's financial performance is expected to improve by replacing the actual management with a more efficient one. The threat of a hostile takeover may dissuade managers from satisfying their own interests to the detriment of shareholder equity. This is an important and effective exit mechanism that comes into play when ownership interest is freely transferred, and one that punishes inefficient management.

A monitoring and review mechanism also needs to be put into place to show if managers' goals are compatible with the interests of shareholders. Investors must be able to rely on watchdogs to ensure that financial statements are produced and audited in accordance with GAAP and GAAS. These watchdogs, in charge of protecting investors' interests, include independent auditors and the organization's own board of directors. Below is an explanation of the functions of each of these bodies.

The Board of Directors

The board of directors is a corporate body that ensures that a company's resources are properly managed. It is the board's job to ask and assess the answers to key questions so as to protect shareholder equity.

The board of directors must represent shareholders, elect the officials who will control the company's resources, and design an incentive program according to which management interests match those of the company owners (shareholders).

The board's involvement in the development of the company's compensation system is fundamental. For example, if senior management receive stock options [26] as part of their compensation packages, they may be encouraged to misreport financial statements to show growth in earnings and greater creditworthiness so that the stock price increases in the short term. Naturally, these measures do not create wealth for shareholders, as this is only achieved when there is sustained and long-term share price appreciation. As a result of the negative consequences such plans may have, the SEC issued a standard in 2003 requiring corporations to ask shareholders to approve the company's compensation program.

25 The term "hostile takeover" comes from the fact that a company is purchased even when management is against it.

26 When referring to the compensation of officers through stock options, the company purchases the stock and gives it to the employee. The employee earns additional compensation when the stock market price increases

The board appoints an auditing committee to ensure that financial statements are sufficiently reliable for users to make decisions based on their content. This committee must be independent from the company and from its chairman, to prevent conflicts of interest.

In order to improve the board's performance as an oversight mechanism, Warren Buffett recommends that companies without a major shareholder should not have more than ten directors on the board and that its directors should be external.[27] According to Buffett, to be effective, directors need to have business savvy, a genuine interest in the company and the job at hand and, very importantly, be owner-oriented. This last item is particularly important, because Buffett implicitly identifies the "agency problem"[28] and solves it, in his own way, by insisting on the importance of external directors to see themselves as directors-owners of the company. Such an attitude preserves and increases shareholder equity and allows objective indicators of the company's financial performance and of its CEO to be established. In addition, he recommends that the CEO should not be present at board meetings.

Independent Auditors

External auditors who review and issue an opinion on financial statements play a fundamental role in monitoring the management of a company's resources. The question is whether auditors have the right incentives to guarantee the truthfulness of the organization's financial information. One possible argument that there are indeed important incentives to conduct an audit diligently is that if GAAS rules are not met, the auditing firm will lose its reputation and its services will no longer be required.

The problem, however, is that there is often no long-term vision and the firm's reputation is sacrificed to keep an important client or obtain short-term profits. In many cases, external auditors have failed to carry out their duties properly because they prefer not to lose the consulting fees they earn from the clients they audit. For example, in 2002 Enron paid Arthur Andersen $29 million in consulting fees and $27 million in audit

27 Lawrence A. Cunningham, *Los ensayos de Warren Buffett: Lecciones para inversionistas y gerentes* (Guatemala: Giancarlo Ibárgüen S., 2000), p. 38.

28 According to Jensen and Meckling in "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (October 1976): p. 6, an agency problem arises when there is a conflict of interest in a relationship where one or more people (the principal or principals) control another person (the agent) for the performance of a service that requires decision making authority to be delegated.

service fees.[29] One reason why it was convenient for companies to purchase consulting and auditing services from the same firm was that the auditing firm knew the company's environment and financial information system. This meant a streamlining of operating costs for both the auditing firm and the contracting company.

Some hold the opinion that strict standards need to be put in place to punish the failure of independent auditors to carry out their responsibilities by issuing opinions without reservations when serious problems exist regarding the reasonableness of the figures presented in the financial statements.[30] Once again, additional laws are proposed to punish external auditors who collude with management in presenting misleading financial statements.

In the United States, the American Institute of Certified Public Accountants (AICPA) has a committee responsible for bringing disciplinary measures against auditing firms that do not conduct their work in accordance with auditing standards. Many consider that this self-regulatory organization does not mete out sufficient punishment to auditors involved in financial frauds; the most severe measure that can be taken by the AICPA is to expel these auditors from the association.

The Incentive Problem

In practice, it is managers, not shareholders, who are responsible for preparing and submitting financial statements. However, as these financial reports have a direct impact on stock price, managers may be tempted to misreport accounting figures to reflect a more buoyant financial condition and better economic performance, with the aim of obtaining higher compensation, hiding errors or reaping greater profits when exercising their stock options. That is why financial statement users and analysts are right to question the reliability of financial statements.

We need to make proposals that will improve the transparency of the financial information reported by companies. This is an extremely serious issue because trust is essential for the continuing growth of capital markets.[31]

29 George J. Benston, "The Quality of Corporate Financial Statements and Their Auditors before and after Enron," *Policy Analysis,* no. 497 (November 2003): p. 20.

30 An "opinion without reservations" or "clean opinion" refers to the issuance of an affirmative professional opinion that the financial statements reasonably show the financial position and operating results and cash flow of the company, according to generally accepted accounting principles.

One way to generate reliable financial information and to rebuild trust in capital market institutions might be through new government regulations and severe penalties for those who breach them. An alternative could be through strengthening the ethical values of board members, officials, investment banks, auditors and others, so that they do not contribute to financial frauds. Another option would be to change their incentives.

More Regulations

After the scandals mentioned earlier, attention was drawn again to the need for reliable financial information. The response of Congress to these financial frauds was the Sarbanes-Oxley Act of 2002. The issuance of more regulations, however, does not solve the problem. The Sarbanes-Oxley Act requires the disclosure of all off-balance sheet transactions and obligations, as well as all operations with non consolidated third parties that may affect the financial future of the organization. This Act also requires that the auditing committee consist of independent members of the corporation's board of directors. The auditing committee is to be responsible for appointing and compensating external auditors.

The Sarbanes-Oxley Act prohibits auditing firms from offering consulting services to audited companies, which increases auditing service costs. It has also established a body called the Public Company Accounting Oversight Board (PCAOB), which reports directly to the SEC. Auditing firms must register with this board, which establishes standards for the preparation of audit reports and inspects the quality of the audits these firms conduct and the internal controls they implement.

The PCAOB may impose disciplinary sanctions on audit companies. These sanctions may include revoking a firm's permit to audit public companies, fines, and the application of corrective measures to solve audit quality defects (training and new internal control procedures), among others.

All this suggests that the PCAOB will soon replace the AICPA in the development of auditing standards. Thus, an institution established by the government will replace a self-regulatory organization. The cost of this government institution will be absorbed by registered corporations according to their market capitalization.

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31 Lack of trust damages capital market liquidity, which increases the cost of capital and hinders the wealth creation process.

The Sarbanes-Oxley Act requires the chief executive officer and financial managers to certify that the financial reports are a reasonable representation of the company's financial situation and operating results. The Act also states in another provision that the lead partner or audit coordinator of the external auditing firm and the partner responsible for reviewing the audit must be changed every five years.

Now, could the Sarbanes-Oxley Act prevent financial frauds in the future? We will try to answer this question below.

Strengthening Corporate Ethics

Another proposal for reducing financial information fraud is to strengthen ethical values so as to promote more responsible corporate behavior. According to Rafael Termes,

> Only ethical values, so often despised, and a punitive legal framework for those who violate the law, will build trust in the relationship system characterizing the market economy.[32]

If the only answer is to enforce criminal laws, managers will be concerned about the law and not about ethics. However, a mechanism for achieving ethical corporate behavior would be complex and difficult to design, and perhaps not within the scope of any practical proposal. Another solution may be more pragmatic.

Changing Incentives

A third proposal would be to change the incentives for managers and auditing firms. In our analysis of this proposal, we will assess whether it is advisable to establish more regulations to provide stability to capital markets and question whether the financial information currently required by regulatory organizations is necessary.

Incentive Structure for Managers

Capitalists decide where resources are to be allocated. When they provide a company with resources through the purchase of shares, they are dele-

32 Rafael Termes, "Las irregularidades financieras y la economía de mercado" (speech delivered to the Royal Academy of Moral and Political Sciences, Madrid, November 5, 2002).

gating the responsibility of managing those funds to that company's directors. The problem appears, however, when the goals of managers and capitalists (shareholders) do not match. Managers could use the company's resources to their own benefit, damaging the well-being of investors. This is an "agency problem." As mentioned above, an agency problem occurs when there is a conflict of interest between the agent and the principal, the latter being the person to whom the agent has undertaken to render a service. Conflicts of interest may hinder cooperative behavior. Adam Smith was the first to warn about the agency problem when he presented a pessimistic view of the conflicts generated by management's own interest in a company. This is shown in the following quote:

> The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.[33]

Berle and Means drew the public's attention to this problem again in 1932. These authors expressed the "agency problem" in a company in the following way:

> The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge, and where many of the checks which formerly operated to limit the use of power disappear . . . In creating these new relationships, the quasi-public corporation may fairly be said to work a revolution. It has divided ownership into nominal ownership and the power formerly joined to it. Thereby the corporation has changed the nature of profit-seeking enterprise.[34]

Berle and Means say that if a company's ownership is diluted, individual shareholders are not sufficiently encouraged to monitor managerial decisions and, consequently, a greater degree of discretion will exist at the expense of the company's market value. In other words, Berle and Means perceive a conflict of interest that will tend to benefit management due to the degree of separation from ownership of a company's shares.

33 Adam Smith, *The Wealth of Nations* (London: Penguin Books, 1970), p. 460.

34 Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, 1932).

In 1970, William Meckling and Michael Jensen wrote a paper on the agency theory, which analyzed the conflicts of interest existing between a corporation's shareholders and its managers. According to Meckling and Jensen, if both parties of an agency relationship are profit maximizers, the agent will not always act in the principal's interest. Consequently, the principal may reduce the non-alignment of shareholder and manager interests by incurring monitoring costs. The cost resulting from the divergence of goals is called "agency cost" or "residual loss." These authors view a company, not as an individual, but as a legal fiction that allows for the development of a complex process, where the conflicting goals of participating individuals are balanced in a contract relationship.[35]

The agency theory contemplates the design of preventive incentives to bring the interests of managers in line with those of shareholders, thereby reducing agency costs. The corporate governance mechanisms used by shareholders may be internal or external.

Internal mechanisms include setting up a board of directors to supervise managers and define the company's performance-based compensation system. These methods include establishing formal control systems, auditing the financial information submitted by managers, budgetary restrictions and others. The agency relationship existing in corporations makes these costs inevitable but they will only be assumed if the benefits exceed the costs incurred.

Regarding an incentive system based on profits generated for shareholders, it is better to consider the economic value added or economic profit as a measurement of performance. Economic profits determine the long-term stock price.

As Bennett Stewart explains, "economic value added" is operating profit after tax minus the capital cost (both debt and net worth). The advantage of this measurement is that it recognizes the creation of wealth only after shareholders have obtained a reasonable return on their investment. If economic profit grows, EPS must increase as well. In order to align management goals with that of creating wealth for shareholders, a percentage of the improvement in economic profit may be provided to managers by way of compensation. Incentives based on economic profit have the following benefits:

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35 Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (October 1976): pp. 305–360.

- Managers have no reason to misreport accounting figures because economic profit is measured according to cash flow rather than profit determined by subjective criteria.

- Managers will develop only projects that create wealth for shareholders. This limits overinvestment and prioritizes projects according to the profit they generate after capital costs have been covered.[36]

External mechanisms include the stock price performance. If the stock price goes down, reflecting poor management and implying a low return on the invested capital, the company is then open to a hostile takeover, to the detriment of management—an effective disciplinary measure. The best way to protect a company is through good management, which will drive the share price up.

An alternative external mechanism consists of providing sufficient monitoring through a concentrated ownership structure. Jensen and Meckling suggest that if the costs of reducing the separation of ownership are lower than the benefits obtained by reducing agency costs, it would be advisable for some individuals or groups of individuals to buy shares on the market and reduce the separation of ownership.[37]

If individuals hold a significant number of shares in a company, they can sit on the board of directors and can, therefore, supervise and influence the corporation's management. This situation allows them to obtain "insider information."

As mentioned by Demsetz,

> Undoubtedly, many persons own a large fraction of shares in a firm because they have, or feel they have, a comparative advantage in exercising control, and that this advantage is worth utilizing to realize pecuniary and non-pecuniary returns.[38]

The concentration of ownership and shareholder control is especially relevant when the firm has a high specific risk. There are two kinds of risk: 1) market or systematic risk, caused by general movements in the stock market produced by economic events such as interest rate and exchange rate variations; 2) firm-specific risk, related to factors that do not affect other

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36 Stern Stewart & Co., "Enron Signals the End of the Earnings Management Game," *EVAluation* 4 (April 2002).

37 Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (October 1976): pp. 305– 360.

38 Harold Demsetz, "Corporate Control, Insider Trading, and Rates of Return," *The American Economic Review* 76, no. 2 (May 1986): pp. 313–316.

firms. Studies by Demsetz and Lehn show a positive correlation between the concentration of ownership and firm-specific risk. They consider that firm-specific risk is an indicator of the potential profitability of "insider trading,"[39] therefore, the greater the firm-specific risk (instability), the greater the shareholder control should be. Insider information allows shareholders to obtain a higher return than the market average.

The agency cost problem, even in companies with disperse stock ownership, could be substantially reduced if insider trading were allowed. As Henry Manne eloquently concluded in 1966, insider trading boasts at least two important advantages: 1) it allows for the compensation of "corporate services" performed by company managers; and 2) it guarantees a fast and accurate adjustment of the company's stock price.[40] Therefore, a regulatory framework allowing insider trading could become an important mechanism of corporate governance. If managers, or other people privy to insider information, were to identify problems affecting the company's future, they would sell their shares in advance, because they would have insider information. This behavior would send a warning message to the stock market, which would react accordingly. The same thing would occur if the opposite were true. If managers or the people with insider information were to foresee a better future, they would buy shares, giving a boost to the stock price.

Finally, there are certain external factors that affect the degree to which the interests of managers and owners may diverge:

1. Competition among potential managers creates a limit to administrative service costs. If responsibilities require little specialized knowledge, if it is easy to assess performance and if replacement costs are moderate, the degree of divergence will be lower and vice versa.

2. Non-aligned interests are also limited by capital markets because shareholders always have the option of selling their shares.[41]

39 Insider trading takes place when stock is purchased or sold based on information about that stock that is not yet in the public domain. For example, one of the most common cases of insider trading occurs when the associates or family members of officers, directors or employees make stock purchase and sale transactions after receiving information about a confidential corporate event. The SEC punishes insider trading because it considers that it reduces investors' trust in the justice and integrity of the capital market.

40 Henry G. Manne, "Insider Trading and the Stock Market," *The Journal of Business* 41, no. 2 (April 1968): pp. 263–265.

41 Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3, no. 4 (October 1976): pp. 305–360.

The Proposal: A Competitive Financial Information Market

For shareholders to make the economic calculations necessary for capital markets to function correctly, they need to have access to reasonable financial information. This is why a competitive financial information market is so important.

As mentioned above, the auditor's role is to check that the figures contained in financial statements are reliable and have been prepared in accordance with generally accepted accounting principles. As stated in the AICPA Professional Standards,

> Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services.[42]

Independence here means an attitude conducive to objectivity and freedom from external influences when conducting an audit and issuing an opinion.

Both the AICPA and the SEC have established certain rules concerning this independence. According to the AICPA,

> Members often serve multiple interests in many different capacities and must demonstrate their objectivity in varying circumstances. Members in public practice render attest, tax, and management advisory services. Other members prepare financial statements in the employment of others, perform internal auditing services, and serve in financial and management capacities in industry, education, and government. They also educate and train those who aspire to admission into the profession. Regardless of service or capacity, members should protect the integrity of their work, maintain objectivity, and avoid any subordination of their judgment.[43]

The criteria established by the SEC are very similar to those of AICPA. According to the SEC,

> The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial

42 American Institute of Certified Public Accountants (AICPA), *Code of Professional Conduct*, Section 100, Rule 101–Independence, http://aicpa.org.

43 Ibid.

> judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.[44]

We could sum up by saying that the AICPA and the SEC mention two conditions that could impair auditor independence:

1. conflict of financial interests; and
2. holding a public position that is not compatible with the objectivity required for rendering attestation services.

In turn, the Code of Professional Conduct refers to contingency fees. Rule 302 of this code states,

> A member in public practice shall not: (1) Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member's firm performs, (a) an audit or review of a financial statement; or (b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or (c) an examination of prospective financial information.[45]

Curiously, however, neither the AICPA nor the SEC consider independence to be impaired by the fact that in most cases financial statement audit fees are paid by the audited companies themselves. This practice allows for a potential conflict of interest, as auditing firms may be encouraged to issue opinions without restrictions or to conceal part of the relevant information in order to keep the client. That is to say, if the audit firm's fees are paid by the audited company, the firm's interests are in conflict with its professional responsibilities.

Before the Sarbanes-Oxley Act was passed, auditing firms could provide consulting and financial statement auditing services to the same company. Consequently, auditing firms were tempted to issue audit reports without restrictions so as not to lose the revenue from the consulting services provided to the same client. Separation of these functions, however, is not an answer to the conflict of interest identified above.

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44 Securities and Exchange Commission (SEC), *Regulation S-X,* http://sec.gov/divisions/corpfin/forms/regsx.htm.

45 American Institute of Certified Public Accountants (AICPA), *Code of Professional Conduct*, Rule 302-Contingent Fees, http://aicpa.org.

How, then, can the interests of an auditing firm be aligned with those of investors to ensure reliable reports are made? In other words: how can we make public accountants independent from the companies they audit?

Our proposal is to promote a financial information market where auditing (or other) firms compete to make the opinions they issue truthful and relevant. These companies would offer their reports to investors in different formats and with different levels of detail. To this end, the SEC would need to eliminate the legal requirements which currently determine the flow of information, such as quarterly reports and 10-K forms. At present, these legal requirements minimize the disclosure of financial and accounting information because they encourage public companies to meet the minimum requirements. Moreover, there is no incentive to ensure that all the pertinent information is considered. Minimum requirements are met and nothing more. This proposal aims to remove these "minimalist" incentives.

Eliminating the SEC's requirements for a flow of information would not leave the capital market adrift, because public companies would find other alternatives to provide investors with the necessary information to value a company. However, incentives would change because, in order to win the trust of investors, managers would have to provide the necessary information to make their shares appealing, not just the minimum information required at present. When managers recognize their dependence on the capital market, they will assess different ways of publishing their financial and accounting information. This information will not be exclusively focused on accounting reports, but also on any other data that is currently omitted due to legal restrictions. Therefore, managers could decide to provide profit and cash flow forecasts, for example.

Some public companies would probably choose to show their books and financial information to one or two auditing firms. These companies would not be bearing any cost by doing this, as investors themselves would, in one way or another, be paying the auditing firms directly for the reports. This necessarily changes the incentives for wrongdoing identified earlier in this paper, as fees would no longer be contingent on or linked to the board or to the management of the economic organization.

The most important advantage of this proposal is that it would guarantee the autonomy of external auditors, allowing them to remain objective and free from the influence of the organization's management. This independence would give more credibility to the auditor's opinion. Such an

approach would encourage true auditor independence, thus reducing the potential conflict between the organization's management and financial information users, through an effective monitoring system.

However, this proposal will only be successful if auditing firms or other organizations that provide review services of financial information submitted by managers—such as Standard & Poor´s and Moody´s—can compete freely. This competition would increase the quality of the service provided to buyers (investors). In turn, competition in the financial information market would promote the spontaneous development of different ways of determining the economic value of companies and would allow shareholders to choose from a range of alternatives the one that suits them best. Therefore, as is the case in any competitive market, innovation in the preparation and submission of financial information would increase. To foster competition in this market, there should be no regulations that create entry or exit barriers.

Within this scenario, competition would encourage auditing firms to make greater efforts to provide reliable opinions, with the aim of obtaining an excellent reputation that would, in turn, result in higher future profits. Auditing firms would be selling trust and diligence when dispatching their responsibility.

In a competitive financial information market, a brand's most important asset is its reputation. This reputation is achieved by issuing truthful audit opinions. As Hayek says, "Competition is in large measure competition for reputation or good will."[46]

Therefore, this system would generate reliable, timely and accurate financial information for decision-making purposes. If the auditing firm and an organization's management colluded to show misleading financial information, in the future, users would not accept financial statements audited by that firm. The reputation of the firm would be destroyed.

These measures would encourage independent auditors to carry out a careful examination to provide reasonable certainty that a company's financial statements do not contain incorrect assertions, resulting from

46 F. A. Hayek, "The Meaning of Competition" in *Individualism and Economic Order* (London: Routledge & Kegan Paul, 1949), p. 97.

either mistakes or irregularities. Auditors would show professional skepticism[47] so as not to damage their reputation.

With reliable information now available, the market value of shares would move closer to their intrinsic value. This would allow for a more efficient allocation of resources, as stock prices are signals as to which company to invest in.

In a free market there should be no legal restriction on a firm providing auditing and consulting services to the same company. Shareholders, however, should be warned that there is a potential conflict of interest if the company hires consulting services from the same company that investors have selected to audit its financial information.

How would this competitive financial information market work? Information is owned by the company, so that the company itself would have to select at least two external auditing firms to issue an opinion about its financial statements.

Financial information users (current and potential investors, creditors, rating agencies and others) would purchase the auditing report from the auditing firm they trust most. If one of the firms selected by the company did not conduct an audit properly, investors would not buy its reports in the future and the audited company would have to select another firm. Therefore, the preferences of financial information users would determine which firms would audit public companies.

If a public company does not select auditing firms that issue reliable and accurate opinions, investors will not buy its shares. That company's stock will then be less liquid (fewer purchase and sale transactions).

Regarding fee payment to external auditing firms, there are three alternatives:

> **One.** The auditing firms selected by the company would provide a quotation for their professional fees. Financial information users who wish to obtain the report from a specific firm, and who agree with the fees quoted, would pay a contribution. These users must sign a confidentiality agreement in which they agree not to provide the audit report to third parties.

47 Professional skepticism refers to the obligation of auditors to conduct their job without discarding the possibility that an important fraud may exist, despite past experiences which would inspire trust in management's integrity and honesty.

Two. The main users of financial information (investment banks, mutual funds, insurance companies and others) would pay the auditing firm's fee and the financial statements would become public.

This alternative could be criticized in that, if ownership of a company's stock is concentrated, large shareholders could collude with the external auditing firm to the detriment of minority shareholders. Minority shareholders would not be able to influence the selection of the audit report to be acquired. For example, majority shareholders could influence the external auditors to submit misleading reports and use derivative market instruments to obtain additional profits. However, as with the use of insider information in a concentrated ownership structure, these shareholders are incurring costs to reduce residual loss from the agency relationship, so it is only fair that they should obtain additional profits. Minority shareholders are not willing to incur these monitoring costs because they do not think they will obtain benefits that exceed those expenses. If shareholders with greater ownership concentration select the right auditing firm, minority shareholders will also benefit from this decision (we could say they are "free riders").

We must remember that, in the long term, the stock price will show the value of the company and that minority shareholders can always sell their shares (i.e., they always have a way out).

Three. Auditing firms publish and sell their reports directly to investors.

Apart from establishing that users must pay independent auditors' fees so that interests are properly aligned, other corporate governance measures would need to be adopted to help prevent and identify fraud in a company's financial statement, namely:

- Establishment of a board of directors as an active and vital monitoring mechanism. This board of directors would supervise management activities and the issuance of the company's financial information.
- Establishment of an auditing committee to support the board in discharging its responsibility to supervise internal control systems and the auditing process and to review financial information.

- Defininition and implementation of a *code of ethical conduct*, and a program to enforce it. Although incentive changes are preferred, it is also important that a company's employees know the values that underpin the organization's development and growth.
- Selection of the external auditing firm on the basis of its reliable auditing services and reputation.
- Establishment of an internal audit department to permanently assess the company's internal control system and follow up on management activities. This internal audit department would report to the board of directors.

These measures would help to identify and quantify operational and financial information risks existing in the organization.

This paper does not aim to provide a definitive solution because we consider that in a competitive financial information market, information agents and companies need to test different procedures by trial and error until the most efficient alternative is usually adopted. A competitive process is, after all, a process of discovery. However, this process of trial and error will not start from scratch because there are already companies that offer information other than that offered by auditors; for example, financial analyses offered by Value Line to investors. This company offers independent information on more than 1,700 companies. Some investors use these reports exclusively because, in their opinion, they provide a more objective and reliable analysis. But the information base available to Value Line analysts is limited because they do not have access to companies' detailed accounting and financial information as auditors assumedly do.

Criticism of the Proposal

One problem we identify is that public company audits could be carried out by a handful of firms.[48] However, in a competitive system, new auditing firms can always come onto the market. If these offer excellent standards of quality, financial statement users will come to trust and prefer them.

Another potential danger is that these few firms could work in collusion, setting up a kind of cartel. However, when we refer to free competition, we are not speaking about a perfect competition model, where the market is fragmented and participants are price takers. Rather, we are referring to the free competition that results from the lack of entry and exit barriers. Even

48 At present, audit work is concentrated in a few firms. According to the General Accounting Office, the four largest firms, Deloitte & Touche, PricewaterhouseCoopers (PWC), Ernst & Young (E&Y) and KPMG, audit 97% of public corporations in the United States, whose sales exceed $250 million. These four firms also audit more than 80% of public companies in Japan.

when there is some degree of concentration, new competitors will enter a competitive market so long as there is a possibility of obtaining economic profit.

Another problem could be whether a competitive financial information market would fully eliminate financial fraud in corporations. Fraud will always exist, but under this proposal, the number of cases requiring adjustments to previously reported periods, as a result of undetected or unreported mistakes or irregularities by external auditors, would be reduced because auditors would focus on offering a diligent review service to financial statement users. If they failed to do so, the market would make the necessary corrections. Just as consumers stop buying a poor quality product, investors would stop hiring the services of an external auditing firm that did not issue reliable opinions.

It might be argued that, after the Enron case, the market stopped hiring Arthur Andersen's services anyway, which would invalidate the need for this proposal. However, the point is that the likelihood of financial frauds occurring in a competitive financial information market would be less than it is in today's market, where there are always conflicts of interest.

Another criticism could be that the safety of investors cannot be left in the hands of the market. First, we must make it clear that investors are also businesspeople, because they decide on the direction of capital. Mises argued that economic profit originates when undervalued markets are identified.[49] In this case, investors seek to identify shares whose market price is lower than their intrinsic value and which may, consequently, produce returns. Economic profit is a process of arbitration. When shareholders decide to invest, they seek such hidden return, and face uncertainty. For Frank Knight, economic profit is the return obtained from facing uncertainty.[50] According to Knight, uncertainty exists because there is no such thing as perfect knowledge. That is to say, uncertainty forms part of entrepreneurial decision-making. It is not possible to protect investors from every loss, because each entrepreneurial decision presupposes the acceptance of the uncertainty associated with its results.

An investor (shareholder) may therefore overvalue or undervalue stock, make a mistake or not. Every decision is subjective. Bearing uncertainty is part of the business function of buying and selling shares (allocating or

49 Ludwig von Mises, *La Acción Humana* (Madrid: Unión Editorial, 1980), p. 42.
50 Frank Knight, *Risk, Uncertainty and Profit* (Boston: Hart, Schaffner & Marx; Houghton Mifflin Company, 1921), chap. IX.

not allocating resources). Even when investors have the most accurate financial information, they may make mistakes in their appreciation and suffer losses, because the future is uncertain.

If we seek to protect investors by establishing a complex network of information requirements and regulations, we are only encouraging childish behavior in decision-making processes, which leads investors to misread financial analyses and assume excessive risk. In analyzing this situation, one cannot help wondering whether the SEC and government regulations are causing these financial crises themselves.

Are New Financial Reporting Regulations Necessary?

For this proposal to be implemented, SEC reporting regulations and requirements would need to be eliminated first. Many might oppose this measure on the grounds that investors would be unprotected and open to financial fraud. In response to this, we would first have to question the effectiveness of and need for the complex regulation system existing today.

This in turn brings us back to a question raised earlier in this paper: Will the Sarbanes-Oxley Act prevent financial frauds in the future?

Excessive financial information regulation breeds complacency among investors, who feel protected by an institution such as the SEC. The government creates a paternalistic environment. Then, when faced with the market damage of a financial crisis caused by its interventions and regulations, the SEC responds defensivly by issuing more regulations.

The problem with issuing new regulations is that they may bring undesired consequences. Frequently, they achieve the direct opposite of their original purpose. Whenever there is a problem, new laws must be issued to correct it. However, no one analyzes whether it is the regulatory regime itself that is causing the crisis. Is it possible that the Enron, WorldCom or TYCO frauds were the result of excessive regulations? What will the unintended effects of the Sarbanes-Oxley Act be? Following are our comments on some of the provisions of the Sarbanes-Oxley Act that will damage investors.[51]

- This Act will increase the number of reports but not their quality. Accounting is not an exact science; therefore, managers will seek to

51 Richard Bassett and Mark Storrie, "Accounting at Energy Firms after Enron: Is the 'Cure' Worse Than the 'Disease'?," *Policy Analysis*, no. 469 (February 12, 2003).

reduce their personal risks by using careful and complex language to prevent legal sanctions.

- The creation of the PCAOB, the new accounting standards regulatory body, will cause public companies to incur in more direct costs. It is estimated that the Sarbanes-Oxley Act has doubled the costs related to compliance with reporting requirements for public companies.[52] These costs include higher fees for law and auditing firms, new internal control systems, insurance premiums and others.

- As a result of the high costs required to meet the Act's provisions, many companies have decided not to list their shares on the main exchanges; these are now listed on the OTC stock market.[53] A survey carried out by Christian Leuz[54] indicates that the number of companies delisted after the Sarbanes-Oxley Act went from 67 in 2002 to 198 in 2003. Investors punished this measure by reducing the stock price.

- Company management will have a compliance-based approach and will abandon the principle-based approach. That is to say, the principle of substance over form will be abandoned.

- These new requirements may discourage the flow of investment towards the United States.

- Management will not submit additional information for fear of being punished for submitting data that may later be invalidated. This will damage the stability of capital markets because, if investors have less information about a company's long-term plans, they will focus on short-term investments, thus increasing stock volatility.

It is estimated that during the last decade accounting-related regulations have increased by 150%. This staggering increase has not prevented financial frauds nor has it protected investors. It would appear that no cost-benefit analysis is being made of these laws and requirements. For example, what is the cost of having organizations such as the Public Company Accounting Oversight Board (PCAOB) or the SEC? What is the cost of meeting SEC reporting requirements? What is the cost of inefficient resource allocation resulting from the implementation of laws that distort economic decisions? These last two aspects are more difficult to quantify. As John Blundell has said: "More regulation is less protection; less regulation is more protection."[55]

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52 Patrick Jenkins, "Most German groups rue listings in U.S.," *The Straits Times*, November 20, 2004.

53 Stock traded in the unofficial or over the counter market.

54 Christian Leuz, Alexander Triantis and Tracy Wang, "Why do Firms go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations" (2003): p. 4, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=592421.

There are other proposals in favor of deregulation. For example, Myddelton suggests making accounting standards more flexible and fostering competition in the creation of standards to measure companies' economic performance. That is to say, allowing for the spontaneous evolution of accounting standards for how a company's transparent profits and financial position are presented. This spontaneous evolution requires deregulation on the part of the regulatory organization.

For example, U.S. GAAP establishes three methods for recording stock investments: 1) the consolidation method, for investors with more than 50% ownership; 2) the equity method, for those with 20% to 50% ownership; and 3) the cost method, for those with less than 20% ownership. The consolidation method shows the revenue, income, expenses, taxes and profits of the company in which the investor has more than a 50% ownership. With the equity method, a single line is included in the "P&L statement," showing the investor's share in net profits. With the cost method, only the dividends received must be included in the "other income" item of the "P&L statement." However, as the share capital is fragmented, only the dividends received will be shown if an investor owns, for example, 15% of Dell. But it is Dell's policy not to pay dividends, so retained earnings are never taken into account. If new accounting standards were allowed to be developed, this cost method criterion could be changed to show what Warren Buffett defines as "more look-through earnings." We must bear in mind that the economic transaction takes place first and the accounting standard demonstrating it needs to be created later.

We need to seek order. As Ortega and Gasset once said, "Order is not pressure exerted on society from the outside but a balance that arises from the inside."[56] Therefore, there is a need to adopt accounting standards that best reflect the financial performance of organizations, if investor trust is to be upheld.

Imposing regulations only prevents the creation of better accounting standards, reduces the responsibility of professional associations and increases investors' financial risk. With arbitrarily imposed rules, concern is no longer focused on whether the accounting standards show reasonable values, but on compliance with provisions. We could say that the spirit of the standard is lost and replaced by mere formalities. In addition, the inde-

55 John Blundell, "Remember Blundell´s Law," *The Scotsman*, June 30, 2004.

56 Ortega y Gasset, *Mirabeau o el Político* (Madrid: Alianza Editorial, 1986), p . 603.

pendent auditors' criteria are left aside, as their only responsibility is to meet accounting standards.

We could say that arbitrary accounting standards do not prevent fraudulent accounting practices, but they do prevent the development of better practices.

Despite the complex regulatory system, investors cannot be misled for long. Sooner or later, frauds come to light and the stock prices of companies that have used creative accounting to show a better financial position are corrected accordingly. However, when regulations are eliminated, company costs are reduced, better methods for measuring economic performance can develop, and there is an incentive to submit additional financial information to investors and, thereby, improve rating quality.

Are SEC Reporting Requirements Necessary?

Could capital markets survive without the quarterly and annual submission of financial reports legally required of public companies? Some think that managers cannot be trusted to disclose the information that investors require to make decisions. For example, Salomons argues that investors would be seriously damaged:

> Managers may have more to gain by withholding information than from disclosing it. We cannot depend on the market to discipline promptly companies that are free to choose what and how to report to investors. Even if good accounting can be relied on to drive out bad in the long run, investors may suffer too much damage in the short run to permit freedom from regulation.[57]

This suggests minimum disclosure levels and specific measurement methods, such as U.S. GAAP and SEC requirements,[58] will still be necessary to reduce the information asymmetry existing between a company's officers and its shareholders.

Another position considers that there are incentives for the submission of financial reports by public companies. On the one hand, if companies wish to obtain funding through the sale of shares, they will promote the

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57 David Salomons, "The Political Implications of Accounting and Accounting Standard Setting," *Accounting and Business Research* 13, no. 50 (1983): p. 107.

58 At present, the SEC requires public companies to file form 10-K, which requires them to disclose the following information: business description, issues voted by stock owners, legal procedures, stock reacquisitions, management's discussion and analysis of results of operations, quantitative and qualitative disclosures on market risk, financial statements and supplementary information, changes and disagreements with auditors regarding the disclosure of accounting and financial information, company directors and executives, compensation of officers, ownership of stock, related transactions, break down of tax, accounting and consulting fees for financial statements and other additional information.

generation of trust in the company's current and future financial performance by submitting full financial reports. On the other hand, if control (management) and ownership (shareholders) are separated, current shareholders will require information about the financial creditworthiness and operating results of the business organization if they are to continue contributing their capital. If a company does not submit timely and reliable information, investors will lose trust and stop allocating resources to that company.

In this sense, Warren Buffett refers to the importance of informing shareholders in his *Owner's Manual* of 1996:

> We will be candid in our reporting to you, emphasizing the pluses and minuses important in appraising business value. Our guideline is to tell you the business facts that we would want to know if our positions were reversed. We owe you no less. Moreover, as a company with a major communications business, it would be inexcusable for us to apply lesser standards of accuracy, balance and incisiveness when reporting on ourselves than we would expect our news people to apply when reporting on others. We also believe candor benefits us as managers: The CEO who misleads others in public may eventually mislead himself in private.[59]

If company officers wish to generate trust and long-term value, they will not seek to overvalue the stock price by misreporting accounting figures. Buffett explains the stock price approach of his company Berkshire Hathaway in the following way:

> To the extent possible, we would like each Berkshire shareholder to record a gain or loss in market value during his period of ownership that is proportional to the gain or loss in per-share intrinsic value recorded by the company during that holding period. For this to come about, the relationship between the intrinsic value and the market price of a Berkshire share would need to remain constant, and by our preferences at 1-to-1. As that implies, we would rather see Berkshire´s stock price at a fair level than a high level.[60]

Corporate managers with long-term vision and value-based compensation packages will provide relevant financial reports to investors in order to obtain funding for the growth of their organization.

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59 Warren Buffett, *An Owner's Manual*, 1996, http://www.berkshirehathaway.com/ownman.pdf
60 Ibid.

Conclusion

The purpose of an independent audit is to issue an opinion on a company's financial statements. Financial statements, together with an independent auditor's report, are sent to clients, creditors, current and potential investors, and other interested parties. The external auditor's report provides credibility to the company's financial figures.

Independent audits are necessary because of the inherent conflict between an organization's management (stewards) and the users of financial reports. An external audit may generate confidence in a company's financial information, making it possible to assess compliance with management responsibility, make economic calculations and take decisions on resource allocation.

Many solutions have been sought for the crises caused by financial information frauds. Some think the answer is to create more regulations to prevent financial irregularities by punishing the parties involved. The problem, however, is that very often these regulations cause effects that run counter to their original purposes and restrict the creation of new accounting standards that would give a better picture of a company's financial performance. Others consider that competition among the different accounting standards should be permitted so that companies can choose the set of accounting standards they are going to use to show their financial position and operating results. However, financial frauds have taken place even when different sets of accounting standards have been used. Other suggestions include establishing codes of ethics aimed at strengthening the ethical principles of directors, auditors and other parties involved.

However, even though more regulations have been issued, such as the Sarbanes Oxley Act of 2002, and the importance of improving ethical values and corporate responsibility has been highlighted, this has not prevented huge financial frauds from causing instability in capital markets, and, therefore, hindering the creation of wealth in our society. This problem could be eased if monitoring mechanisms, such as boards of directors and independent auditors, are strengthened.

Boards of directors need to perform an independent, active and critical role in the supervision of management activities, and to act as the watchdogs of effective corporate governance. Boards of directors must also

design a compensation system for company directors that will encourage long-term value creation for the company itself, in the sense of a sustained return on invested capital, in excess of capital cost.

Regarding independent auditors, their interests must be aligned with those of financial report users so that they issue accurate auditing opinions. One way in which these interests could be brought into step is by establishing a competitive financial information market. In this market, only reliable financial reports would be valid, because the user of financial statements would be the one who pays the auditing firm's fees. Thus, independent auditors would seek to comply with the public interest and report whether financial statements have significant errors or irregularities that could affect users' economic decisions. Changing incentives would result in the generation of reliable, timely and accurate financial reports. This would provide stability to the capital market, and the confidence generated in organizations would allow for greater economic development.

Finally, we must assess whether there is a need for the information requirements demanded by regulatory organizations. Public companies use capital markets to obtain funding for their projects. To obtain funding, they have to generate confidence in investors. So, even when there are no formal financial reporting requirements, these companies will still be encouraged to submit financial reports with the aim of attracting the resources they need to grow.