

IRQ

VOLUME 5, NUMBER 3



Investor Confidence Interrupted

4 **WHITE PAPER**
Rebuilding Trust

18 **ACADEMIC RESEARCH**
Auditor Independence
Fraud Costs

35 **IRQ ROUNDTABLE**
After the Mania

50 **CASE STUDY**
Whose Business Is It, Anyway?



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Investor Confidence Interrupted

FEATURES

WHITE PAPER

page 4 Rebuilding Trust — BY JOEL SELIGMAN, J.D.

ACADEMIC RESEARCH

page 18 Auditor Independence — BY RICHARD M. FRANKEL, PH.D, CPA,
MARILYN F. JOHNSON, PH.D AND KAREN K. NELSON, PH.D, CPA

page 27 Fraud Costs — BY DAVID B. FARBER, PH.D AND MARILYN F. JOHNSON, PH.D,

IRQ ROUNDTABLE

page 35 After the Mania

CASE STUDY

page 50 Whose Business Is It, Anyway?

DEPARTMENTS

page 3 **EDITOR'S NOTE**

page 63 **BIG ISSUES FOR SMALL CAPS**

page 66 **IR BOOKSHELF**

page 71 **IRQ CONTRIBUTORS**

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Editor's Note

As much as investor confidence has been discussed, dissected and desired of late, one might think that the concept was newly concocted. Investor relations practitioners know differently. Investor confidence may not appear as a phrase in our job descriptions, an identifier in our bios or, before now, an item on the agenda for the next corporate strategic planning session. But it's inherent in what we do. And it'll still be part of the IR landscape long after the phrase fades from the headlines.

As this issue of *IRQ* took shape, investor confidence — or, more specifically, its erosion — commanded mass media attention, framed congressional debates, provided context for corporate announcements and started to feel like the houseguest that moved in for keeps. As unsettling as that constant presence has been at times, the experience has served as a reminder not to take investor confidence for granted. The heightened awareness — and especially the events that brought investor confidence into day-to-day conversation — have encouraged some re-evaluation of routines. That is a healthy exercise.

Our contributors to this issue of *IRQ* bring wide-ranging expertise to the investor confidence discussion. When a number of financial community leaders gathered for a NIRI-sponsored roundtable in 2002's first half, investor confidence was reeling from a litany of specific shocks. Not surprisingly given the participants' stature, their observations applied to the events as well as to the expected fallout, which all of us have had to manage as investor confidence continued to slide. As the year progressed, we grappled with those effects and debated the fixes. Our white paper focuses on that aspect of rebuilding investor confidence, most notably the Sarbanes-Oxley Act. We also look at academic research that helps us understand the relationships between certain familiar corporate practices and their unintended consequences.

The circumstances that have led us to examine investor confidence have been unsettling at times. But they also served to remind us of how critical — and how fragile — investor confidence is. Recent events may have interrupted investor confidence, but the practice of investor relations plays a significant role in its repair.

Connie Harrison

Connie S. Harrison

February 12, 2003

WHITE PAPER

Rebuilding Trust

Corporate and Securities Law
After Enron

[4]

BY JOEL SELIGMAN, J.D.

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IN 1934, THE SAME YEAR THAT THE SECURITIES AND EXCHANGE Commission began operations, Supreme Court Justice Harlan Stone memorably observed at the dedication of the University of Michigan Law School Quadrangle:

“I venture to assert that when the history of the financial era which has just drawn to a close comes to be written, most of its mistakes and its major faults will be ascribed to the failure to observe the fiduciary principle, the precept as old as holy writ, that ‘a man cannot serve two masters.’ More than a century ago equity gave a hospitable reception to that principle and the common law was not slow to follow in giving it recognition. No thinking man can believe that an economy built upon a business foundation can permanently endure without

some loyalty to that principle. The separation of ownership from management, the development of the corporate structure so as to vest in small groups control over the resources of great numbers of small and uninformed investors, make imperative a fresh and active devotion to that principle if the modern world of business is to perform its proper function. Yet those who serve nominally as trustees, but relieved, by clever legal devices, from the obligation to protect those whose interests they purport to represent, corporate officers and directors who award to themselves huge bonuses from corporate funds without the assent or even the knowledge of their stockholders, reorganization committees created to serve interests of others than those whose securities they control, financial institutions which, in the infinite variety of their operations, consider only last, if at all, the interests of those whose funds they command, suggest how far we have ignored the necessary implications of that principle. The loss and suffering inflicted on individuals, the harm done to a social order founded upon business and dependent upon its integrity are incalculable.”

At their core, federal securities laws involve the remediation of information asymmetries — that is, equalization of information that is available to outside investors and insiders.

This most obviously is true with respect to the mandatory disclosure system, which compels business corporations and other securities issuers to disseminate detailed, generally issuer-specific information when selling new securities to the public and requires specified issuers to file annual and other periodic reports containing similar information. In essence this system was a response to the failure of business and foreign government issuers to sufficiently disclose information that was material to making investment decisions in the period preceding the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934.

In the years since the SEC began operations, U.S. securities markets have experienced an almost unimaginable growth and vitality.

The number of stockholders in the United States has increased from 1.5 million, or 1.2 percent of the population, in 1929 to 84 million, or 43.6 percent of the adult population, in 1998. As long ago as 1980, 133 million U.S. citizens indirectly owned shares through such intermediaries as mutual funds or pension plans.

When the stock market began its collapse in September 1929, the aggregate value of all shares on the New York Stock Exchange was approximately \$90 billion. By 2000, NYSE capitalization had grown to nearly \$12.4 trillion. Perhaps most remarkably, in 2000 more than \$2.3 trillion in new securities was sold in some 16,481 corporate underwritings and 3,540 private placements.

Underlying these remarkable numbers was the longest sustained bull market in U.S. history. Focusing on year-end closing indexes, the Dow Jones Industrial Average rose from 875 in 1981 to 11,497 in 1999, paralleling similar surges in other leading composite indexes. To put this in different terms, between 1981 and 1999 the NYSE stock market capitalization increased nearly elevenfold to \$12.3 trillion.

A lulling of institutional sensibilities seems to have come with this unprecedented success. A widespread belief appears to have evolved in the U.S. financial community that time-honored rules such as those that discourage conflicts of interest are quaint and easily circumvented. Too frequently in recent years, sharp practitioners in business, investment banking, accounting or law appear to have challenged the fundamental tenets of full disclosure of material information or fair presentation of accounting results. A deterioration in the integrity of our corporate governance and mandatory disclosure systems may well have advanced not because of a novel strain of human cupidity but because we had so much success, for so long, that we began to forget why fundamental principles of full disclosure and corporate accountability long were considered essential.

ENRON’S DESCENT

No recent case better illustrates this deterioration than Enron.

Enron was an extraordinarily fast-growing provider primarily of natural gas, electricity and communication products and services whose total assets quadrupled between 1996 and 2000 to \$65.5 billion. Its 2000 Form 10-K annual report was a consistently upbeat review of its many claimed successes, unusual only in that Exhibit 21 to its certified financial statements was a 49-page list of subsidiaries. In 2001 Enron ranked seventh on the Fortune 500 list, with revenues in 2000 of \$100.8 billion.

Then, abruptly, essentially without warning, Enron melted down. A November 8, 2001, Form 8-K stunningly stated, “Enron intends to restate its financial statements for the years ended December 31, 1999 through 2000 and the quarters ended March 31 and June 30, 2001. As a result, the previously issued financial statements for those periods and the audit reports covering the year-end financial statements for 1997 to 2000 should not be relied upon.”

Besides charges against earnings, reductions in reported shareholders’ equity and increased debt, Enron also revealed that its chief financial officer had received substantial amounts of money from special partnerships that he controlled. These announcements destroyed market confidence and investor trust in Enron. Less than one month later, the company filed for bankruptcy.

Subsequent investigations, most notably the Enron Special Investigative Committee Report that was prepared under the guidance of University of Texas Law School Dean William Powers, which came to be known simply as the Powers Report, made it clear that Enron created the partnerships not to achieve economic objectives or to transfer risk but just to affect financial results.

In the process, the company bypassed applicable accounting rules, which

allowed it to conceal from the market very large losses resulting from its merchant investments by creating an appearance that those investments were hedged—that is, that a third party was obligated to pay Enron the amount of those losses—when in fact that third party was simply an entity in which only Enron had a substantial economic stake.

Underlying this pivotal aspect of the debacle was a breakdown in the integrity of Enron’s accounting, the result of mistakes either in structuring the transactions or in basic accounting. There were also substantial corporate governance and management oversight failures, particularly in allowing Enron executives to participate in—and benefit from—the partnerships.

[8] It appears that there was little in the way of internal checks or balance when senior managers engaged in questionable transactions. Nor did Enron’s board of directors carry out its oversight duties. It failed to demand more information and to probe and understand the information that did come to it. Typically a board will be aided in review of complex auditing and financing issues by committees, often largely and entirely involving outside or nonemployee directors. This did not happen here. Nor was the board or its committees provided the type of critical questioning by the outside auditor, Arthur Andersen, that reasonably could be anticipated.

A different type of check and balance is typically provided by outside legal counsel. But that brake similarly failed at Enron.

Another aspect of bringing the partnerships’ nature to the surface fell short as a result of Enron’s systematically inadequate public disclosure. Even when the entities were referred to in notes to Enron’s financial statements, the paragraphs obfuscated, failed to answer basic questions and asserted without adequate foundation that the arrangements were comparable to arm’s-length transactions. The Powers report assigned responsibility for the inadequate disclosures to Enron management, the audit and compliance

committee of the board, Enron's in-house counsel, its law firm and its accounting firm.

LESSONS LEARNED

The Enron debacle raised fundamental policy and regulatory questions.

Perhaps most significant is the empirical question of whether Enron was an isolated but serious breakdown or whether the problems exposed there are more extensive. By early February 2002, commentators attributed a marketwide dampening of stock prices in part to uncertainty as to whether the accounting, auditing and corporate governance problems at Enron would become widespread. Between 1997 and 2001 the number of earnings restatements grew each year from 116 in 1997 to 158 in 1998, 216 in 1999, 233 in 2000 and 305 in 2001.

Another topic of discussion was whether the kinds of problems illustrated by Enron would be self-correcting, at least for the foreseeable future. SEC, Justice Department and private investigations or litigation soon were under way. The SEC began a series of regulatory initiatives, including proposed changes in corporate disclosure rules that, among other points, significantly broaden the list of events that require current disclosure on Form 8-K.

Even without further legislative action, it is reasonable to anticipate enhanced board review of transactions, more detailed and more precise disclosure in SEC filings, more demanding internal accounting controls and outside audits, and more skeptical investment analyst reports. However, a caveat is in order here. Voluntary steps often work well when there is a mood of crisis or a fear of legislation or regulation. There is a different type of uncertainty regarding whether voluntary steps will endure after a crisis mood has abated.

ENRON LEGACY: MORE AUDITING REGULATION

As the Enron meltdown continued, it became evident that there was broad support to address auditing regulation among a number of regulatory bodies and in Congress. In that regard, it is worth disaggregating several specific issues.

First, the off-balance-sheet transactions that Enron employed were made in accordance with generally accepted accounting standards. This fact appropriately focused attention, once again, on the quality of the existing accounting standard-setting organization, the Financial Accounting Standards Board.

Long before Enron, FASB's political and financial weaknesses were much discussed. Congress or the SEC should systematically review the process and substance of accounting standard-setting. It is urgently necessary to restore and strengthen the fundamental premise that financial statements provide a fair presentation of an entity's financial position. This involves addressing specific disclosure items such as off-balance-sheet transactions, stock options and derivatives as well as strengthening the independence of accounting standard-setting.

The key here, as elsewhere, is money. A government agency or private entity cannot be expected to be truly independent without an assured source of funds.

At its core Enron involved an audit failure. The outside auditor appeared to operate with significant conflicts of interest and to have been too beholden to a highly aggressive corporate management.

The need for a new auditing self-regulatory organization became clear. It needed to replace not just the existing oversight board but also a Byzantine structure of accounting disciplinary bodies that generally have lacked adequate and assured financial support, clear and undivided

responsibility for discipline and an effective system of SEC oversight. The magnitude of the need was evident in a proposal from the SEC that was striking for the vehemence of its premise. It said, “The current system of oversight has not produced a credible result. Flaws in the system have contributed to the confluence of several factors that have undermined investor confidence in financial information and market efficiency.”

One significant outcome of the discussions and proposals was the Sarbanes-Oxley Act, enacted in July 2002. In congressional hearings preceding its enactment, particular attention was devoted to the wisdom of separating accounting firm audit services from consulting. One early result of Enron had been an acceleration of this process by voluntary means among the Big Five accounting firms. The Sarbanes-Oxley Act does not require the division of an accounting firm into an audit firm and a separate nonaudit firm. Instead, it prohibits nine nonaudit services for audit clients and requires preapproval for others. This means that an audit firm can continue to provide nonaudit services to other clients.

A key SEC reform of the 1970s, the board of directors audit committee, also has been sharply criticized for its ineffectuality. Former SEC Chairman Roderick Hills, during whose term in 1977 the New York Stock Exchange adopted the requirement of the independent audit committee, has delineated shortcomings like the following:

- Audit committees may consist of people who satisfy the objective criteria of independence, but their election to the board is too often the whim of the CEO, who decides each year who will sit on the audit committee and who will chair it.
- Audit committees too often seek to reduce the audit’s cost more than to improve its quality. They do not play a sufficient role in determining what the fair fee should be.

- Audit committees seldom ask the auditor if there is a better, fairer way to present the company's financial position.
- Audit committees seldom play a role in selecting a new audit firm or in approving a change in the partner in charge of the audit. They may well endorse an engagement or the appointment of a new team, but they are not seen as material to the selection process.
- Audit committees seldom establish themselves as the party in charge of the audit.

[12]

Changes that will help solve these problems include requiring that corporations of a certain size with publicly traded stock have an effective, independent audit committee with the authority to secure new directors, appoint all members of the audit committee, and be solely responsible for the retention of accounting firms and the fees paid to them. The emphasis on independent directors as well as other elements of the board's and the audit committee's responsibilities are being addressed in Sarbanes-Oxley and the SROs' governing practices.

DISCLOSURE PRACTICES REVISITED

Other necessary initiatives revolve around the SEC's mandatory disclosure system, which deserves to undergo sharp questioning. How could financial reporting practices that were sufficient to bankrupt the seventh-largest industrial firm in the country go undisclosed for so long? Is this simply an isolated instance of bad disclosure, or is Enron suggestive of more systematic failure?

The SEC began to grapple with the latter, more disturbing possibility. In December 2001 the commission issued a cautionary release on pro forma financial information, rapidly followed by a similar statement regarding the selection and disclosure of critical accounting policies and practices

and in January 2002 by a consequential and broad new interpretation of the pivotal management discussion and analysis disclosure item.

More needs to be done. The commission should carefully review whether SEC oversight of the generally accepted accounting principles and the context of its mandatory disclosure system has unacceptably deteriorated. The commission also needs to seriously and patiently review whether we have the right construct of disclosure requirements, proceeding item by item, and whether changes in timing and delivery of data would be appropriate given the evolving changes in technology and international securities trading.

HIGHER EXPECTATIONS FOR CORPORATE ACCOUNTABILITY

[13]

Another principal culprit at Enron was a dysfunctional corporate management—enveloping not only senior executives but also the outside auditor and both internal and outside legal counsel. The genius of U.S. corporate law—if genius there be—is its redundant systems of corporate accountability. The board is intended to monitor the principal executives. Outside accountants and outside legal counsel are supposed to buttress this accountability system as are a series of legal devices, most notably including board and executive potential liability for false and misleading filings with the SEC and state corporate law negligence liability.

The overlapping accountability systems can fail individually. What made Enron unusual is that they all appeared to fail simultaneously.

I am skeptical that similar simultaneous dysfunction will become widespread. I am also mindful that poorly designed regulatory solutions could stultify the type of product innovation and risk-taking that has been consequential to the recent growth of the U.S. economy. I am also aware that corporate governance has largely been addressed by state corporate law.

The Sarbanes-Oxley Act addressed breakdowns in the system of corporate

responsibility. As the fervor of Congress increased in late July 2002, the dimensions of the legislative response increased exponentially. Section 302 of the new act, for example, requires quarterly and annual reports filed in accordance with specific sections of the 1934 act to be certified by the principal executive and financial officers.

The personal responsibility imposed on the signing officers makes this among the most draconian sections of the new act. While it does not go so far as to require certification by board chairs, as earlier considered, the demand for personal responsibility virtually screams from the legislative page. In this instance, Congress may have gone too far. While personal responsibility in the abstract is commendable, the way in which this burden was imposed may prove to be unduly burdensome or satisfied by pro forma responses.

There are, however, countervailing considerations. At many corporations the chief executive officers of late have characterized themselves as salespersons in chief. The certification requirement is a powerful personal reminder of the need for chief executive and financial officers to be personally involved with a significant compliance system. Certification also has the collateral advantage of signaling the securities market that it is less likely that covered corporations will have future earnings restatements.

ENRON'S EXTENDED EFFECTS

One step removed from Enron, but strongly suggested by its failure, are serious questions about the integrity of investment analysts. In April 2002 the New York attorney general reached a tentative settlement with Merrill Lynch after earlier that month having obtained a court order that required the firm to make disclosures to investors regarding its relationships with investment banks.

In 2002 the Commission approved new NASD and NYSE rules relating

to conflicts of interest in which research analysts can become involved as they prepare and publish research reports for equity securities. The proposals limit the relationships and communications between a firm's investment banking department and its research department. They prohibit tying analysts' compensation to specific investment banking transactions and spell out measures to prevent promises of favorable research. The proposals place various restrictions on an analyst's personal trading and require certain disclosures about the ownership of securities by the firm and the analyst. Finally, the proposal requires that research reports provide information to help investors assess the firm's research, such as definitions of the ratings system in plain language, and the percentages of ratings assigned to buy, hold and sell categories.

[15]

Other provisions in the Sarbanes-Oxley Act directly address operations of the Securities and Exchange Commission. It also requires several specific studies, including principles-based rather than rules-based accounting reporting, an SEC report on off-balance-sheet transactions, and the role and function of credit rating agencies in the operation of security markets.

The section of the new act that may prove to be among its most consequential provisions amends existing provisions that address civil actions arising under acts of Congress and adds a section to extend the time during which such actions can be brought. This amounts to a legislative reversal of the United States Supreme Court's decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, which had limited such litigation to one year after discovery of the facts constituting a violation and three years after the violation. It represents a return to the understanding that private litigation performs an important role in deterring securities fraud, a notion that was overturned in 1995 when Congress became concerned about frivolous litigation.

The new law is likely to lead to an increase in private claims. The

pendulum appears to have swung, at least temporarily, to a greater concern about malevolent corporate insiders and certified public accountants.

RESTORING INVESTOR CONFIDENCE

Enron and subsequent corporate scandals represented the triumph of aggressive corporate management and financial chicanery over time-honored concepts of fair presentation of financial information and full disclosure of material information. No event in my adult lifetime has so powerfully driven home the need for public confidence in our securities markets as Enron and subsequent audit failures. If a substantial proportion of domestic and international investors cease to believe that published corporate records are honest, the loss to our stock markets can be measured in trillions of dollars, with related and substantial losses in tax revenues and employment.

Confidence in our securities markets is not merely a reformer's nostrum or a soft variable. It is a practical necessity.

The core of the Sarbanes-Oxley Act is a thoughtful, well-drafted effort to address a breakdown in corporate responsibility that on occasion involved audit failure, auditor conflict of interest, porous generally accepted accounting principles, dysfunctional boards and audit committees, investment analyst conflict and an overstretched SEC. At its core the act is generally sound.

Will it make a difference in reviving investor confidence? I believe that when this act is combined with other changes involving more vigilant boards and audit committees, an expanded SEC with an activist enforcement program, greater private litigation and much voluntary restraint, for the foreseeable future there will be a material diminution of the type of accounting scandal that typified our recent past. This is all Congress could hope to achieve. If history is a guide, investors will gradually regain faith.

After Enron and the Sarbanes-Oxley Act, the significance of history in reminding us of the need for a thoughtful balance between unfettered commerce and financial regulation also will be restored, at least for a while. As John Kenneth Galbraith memorably observed in *The Great Crash*, “As protection against financial illusion or insanity, memory is far better than law. When the memory of the 1929 disaster failed, law and regulation no longer sufficed. For protecting people from the cupidity of others and their own, history is highly utilitarian. It sustains memory and memory serves the same purpose as the SEC and, on the record, is far more effective.” ■

ACADEMIC RESEARCH

Auditor Independence

Are Managed Earnings
More Likely at Firms
With Big Non-Audit Fees?

[18]

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FOLLOWING A SERIES OF MAJOR FINANCIAL SCANDALS INCLUDING those at Enron, WorldCom and Global Crossing, President George W. Bush signed the Sarbanes-Oxley Act of 2002 last July 30.

Designed in large part to assure the public that public companies' certified financial reports are reliable, the act includes several major provisions

aimed at strengthening auditor independence. Among those provisions is a prohibition on the performance of certain non-audit services by a public firm’s financial statement auditor.

These restrictions on the provision of non-audit services are a response to a simple question repeatedly raised by lawmakers, regulators and the general public whenever news of a financial scandal breaks: “Where were the auditors?” In particular, many commentators question whether an auditor would say no to a client’s aggressive accounting when the client also pays large fees for the audit firm’s consulting services.

Although financial scandals and resulting legislation grab headlines, anecdotes—however sensational—do not always tell the entire story. That is why, before the recent spate of financial scandals and the passage of the Sarbanes-Oxley Act, we conducted a large-scale study that examines whether firms that purchase non-audit services from their independent auditors are more likely to engage in earnings management. We also looked at what investors thought of these consulting fees by examining how stock prices reacted to the corporate proxy statements’ disclosures of the fees.

We found that earnings management is generally greater at companies that paid large non-audit fees—either relative to their audit fees or in comparison to those paid by other clients of the auditor. We also found evidence of a negative share price reaction to non-audit fees on the date that the fees were disclosed, although the reaction was small in economic terms.

The takeaway from our study is that the charges that providing non-audit services compromises an auditor’s independence may, in fact, be warranted.

BASIS FOR THE STUDY

Accounting standards permit managers to exercise judgment in financial reporting. For example, they apply judgment when they estimate future

economic events that are reflected in financial statements, such as expected lives and salvage values of long-term assets, obligations for pension benefits and other post-employment benefits, deferred taxes, and losses from bad debts and asset impairments.

The need to interpret circumstances creates opportunities for earnings management, in which managers choose reporting methods and estimates that do not reflect their best knowledge of their industry and the business conditions facing their firms. The overall increase in stock market valuations during the 1990s and the accompanying increase in stock-based wealth and compensation provided strong incentives for the typical executive to engage in earnings management.

Shareholders rely on earnings information that is provided by management for investment decisions. To assure users of the veracity of this information, management hires auditors to attest to the reliability of the statements. However, at least until now, management controlled the process of hiring and firing the auditors. Auditors, therefore, had incentives to yield to pressure from management.

This implies that the reliability of the information contained in audited financial statements depends on the level of auditor independence. The provision of non-audit services has the potential to compromise auditor independence by creating an economic bond between auditor and client. An auditor who is concerned about the possible loss of non-audit fee revenue may be less likely to object to management's accounting choices if being dismissed as auditor increases the probability that the auditor no longer will be hired to provide non-audit services.

MEASURING THE IMPACT OF NON-AUDIT WORK

Little evidence about the impact of non-audit services on auditor independence exists because data to address the issue has not been available

until recently. The situation changed in November 2000 when the Securities and Exchange Commission issued a rule requiring proxy statement disclosure of fees billed by companies' financial statement auditors for the most recent year.

We collected fee data from 3,074 proxy statements filed by nonfinancial-services firms between February 2 and June 15, 2001. At the time of our study, companies were required to disclose fees in three categories—annual audit and quarterly reviews, financial information systems design and implementation, and all other services. The SEC recently voted to expand the definition of audit fees to include “services that generally only the independent accountant can reasonably provide, such as comfort letters, statutory audits, attest services, consents, and assistance with and review of documents filed [with the SEC].”

Our descriptive evidence indicates that 51 percent of the fees paid by the average client are for audit services. Total non-audit fees are split between fees for financial information system design, which covers 2 percent of total fees, and other services, which accounts for the remaining 47 percent.

There is a great deal of variation across companies in the amount of fees paid for non-audit services. Several firms in our sample did not purchase any non-audit services from their auditors. At the other end of the spectrum, non-audit fees for about one-quarter of the sample were at least 75 percent of total fees, reaching an upper limit of 98 percent.

In addition to calculating the fees paid by the average audit firm client, we also examined the composition of total fees earned by each of the then Big Five audit firms, as well as for all other audit firms combined. We found that audit fees comprised no more than one-third of total fees billed for any of the Big Five auditors compared with 58 percent of total fees billed by non-Big Five auditors. Non-audit fees ranged from 67 percent of total fee revenue for Arthur Andersen to 75 percent for PricewaterhouseCoopers.

NON-AUDIT SERVICES AND EARNINGS MANAGEMENT

To conduct our study, we needed to determine the amount by which sample firms were managing earnings.

We first estimated what we categorized as abnormal accruals—the amount of accruals (net income minus cash from operations) that cannot be explained by typical working capital and fixed asset needs within the firm’s industry. Our evidence indicates that abnormal accruals are higher at firms that purchase more non-audit services from their financial statement auditors.

A second way to gauge whether firms are managing their earnings is to look at how their earnings compare to important benchmarks such as analysts’ expectations and prior-year earnings.

Both the SEC and the Public Oversight Board expressed particular concern that firms wanting to meet analysts’ expectations and/or project a smooth earnings path pressure their auditors to allow them to manage earnings to meet those benchmarks. In fact, in recent years there has been a higher-than-expected frequency of firms with slightly positive earnings surprises (reported earnings minus the consensus forecast) and earnings increases, consistent with firms managing earnings to meet benchmarks.

If non-audit services have no effect on earnings management, we would expect that firms paying high non-audit fees would be just as likely to meet the benchmarks as firms that purchase fewer non-audit services. Instead, we found that firms purchasing more non-audit services were more likely to report earnings that just met or exceeded analysts’ earnings forecasts and were less likely to report earnings that just missed earnings forecasts.

We found no evidence that firms that reported small increases in earnings over the previous year purchased larger amounts of non-audit services. However, showing growth in earnings may have been less of a concern than meeting analysts’ expectations during the period of our study.

INVESTOR RESPONSE TO FEE DISCLOSURES

We found a statistically significant negative stock price reaction to the public disclosure of non-audit fees that was higher than expected given the firm’s circumstances. This evidence is consistent with the argument that the provision of non-audit services compromises auditor objectivity and the credibility of firms’ earnings reports.

However, the economic magnitude of the effect was small. For example, an increase in unexpected non-audit fees from the lowest to highest quartile in our sample decreased share values by a modest one-half percent.

It is also important to note that the disclosure of unexpectedly high non-audit fees may signal other value-relevant information to the market—such as poor management quality or operational difficulties—that is unrelated to the independence of the firm’s auditor.

DEFINING ALLOWABLE NON-AUDIT SERVICES

Before the adoption of Sarbanes-Oxley, there was some confusion over the types of non-audit services an auditor could perform for a public client. The act attempts to eliminate specified potential conflicts of interest arising out of non-audit services. It explicitly prohibits financial information systems design and implementation or information technology work. It also bars internal audit outsourcing. In addition to information systems and internal audit, the new law prohibits:

- Bookkeeping or other services relating to the accounting records or financial statements of the audit client
- Appraisal or evaluation services, fairness opinions or contribution-in-kind reports
- Actuarial services

- Management functions or human resources
- Broker or dealer, investment adviser or investment banking services
- Legal and expert services unrelated to the audit
- Any other service that the accounting board determines, by regulation, is impermissible.

[24]

However, both the act and implementation guidance issued by the SEC on January 22, 2003, explicitly permit the provision of tax services, unless the provision of such services “would impair the independence of an accountant, such as representing an audit client in tax court or other situations involving public advocacy.” Tax services often include the development of tax minimization strategies for a client, and all of the major accounting firms have large tax practices. Under financial accounting rules, particularly aggressive tax minimization strategies may require the establishment of reserves for an estimate of the additional taxes the company will have to pay if the Internal Revenue Service eventually disallows the shelter.

Critics contend that when an audit firm creates a particular tax shelter, it may not be able to objectively assess the probability that the tax strategy will fail. However, the audit of a tax shelter by a competing audit firm potentially reveals sensitive, proprietary information about the initiating audit firm’s tax minimization products. Thus, the provision of tax services by financial statement auditors remains a vexing issue.

Our study did not address whether certain types of non-audit services pose a relatively lesser or greater threat to auditor independence. SEC disclosure requirements do not require firms to break out the components of non-audit services. Thus, this category of fees includes such disparate services as preparation and filing of tax returns, tax-related consulting and general consulting services, to name a few. Moreover, we do not know whether the new definition of audit fees will be more or less informative

of threats to auditor independence than the definition in place at the time of our study.

INTERPRETING THE STUDY'S FINDINGS

Although our results are consistent with an independence problem, we do not establish that an actual independence problem exists.

The SEC makes a careful distinction between an auditor who is “independent in fact” versus one who is “independent in appearance.” Auditors are “independent in fact” if their frame of mind is objective and they lack bias. Auditors are “independent in appearance” if an investor with knowledge of the relevant facts and circumstances would conclude that the auditor is capable of being objective and impartial.

Our results only speak to the types of facts and circumstances that an investor might observe. Because we cannot ascertain auditors’ states of mind, we cannot address the more difficult question of whether “independence in fact” is compromised by the provision of non-audit services.

We also do not know whether the provision of non-audit services results in actual audit failures. In subsequent research, we intend to examine the relationship between non-audit services and financial restatements. We will focus on those restatements that represent situations in which the original audit opinion failed to reflect what was subsequently determined to be a material mistake in the financial statements.

However, as four previous SEC chairmen pointed out during the deliberations on the independence issue, it is not only the black-and-white issues that matter. Equally relevant is the subtle pressure to bend to client interests, such as to allow earnings to be managed to meet market expectations.

What do we conclude from our study? Firms experience both costs and benefits when they obtain non-audit services from their financial statement auditors. A possible benefit is the efficiency and cost-effectiveness of pur-

chasing these services—particularly those closely linked to the financial statements—from the auditor. However, such purchases may lead to a conflict of interest—if not in fact then at least in appearance. ■

ACADEMIC RESEARCH

Fraud Costs

Researchers Find That Near-Term Gains Motivate Cooking the Books

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RECENT FINANCIAL FRAUD AT JUST FIVE COMPANIES—ENRON, Global Crossing, WorldCom, Tyco and Qwest—destroyed more than \$460 billion in shareholder value. Those headline-making scandals also contributed to a decline in investors' confidence in the integrity of U.S. capital markets. The scandals raise questions about the circumstances that lead firms to commit accounting fraud and what happens when it is revealed.

In this article, we summarize academic research that examines the causes and consequences of financial statement fraud. We draw three conclusions.

- Before fraud can take place, there must be motive to commit it and means to facilitate it. Accounting research suggests that executives at firms where fraud occurs are motivated to lower the cost of external financing and to allow personal stock transactions to be made at inflated prices. The means are circumstances in which corporate governance is weak. In other words, existing mechanisms do not provide effective oversight of executives.
- Fraud has negative consequences in the form of significant capital market costs. The average stock price declines 9 percent when fraud is revealed. The revelation of fraud also leads to a wider bid-ask spread, reduced financial analyst following, more short interest and broader dispersion of analysts' earnings forecasts. Somewhat surprisingly, there is no consistent evidence that the chief executive officer faces a greater probability of dismissal following the revelation of financial statement fraud or that executives face significant penalties for trading on the inflated share prices.
- Following fraud, companies are likely to take steps to strengthen corporate governance by making the board more independent and by stepping up the audit committee's vigilance. Stock price performance following the revelation of financial statement fraud is positively associated with the degree of improved board independence. In other words, fraud firms that take subsequent actions to restore investor confidence by strengthening their boards are rewarded with higher stock returns than those firms that do not take such corrective action.

DEFINING FRAUD

Each of the studies we reviewed examined earnings manipulation in samples of firms subject to accounting enforcement actions initiated by the

Securities and Exchange Commission. The SEC uses several criteria to identify firms subject to enforcement actions. Some companies are targeted after a review of their periodic filings with the SEC, while others are identified via the major exchanges' market surveillance programs. The financial press, complaints from investors, tips and referrals from other law enforcement agencies serve as additional sources.

The next step is an informal investigation. If it uncovers strong evidence of wrongdoing, a formal investigation follows. Between April 1982, when the SEC first started publishing enforcement releases, and December 1997, the agency issued 1,003 accounting and auditing enforcement releases. The studies that we reviewed used at least 10 years of enforcement releases.

[29]

The SEC's limited resources restrict the commission's formal investigations to cases in which it believes that it has a high likelihood of success—where there is likely to be evidence that executives knew of the earnings misstatement or should have known whether internal control mechanisms were adequate. Nonetheless, it is important to note that a common definition of fraud is the existence of a 10b-5 class action that resulted in a significant, adverse judgment against the firm. The firms in these studies are likely—but not necessarily—to have been the target of additional legal action by shareholders.

MOTIVES FOR COMMITTING FRAUD

In 1996 University of Michigan professors Patty Dechow and Richard Sloan and Dartmouth professor Amy Hutton examined four motivations for firms to commit fraud: insider trading, compensation agreements, debt contracts and the demand for external financing. Executives may directly benefit from fraud by selling shares at inflated prices (insider trading) and/or by receiving extra bonus compensation based on overstated earnings

(compensation agreements). Existing shareholders can directly benefit from earnings overstatements that allow the firm to avoid debt covenant violations (debt contracts) or to obtain capital at a lower cost (the demand for external financing).

The authors' results indicated that fraud is motivated by a desire to obtain financing on more favorable terms and to avoid violating debt covenants. In contrast, the authors found no evidence that fraud is related to insider trading or executive compensation contracts. Of course, in situations where shareholders directly benefit from earnings manipulations, managers typically obtain indirect benefits.

[30] In 1999 Indiana University professor Daniel Beneish examined the same four motives using alternative measures of insider trading that controlled for insider purchases and the decline in the fraud firm's market value during the period that earnings were manipulated. His study provided evidence that insider trading is a more powerful explanation for fraud than is a firm's demand for external financing. Beneish also found that executives are more apt to sell stock appreciation rights during the period of earnings manipulation. He concluded that fraud is motivated by "managers' desire to sell their equity-contingent wealth at higher prices."

WEAK CORPORATE GOVERNANCE

Dechow, Sloan and Hutton also compared the corporate governance profile of fraud firms to a control group matched on size and industry. Relative to the control firms, the fraud firms are less likely to have an audit committee, more likely to have the company founder as CEO, more likely to have a CEO who also serves as chairman of the board of directors, more likely to have insiders on the board, and less likely to have an external shareholder who owns a large block of stock and monitors management. The authors concluded that, "the likelihood of earnings manipulation is

systematically related to weaknesses in the oversight of management.” In particular, their evidence indicated that fraud is most likely to occur in firms with powerful CEOs and weak external monitoring mechanisms.

In 1996 North Carolina State University professor Mark Beasley also examined the relationship between corporate governance characteristics and fraud. His conclusions were consistent with those of Dechow, Sloan and Hutton.

However, he examined a different and somewhat broader set of governance practices and found that fraud firms have a smaller percentage of outsiders on their boards, outside directors hold a smaller percentage of their shares and their outside directors have shorter board tenure. Moreover, their outside directors are busier, as evidenced by their higher number of directorships.

Relevant to the current debate over optimal governance structure, Beasley also found that the composition of the board was more important than the composition of the audit committee. In particular, he found no evidence that the presence of an audit committee or the percentage of inside directors on the audit committee explained differences in governance structure between his fraud and non-fraud firms.

In ongoing research, Farber, one of the authors of this article, has found that the audit firm’s scope is a potentially important indicator of fraud. Specifically, he is finding that fraud firms are more likely than nonfraud firms to use non-Big Four auditing firms before fraud detection. His research also provides evidence that the vigilance of the audit committee is an important indicator of fraud. In particular, fraud firms hold fewer audit committee meetings in the year before fraud detection than do nonfraud firms. These results are consistent with the general notion that the strength of governance mechanisms has a bearing on whether fraud is committed.

CONSEQUENCES OF COMMITTING FRAUD

Dechow, Sloan and Hutton predicted that fraud firms will experience increases in their cost of capital because the discovery of fraud leads to downward revisions in expected cash flows, investor confidence, and investors' assessments of executives' reputations.

When fraud is revealed, the firm's stock price declines as investors incorporate news of the firm's overstated earnings. The lower a firm's share price, the more shares that must be sold to raise a given amount of money. Because investors may be uncertain about the magnitude of the fraud, there is increased uncertainty about future firm value. Market makers in turn widen bid-ask spreads. In addition, there is likely to be an increase in short selling and a wider range in analyst estimates.

Consistent with these arguments, the authors reported that the revelation of fraud is accompanied by an average drop in share price of 9 percent, an increase in short interest from an average of zero to 6 percent of outstanding shares, a doubling in the level of disagreement among analysts as measured by the change in the standard deviation of analysts' forecasts scaled by the absolute value of the mean forecast, and an average increase in the bid-ask spread of 0.7 percent of stock price. Additionally, in the three years preceding the announcement of fraud, analyst following fell from an average of 13 to five analysts. Over the three years following the fraud discovery, analyst following gradually rebounded to an average of eight analysts. Thus, Dechow, Sloan and Hutton find consistent evidence that fraud firms face significant capital market costs.

Beneish's focus on incentives for executives to commit fraud led him to examine the consequences of its discovery. He found that the SEC does not typically impose trading sanctions on executives who overstated earnings unless the executives sold their shares as part of a secondary offering. He also found that those executives—either the CEO or all officers as a group—

are no more likely to lose their jobs than are the executives at control firms. When executives do lose their jobs, the development is likely to occur as part of bankruptcy. However, CEOs at bankrupt fraud firms were no more likely to lose their jobs than were the CEOs of bankrupt firms where there is no evidence of fraud.

THE ROLE OF GOVERNANCE IN RESTORING INVESTOR CONFIDENCE

Farber has examined the actions that fraud firms take to improve their governance structures following the detection of fraud. His research is finding that during the three-year period following the fraud revelation, fraud firms experience an increase in their outside director percentage and hold more audit committee meetings. By the end of the three-year period, fraud firms have a board composition similar to that of the control firms and hold more audit committee meetings than firms that did not commit fraud.

Farber also has examined how investors and analysts respond to these governance improvements by measuring abnormal returns—stock returns adjusted for market movements—and changes in analyst following over the three-year period subsequent to the detection of fraud. Fraud firms with the largest increase in their outside director percentage experience significantly larger market-adjusted returns than do fraud firms with the smallest improvements in board structure. The research shows that analyst following subsequent to the revelation of fraud is not associated with improvements in board structure.

CONCLUDING REMARKS

The academic research reviewed in this article paints a fairly clear picture of links between fraud, corporate governance and investor confidence.

Weak governance is associated with fraud, fraud detection is associated with capital market costs, and improvements in governance are associated with relatively positive market returns.

Given the importance of maintaining investor confidence, it is surprising that so little is known about effective measures that firms can implement to restore investor confidence following fraud or any other credibility-reducing event, such as an earnings restatement. Much more work in this area would prove to be beneficial. ■

IRQ ROUNDTABLE

After the Mania

Starting Down the Path of Restoring Investor Confidence

[35]

THE IMPACT OF MUSHROOMING CORPORATE AND ACCOUNTING scandals on investor confidence was the subject of a symposium and web-cast sponsored by NIRI at the National Press Club in Washington, D.C., on May 6, 2002. The previous issue of *IRQ* featured the panelists' comments on corporate governance. This issue returns to the symposium for the part of the discussion that concentrated on restoring investor confidence.

The moderator for the symposium was Donald E. Eagon, vice president of global communication and investor relations at Diebold, Incorporated and chairman of NIRI. Members of the panel were:

Alan L. Beller, director, division of corporation finance, Securities and Exchange Commission

Kenneth A. Bertsch, director of corporate governance, TIAA/CREF

John C. Bogle, founder and former chairman, The Vanguard Group

Richard C. Breeden, chairman of Richard Breeden and Company and past chairman of the Securities and Exchange Commission

Michael Emen, senior vice president, listing qualifications, The Nasdaq Stock Market

Margaret M. Foran, vice president of corporate governance, Pfizer Inc.

Samuel B. Jones, Jr., CFA, senior vice president and chief investment officer, Trillium Asset Management Corp.

Ira Kay, Ph.D., national director of compensation consulting, Watson Wyatt Worldwide

Donald Langevoort, professor of law, Georgetown University Law Center

Philip B. Livingston, president and chief executive officer, Financial Executives International

Michael McNamee, senior correspondent, *Business Week*

Edward Soule, Ph.D., assistant professor of business ethics, McDonough School of Business, Georgetown University

Louis M. Thompson, Jr., president and chief executive officer, NIRI

[36]

MR. EAGON: Accounting shenanigans, corporate misbehaviors and incidents of what appear to be executives' enrichment at the expense of shareholders have hammered investor confidence, on top of the beating it has taken from tough economic conditions. To start our discussion about restoring confidence in corporations and in investing in the U.S. securities markets, I'll ask Mike McNamee for a summary of what brought us to this uneasy situation in the first place.

MR. McNAMEE: Unfortunately, the major reason that investors are upset is that they've never experienced a down market. Probably most of the folks on this panel have been through two or three market cycles, but millions of investors have not.

Even so, there are real and serious problems beyond market cycles. One is the feeling that the numbers game drives companies to take extraordinary measures to make their numbers, and that was especially true in the late 1990s. Another factor driving stock prices is the emphasis on a single earnings number.

With the restatements that have flowed out of the numbers game, and as the corporate scandals have piled up, the general feeling has turned into a perception that the guardians were not at the gates. The accountants and auditors appear to have let us down. Boards did not seem to be on top of their game, doing what they were supposed to do. The analysts proved to be compromised. The financial press has been seen as a cheerleader for the bull market and the new valuations.

All this just leads to an overwhelming impression that the game was not set up for investors.

MR. EAGON: How deep and how pervasive are ethical issues in corporate America and the U.S. securities industry today?

DR. SOULE: Although I teach business ethics now, I spent most of my career in business, half as a CPA and half as a CFO in the securities industry. Therefore, I've been on both the giving and receiving ends of these issues.

There are some 15,000 audits annually of SEC registrars, most of which are completed without issue. This is an area where statistics are not much help. The pervasive breakdown in a situation like Enron is frightening. If the question is how widespread the problem is, the answer is that it's widespread enough. We have a profound problem, not just in terms of the number of instances but also in the characteristics. While there is absolutely no substitute for personal integrity—and that would be the reason that this isn't more widespread—in a situation like Enron, every safeguard failed. The ethical breakdowns are widespread enough that this subject deserves to have attention devoted to it.

MR. EAGON: Even if it seems as if these things have just been happening in the last year, isn't it a fact that this started several years ago?

DR. SOULE: I don't know that there's any difference today in terms of the integrity of the people who have ultimate responsibility for financial

disclosure. By and large people in the accounting profession and the financial divisions of publicly traded companies take responsibility seriously. What has changed is that the incentives have been skewed in recent years. The safeguards have been seriously weakened, not by any one thing but by a progression of events.

MR. LANGEVOORT: In the last 10 or 15 years, the pace of financial innovation and the changes in the environment in which executives are working have increased. In that setting, discipline and authority have weakened. When people don't know the rules, they tend to construe the norms in fairly self-serving ways. That's the first step down the slippery slope.

MR. LIVINGSTON: I don't know that financial accounting prac-

tics and unethical reporting are a prevalent problem.

I do know that during the bull market of the 1990s we got so full of ourselves that we let controls get too lax. If anything is prevalent, it is that some boards became too relaxed.

Things were too good in the 1990s. Even if you corrected the numbers by 100 percent or even 200 percent, you still couldn't justify some of the valuations. It continued as an attitude. Now we're going to have major contraction, controls and improvement of controls.

MR. EAGON: The issue of companies managing their earnings in an attempt to meet the short-term quarterly numbers, the evaluation of portfolio managers

on a short-term quarterly basis, and analysts attempting to predict quarterly earnings all seem now to have driven these market participants to the brink—and sometimes over the edge—when it comes to ethical behavior. Is there a way to turn this around so that we focus more on the long term rather than on a system based on quarterly results?

**... THAT WHEN THERE
IS A GAP BETWEEN
PERCEPTION AND
REALITY, IT'S ONLY
A MATTER OF TIME
UNTIL REALITY
TAKES OVER.**

—*Jack Bogle*

MR. BOGLE: When the history of this era is written, it will be another great mania—the managed-earnings mania or the information-age mania—right up there with the stock-market mania of 1929, the South Sea bubble and the tulip mania. What we have in this case is a result of what I call the happy conspiracy: CEOs, CFOs, compensation committees, audit committees, auditors, attorneys, Wall Street sell-side analysts, institutional buy-side analysts—and even the shareholders themselves—engaged in this happy conspiracy to raise stock prices.

What is the matter with that? Isn't that wonderful? The answer is, no, it isn't wonderful, because what we have been engaged in is a complete loss of any linkage between the price of a stock—we'll call that perception—and the value of a corporation—we'll call that reality. I've said to our people at Vanguard for years that when there is a gap between perception and reality, it's only a matter of time until reality takes over. It's a lot easier to raise the price of your stock than it is to increase the value of your corporation—which is hard, long-term work.

The inclination to manage earnings is a wonderful example of this phenomenon, because the focus is on stock price rather than on corporate value. Executives, staff and directors of course want earnings to go up. It's profitable for executives to be able to exercise stock options at inflated prices and not worry much about the problems they leave for their successors.

One of the great examples of this focus on immediate gratification—one that gets far less publicity than other areas—is the almost grotesque inflation of assumptions about future returns for pension funds. On average, corporations are using a 9.5 percent return. But if you project stock and bond returns, take into account the ratio of stocks and bonds in pension plans, take into account the fact that pension plans earn about 80 percent of market return—not 100 percent—that's assuming about a 14 percent or 15 percent future return on equities, which I don't believe is in the cards.

So executives take an extra \$100 million or \$200 million or more of earnings from those high assumptions. Later, when reality takes over, they'll take that amount and much more back out of earnings. If my observation that stocks aren't going to deliver a 14 percent or 15 percent return is correct, the pension situation will lead to a backlash in earnings.

Then throw the mutual fund industry into this mix. Our average annual portfolio turnover was 16 percent when I came into this business in 1951, which meant that an average fund held an average stock for an average of six years. The most recent report from Morningstar puts portfolio turnover at 112 percent a year, which translates to a holding period of 11 months.

That is a focus on short-term speculation and has absolutely nothing to

do with long-term investing, which is what mutual funds preach but don't practice. Funds have little concept of the value of a corporation. It's all about the price of the stock.

Part of this change, parenthetically, arises from an unfortunate but almost total shift in this industry's investment approach. Mutual funds used to be run by investment committees. Then we moved to a system of individual portfolio managers, and we got the star system.

Part of the reason for the problem is that institutions have simply failed to exercise their responsibility of corporate citizenship. When you think about it, why would we? With turnover at 112 percent a year, we probably won't even be holding the stock at the next annual meeting. Why not just throw the proxy in the trash can?

Another part of the problem is an extraordinary conflict of interest. The corporations whose shares mutual funds own and could therefore vote are also our biggest clients. They are the same companies that have

**... THERE IS A NEED
FOR MUCH MORE
STOCK OWNERSHIP
BY THE EXECUTIVE
TEAM AND BY ALL
EMPLOYEES.**

—*Ira Kay*

hired us to manage their 401(k) and pension plans. We don't dare offend them by being corporate activists. We don't want to risk losing those highly profitable accounts.

I recently received a note from an old friend who was an institutional money manager. He told how he had voted against corporate management in a company that was also a client. When that vote went in, he got a call from the company's chief executive, who said to the money manager, "Let me explain the world to you. You are the red button, and I am the finger." The next day, the account left.

So what's the best way to restore confidence in our financial markets? Certainly we need some regulation. I agree with the proposals to have real-time disclosure of executive purchases and sales, an idea whose time has long since come. But it's more than a regulatory issue; it's an institutional issue. The 75 largest institutional investors own 44 percent of the stock in America, and all we have to do to solve this problem is to get those institutions to stand up and be counted — to act like responsible owners.

DR. KAY: Related to the issue of long-term versus short-term perspective there is a need for much more stock ownership by the executive team and by all employees. This is definitely a trend that has been growing over the last 10 years.

In both the stock-option and stock-ownership arenas, there needs to be some guidance for executives in terms of when and how they should sell their stock. Some of the rules will be unpopular with the executives, I can guarantee you, but if they are truly not acting on inside information, theoretically they should be indifferent.

MR. BOGLE: How does it link the interest of the executives or the interest of the shareholders if we focus on how quickly they can sell the stock? Shouldn't they have to hold it for as long as they hold executive positions?

DR. KAY: They should be required to own a lot of stock, typically

described as a multiple of their salary, for as long as they are in executive positions. They should be allowed to diversify amounts above that, but they should be required to announce that they're going to be diversifying.

MR. BELLER: The great irony of stock options is that originally they were put in place because it was thought that they could be used to better align the interests of shareholders and managers. What we've seen in the last few years is that it's not a one-year problem. A variety of weaknesses have become increasingly evident. A lot of what we as regulators should be doing and what boards and executives themselves have to be thinking about is how to realign the incentives better.

I agree that there are too many investors who believe that the system is

not set up for them. A principal reason is that they perceive that the incentives favor the managers and not the owners.

MR. JONES: What has happened is more than just the bursting of the dot-com bubble. Earnings surprise as a strategy has become popular in the last decade or more, and it isn't necessarily applied just to growth and biotech stocks. It even applies to utilities. As long as dependence on earnings surprise is a model that is driving the investment process, or if it is even one of your models, you're going to gravitate toward a short-term orientation.

MR. BOGLE: There is a hopeful reality out there.

The share of equity fund sales by index funds—which buy stocks and hold them forever—is growing. If you look at who is getting the best cash flow in this industry, it is active managers with a long-term focus, often value-oriented managers, but not necessarily to the exclusion of growth stocks. There is a certain amount of self-correction, and we should give it a lot of help.

**I DON'T KNOW THAT
CONGRESS CAN
OUTLAW HYPE.**

—*Richard Breeden*

This might sound a little argumentative, but aggressive earnings guidance is not a problem that is limited to a handful of companies. If you look at earnings estimates, the earnings growth rate projected for the next five years is about 12.3 percent. The reality is that corporations' after-tax earnings grow at about the same rate as gross domestic product. They might grow at a 5 percent or 6 percent or even 7 percent nominal rate. On the other hand, who's to say that earnings will grow at all over the next five years? But 12.5 percent is just not there. However, that's what's being given out in terms of managed earnings estimates. It's not just one or two isolated examples. It's a pervasive problem.

MR. EMEN: As the other regulator at the table, I want to pick up on the comment that was made at the opening: every safeguard that was in place at Enron broke. There's not going to be a silver bullet in terms of rules or legislation, because for every rule you write, the wrong people are going to get around it.

MR. EAGON: Can Congress or the SEC solve these problems? Does the SEC need additional regulatory authority?

MR. BREEDEN: The culture of transparency and caution that I remember from when I started my career, doing underwriter's counsel work and due diligence on underwritings, has been transformed into a widespread and pervasive culture of hype. This culture of hype has worked its way through the Street, through the elements of the corporate community and through many of the institutions. I don't know that Congress can outlaw hype. The SEC has an enormous role to play here—and a constructive one.

When people have an upside measured in tens or hundreds of millions of dollars of personal gain, there is no administrative rule or sanction that is going to realistically deter conduct. There has to be a strong rule that sends people to jail to get their attention. Where we have lost our way is the

failure of the SEC and the criminal authorities to prosecute some corporate reporting cases of the magnitude of the big insider trading cases of the 1980s. We need to swing back to the culture of probity that we used to have and now have lost.

DR. SOULE: Somebody once said that all of economics can be summarized in four words: people respond to incentives. It is absolutely true. Particularly in the accounting profession, there's been an ongoing effort of one sort or another to define independence, when in effect the sorts of reforms that I think will matter are those that Richard described.

MR. BELLER: The culture of hype is partially a result of the incentives that were in place. Changing those incentives, making them more long

[44]

**... ALL OF ECONOMICS
CAN BE SUMMARIZED
IN FOUR WORDS:
PEOPLE RESPOND
TO INCENTIVES.**

—*Ed Soule*

term, having people have the right kind of skin in the game, with downside risks as well as upside potential, not assets given to them but assets that they have earned—these aren't things that regulators can solve by themselves. It's important to remember that you can't have a failure of the guardians until the primary actors have failed first. Our regulatory attention has to be targeted—corporations, executives, better disclosure, faster and more transparent disclosure, and corporate governance reforms that attack the problem of executive behavior and executive incentives.

We have to target management first. There are a small number of bad apples. One of the functions of regulation is to deal with those bad apples. Another function of regulation is to reinforce what the vast majority of good apples want to do. Most corporate executives are trying to do the right thing, and supportive regulation has helped them in one fashion or another.

MR. BREEDEN: Those of us who sit on boards, run companies, advise

companies or write about companies all have a very constructive role to play here in getting back to a solid base of reporting earnings with clarity and accuracy, in a timely way. With an event as widespread as the bubble that we saw in the 1990s, government can play a constructive role in helping to change attitudes and cause the major actors to understand that they have to rethink what they have accepted as the status quo. A large part of Wall Street came to accept insider trading as the status quo. There was this quaint little law that said you couldn't do it, but it was also something everybody did and there were huge gains to be made. It took government to change that perception and get the Street back onto more solid ground.

There's a similar role in the corporate reporting world. Many individual investors feel a profound sense of dismay and disenchantment when they see a CEO pocket \$752 million as his company goes into bankruptcy. No one in the next 10 generations of that executive's family will have to work, while the shareholders are wiped out.

One regulatory alternative would be a rule that says executives cannot sell their stock as long as they remain senior executives. Another possible approach would be to say that in the case of bankruptcy or significant earnings restatement, senior executives, or at least the CEO and CFO, would repay any stock profits from the previous 12 months. If the shareholders experience a devastating financial loss from such events, the executives should not be permitted to go off with massive equity-based profits in their pockets. That might help reorient people's perceptions about the importance of these types of events.

MR. BERTSCH: We need vigorous and timely standard-setting and vigorous enforcement not hobbled by political interventions of powerful special interests. In recent years we have seen the standard-setters, including the Financial Accounting Standards Board, unable to proceed in the way that they professionally felt they should because of political pressure being

brought to bear. One element would be an automatic funding mechanism for FASB, and perhaps for the International Accounting Standards Board as well, so that funding can't be part of the pressure that's put on the organization.

MR. LANGEVOORT: It should be the norm that when the SEC can prove financial fraud, two things happen. One is disgorgement: Any compensation going back any number of years that can be tied to the wrongdoings or misleading statements ought to be taken away. Second, nobody who engineered a fraud should be allowed to be an officer or director of a publicly traded corporation.

DR. KAY: The discussion of regulatory activism needs to be put in the

context of how widespread the problem is and how well the U.S. economy is performing. Maybe there were some excesses, but the way we paid our executives was in fact a big part of why the U.S. economy has done so well.

Would you rather have a mutual fund of all Japanese stocks that have lost 65 percent of their value since Japan's bubble burst in 1989? Or would you rather have a portfolio of American companies, even with the problems? If you did a survey of investor confidence right now, you would probably find a lot of very unhappy investors out there—but nowhere near as unhappy as the Japanese investors are in their economy.

MR. JONES: An idea that has been floated is to make CFOs responsible to the audit committees instead of to the COO and/or the CEO. That would help get around a lot of the pressures created by morally challenged CEOs and others who might be tempted to coerce a more aggressive earnings release. Obviously, that would hinge on having a strong, independent audit committee.

**OUR CORPORATE
GOVERNANCE
COMMITTEE WANTS
TO KNOW WHAT ALL
INVESTORS, INCLUDING
THE ACTIVISTS,
ARE SAYING.**

— *Peggy Foran*

MR. LIVINGSTON: That is a horrible idea because it isolates the CFO from the rest of the management team.

MR. THOMPSON: NIRI's 10-point program has something of a hybrid of this concept, in which the investor relations officer, or whoever fills that function, must report to the audit committee on what the investment community is saying about the company, provide them with all of the analysts' research and report what institutional and individual investors are saying. This information could be very useful as an early warning that problems might be developing. It would be helpful if the exchanges and Nasdaq would make a governance requirement for the investor relations person to make these reports to the board on a periodic basis.

MS. FORAN: Pfizer goes one step further. Our corporate governance committee wants to know what all investors, including the activists, are saying. It's great to know what investors are talking about, but you need to know what your supporters as well as the others are saying too.

MR. BREEDEN: The events at Enron involving the conflicts of interest on the part of the CFO are probably the most shocking and worst of all, because the CFO sits at the center of the railroad tracks that move the financial information. I can't imagine a board agreeing to let the CFO have a personal conflict of that kind. To take the CFO out of the management loop would run the risk that the board would be getting sterile information.

Another issue that needs to be on the table is, How do we improve the current system so that audit committees can realistically play a more important role? The typical audit committee has no outside adviser. You have the power to hire outside accountants or lawyers, but how do you know that you need to hire them? You don't have your own analysts. You don't have your own staff. You don't have independent sources of information. You're dependent on the company and the auditors—the people you're supposed to be overseeing—to provide it.

MR. BOGLE: If men were angels, we wouldn't need checks and balances. James Madison put forth this wonderful idea. Now 215 years have passed, and men are still not angels.

The biggest part of the governance problem is that we have given so much power, without serious checks and balances, to corporate chief executives. The only way we're going to get an independent check on that power is by having an independent chairman of the board. We need a separate power structure at the board level, with the president being responsible for the management of the company and the chairman being responsible for the governance of the company. If that's the appropriate thing to do, it's going to be up to institutional investors to demand it. It's going to be up to the

shareholders of the mutual funds to insist that their managers demand that. The correction must come out of investors responding to the incentive of getting better returns in the long run.

DR. SOULE: That recommendation would not have changed the outcome at Enron. It's important to know that the techniques that Enron was using were known by any CFO of any other business, and if you didn't know the finer points, Enron had a business that would teach you how to do these things. The interesting question is, Why didn't more companies abuse special purpose entities to the extent that Enron did? The answer to that lies in the basic integrity of the people doing the work.

MR. LIVINGSTON: I would like to come back briefly to how we restore investor confidence. We've had a lot of hearings and a lot of media coverage. We've digested a lot of information, and there's a bunch of rule-making on the cusp. Companies' cost of capital has gone up. There's a lot of shaken investor confidence.

**IF MEN WERE ANGELS,
WE WOULDN'T NEED
CHECKS AND BALANCES.**

—*James Madison*

**NOW 215 YEARS HAVE
PASSED, AND MEN ARE
STILL NOT ANGELS.**

—*Jack Bogle*

Companies need to do better, but the regulators in Congress need to take some action. The SEC needs to get on quickly with these rules about disgorgement and disbarment and the insider transactions, and we haven't even talked about the new oversight body for the accounting profession. There's quite a range of opinions about how that should be structured.

Companies need stronger financial experts on their audit committees and nominating committees. Good companies are setting up independent nominating committees. If we get nothing else out of this whole process, we can get all companies to have independent nominating committees. And I think the better term for them these days is governance committees. That's an emerging trend too.

The stock exchanges are on the cusp of very important rule-making, and at times we're looking for stronger leadership. We need tighter definitions about independence and about who is qualified to be the financial expert on a committee. The whole issue of shareholder approval of stock-option plans must be dealt with now. It's got to get implemented after years of talking about it and fighting about it. We need some quick action to restore confidence in the marketplace.

MR. EAGON: On behalf of the National Investor Relations Institute, I want to thank this panel. The discussion has been lively. We have unearthed things, and we have seen resolve. Even though restoring investor confidence is a multifaceted issue, there are indeed some steps we can take to help lay that foundation. ■

CASE STUDY

Whose Business Is It, Anyway?

The Spirit and the Law of Sharing Information

[50]

ONE CORNER OF BRADFORD INC.'S STATEMENT OF PRINCIPLES peeked out from the stack of manila folders on Hadley Gaines' desk. A tableau for the times, the investor relations director observed to himself. In day-to-day practice the family-restaurant franchisee's code of ethics was about as instructive as the piece of paper in the folders—handy but hardly compelling.

Hadley's prickly mood in part reflected the hammering Bradford's stock had taken in the week since its earnings conference call. Earnings met expectations, albeit barely. Most of the revenue gain came from restaurants in one city that had hosted a weeklong, statewide high school sports tournament. During the question-and-answer period, the chief executive officer happened to mention the recent resignations of two directors.

Until now that information had seemed of little consequence. One director headed Bradford's restaurant-construction and building-management

subsidiary, but inside the company it was understood that he was a figure-head—he had assumed the title and the board seat as part of Bradford’s acquisition of his company two years earlier. The other director, a member of the audit committee, had been in poor health. Bradford’s legal counsel was of the opinion that all that was necessary by way of announcement was to include the resignations in routine filings with the Securities and Exchange Commission.

Hadley had raised the possibility of news releases as the events occurred but was persuaded by the chief communications officer, with the CEO’s concurrence, that the more significant news would be the appointment of new board members. Besides, to tell the truth, Hadley was happy to avoid questions about the progress of the director search or speculation about whether the positions would be filled by members of the company’s founding family, subjects that were sure to come up if the replacements weren’t immediately identified.

Moreover, Hadley was concerned with bigger matters than board vacancies. For one thing, like many companies, Bradford had characterized its unexciting financial performance as a reflection of the stalled economy. That was beginning to wear thin with two big shareholders who urged more aggressive expense control in light of consumer spending trends.

A private investor’s comment during the conference call fanned yet another internal concern. The shareholder complained about the quality of service in restaurants he frequented and questioned whether the company was diverting funds from training programs in order to mask declining profit margins. The comment hit a particularly raw nerve with senior managers. Just a few days before, the CEO had reacted to the most recent customer satisfaction survey by scheduling a summit meeting of key store managers and store operations executives. The last time such events converged, sweeping menu and management changes followed.

Hadley was also aware of newly strained relations between Bradford and its franchiser because of the franchiser's demand that its own audit team review Bradford's accounting. The internal rumor mill said the action was prompted by the size and timing of bonuses for Bradford's top executives and dissatisfaction with how it allocated shared expenses after it acquired its construction and building-management partner.

The fact that the franchiser would question the bonuses at all annoyed Hadley and others who had helped build Bradford from being a single restaurant to being the operator of almost 40 stores in a three-state region. They worked hard and generally were amply rewarded under an incentive compensation program that promoted entrepreneurial behavior and Bradford's version of the philosophy that what's good for the company is good for America.

Hadley was frustrated. Under normal conditions, he reasoned, the investors' issues would represent little more than background noise. Still, he had a sense that in the spirit of teamwork and transparency that was encouraged in the company's statement of principles, he wasn't delivering on implied promises to his key constituency — Bradford's investors. Hadley tried to convince himself that this is what it's like to practice investor relations in a post-bubble stock market and a sluggish economy. Is it? Or have Hadley and Bradford stepped onto a slippery slope of evaporating investor confidence?

For answers to those questions and suggestions on how Hadley should be managing Bradford's IR program in light of these situations, IRQ turned to experts in investor relations and communication. Here are their responses.

IR REQUIRES PROACTIVE CONSISTENCY

Hadley Gaines has to be more self-assured and proactive in his position as director of investor relations. Some areas where he can improve his

performance and learn from the circumstances are the earnings call, board membership change, conflict among executives and financial audit.

Earnings Call. Hadley must control the conference call. Conference calls have time constraints. In that time the company needs to disseminate information regarding earnings, the state of the business and future direction — all within the confines of Regulation FD. The call also is an opportunity for analysts and shareholders to ask questions relevant to the company’s overall operations.

With this in mind, Hadley must make sure that anyone speaking during the earnings call has a script and that incoming questions are monitored. The questions asked should be broad enough to be relevant to the majority of listeners. Having a script would have allowed Bradford Inc. to prepare for questions regarding the board resignations and possible replacements.

The private investor’s implications that management misappropriated funds and ignored customer-service issues could have been prevented if Hadley had been in charge of the earnings call. The individual investor should have been encouraged to address the quality issues through Bradford’s customer-service department. By allowing this person to speculate on related issues, the company—and Hadley in his role as IR director—allowed a single investor to take up valuable time and possibly prejudice first-time listeners by planting doubt with regard to management competence and ethics. The call also put managers on the defensive in that it set an expectation for them to explain and presumably deny allegations.

However, once the subject was raised, the implication of fund misappropriation should have been addressed immediately during the conference call. The executive management should have said in no uncertain terms that the statements were false and that Bradford does not tolerate and has never tolerated misappropriations of funds. In addition, specifics should have been given on how senior management takes a proactive approach

to customer service by sending out surveys to gauge customer satisfaction and then following up with changes. The most important thing is addressing these issues directly and immediately.

The second issue that Hadley must deal with is large investors' apparent lack of confidence in Bradford's executive management, as demonstrated when they pressed the company to reassess expenses. If Bradford's management is convinced that the company's performance is a direct result of the economy, it must stand by that assessment in earnings reporting as well as other discussions. On the other hand, if there are opportunities to decrease expenses, these should be examined — internally.

The fundamental point is that executive management has to instill confidence in its shareholders that it is doing what is best for the company. Although shareholders should voice their concerns, they also have to step back and allow the management team to manage without interference.

Board Membership Change. Because Bradford chose to disclose board membership changes through SEC filings instead of in a press release, it appeared as though the company was trying to hide something.

Given that the board is the foundation of the company and guides executive management, a press release should have been sent out regarding the changes. Regardless of whether the two individuals were figureheads, their departures demonstrated a change in the dynamics and makeup of the board that may be reflected in company practices, which in turn may affect its financial performance.

Hadley should have been especially cognizant of the ramifications of the resignations given the current environment regarding corporate governance. Immediately announcing the resignation of the board members would have kept speculation to a minimum. By not revealing the resignations before the earnings call, Bradford put itself in the defensive position of explaining them during the earnings call instead of concentrating on the

company's financials and direction. Had management had scripts, they would have been better able to anticipate questions.

In the future Hadley must make sure that executive management is clear on the possible consequences of not fully evaluating their decisions. This leads to dealing with internal conflict.

Executive Conflict. The CFO's apparent lack of involvement in Bradford's discussion about communicating the board resignations is a concern. The outcome of the discussion is likely to lead to financial consequences, and the CFO should have been part of it. By not including the CFO, Bradford weakened its management's ability to evaluate the financial ramifications and how and when the information should be disclosed. In the future, Hadley should make sure that the entire executive management team, not a subset, is part of any discussion that may affect the company.

Another concern is Hadley's attitude about avoiding hard questions regarding the board changes. As the director of investor relations, it is his job to discuss these things. Hadley must be proactive in disseminating information so that Bradford builds a reputation as a company that delivers pertinent information regardless of its nature. By being consistent and forthcoming, Bradford builds a reputation for reliability and honesty in the information it disseminates.

The Financial Audit. The last issue that Hadley and the Bradford executive management team have to address is the internal financial audit that the franchiser is requesting.

First, the entire management team should review the Sarbanes-Oxley Act. Because of changing legislation, public companies' financial documents will be scrutinized externally and—as we can see in this case—internally.

It seems that the biggest issue for this management team is not that it has anything to hide but that executives' egos are hurt because they feel that they should be above scrutiny. In an ever-changing economy where

more emphasis is being placed on corporate governance and the financial stability of a company, they should welcome scrutiny that will set them apart from others who have something to hide. As a matter of fact, Bradford has the convenience of having a franchiser peruse its books before that is done externally.

Conclusion. Hadley must be proactive and assertive. In the office, Hadley must strive to be a credible, competent and contributing part of the executive management team so that his opinions are taken into consideration even when the CFO is not present. In addition, he and the CFO should take part in all discussions that have possible financial implications.

[56] With external audiences, Hadley has to be assertive and comfortable in his position as the director of investor relations. He must be willing and ready to deliver all news with consistency and integrity. This is the easiest way for Bradford and Hadley to build credibility.

Controlling the conference calls with scripts and making sure that the conference call is a discussion of the earnings and related developments are other areas where Hadley can improve. Last, Hadley must screen the questions to make sure that they are relevant to the majority of listeners. The conference call should not turn into a debate between executives and callers or become a vehicle to address issues that belong in other parts of the company.

Keeping these things in mind, Hadley should see a change in the company's public perception and a greater respect and need for his position inside Bradford Inc.

Dustin Dumas is the founder of ForeSight Consulting, which assists private and public companies in investor relations strategies.

SHAREHOLDERS ARE THE BOSS

Despite Hadley Gaines' protestations that Bradford Inc.'s problems reflect

outside forces, in his heart he knows that management has developed a culture in which the business is theirs, not their shareholders'. Even sadder is the fact that over the last decade or so, too many companies have adopted the same perspective, with the devastating result being the destruction of shareholder value and the kind of evaporation of investor confidence that Bradford is now facing.

Managing a company's credibility with analysts and investors is Job One for any investor relations professional. If we are to truly fulfill our fiduciary responsibility to shareholders, there are times that we must stand up on their behalf. True, we may not win every battle with the CEO or the legal department—they may have different agendas—but we have to be engaged. We have an obligation to insert ourselves into the debate. Quite frankly, Hadley Gaines showed he was foremost—and virtually exclusively—a company man. How do I know that?

First, no matter the reason, the resignation of board members should not be treated as an afterthought, especially when one was on the audit committee. Though it appears that Hadley tried to get a press release issued beforehand, the suggestion was shot down—although he appears not to have put up much resistance because he wanted to avoid questions regarding the progress of the director search.

Second, while it might be true that Bradford's unexciting financial performance was largely a reflection of the stalled economy, shareholders have a right to ask management what strategies are being contemplated to deal with the situation. Yes, a stalled economy can be a contributor. But at some point—and it appears to be well past that time for Bradford given the shareholder grumbling—management has to step up and take action. Doing nothing over the long term is an open door to Chapter 11. In that light, the shareholders' push for more aggressive expense control is perfectly logical.

My experience in such situations is that usually the first areas to get cut are in staff rather than line positions. Could that have factored into management's resistance to broach the subject? That could well be an indication of a company-focused management. At any rate, Hadley should have been proactive in counseling management to have a position statement on this issue in place, and then he should have taken steps to proactively insert it in the press release or, certainly, the conference call script.

Third, in any service-related business, service quality and training adequacy are paramount. The reaction to the recent service-quality survey indicates that this caught Bradford management by surprise—which by now is really no surprise. Again, Hadley should have prepared management for the eventuality of the question. And if he had been at the top of his IRO game, Hadley should have encouraged management to proactively acknowledge the issue during the conference call. At least by doing this, given the issue's newness and even though the company may not have had specific resolutions ready for announcement, Hadley would have positioned management as informed and concerned.

As a first step the executives could note the summit meeting of key store managers and operations executives, with other steps to be announced as plans are more fully developed. Bradford's management must address perceived cutbacks in spending on training. The case study is silent on this, but I hope that the answer is no—although I have my suspicions.

Fourth, the fact that the major franchiser's questioning of bonuses annoyed Hadley shows how far he and management have strayed into the this-is-our-company mentality. Bradford's management is arrogant. Any demand for an audit should be considered material information. Furthermore, even if the audit is private, it certainly will not remain a secret for long.

No shareholder I've ever met objects to bonus plans that are fair and properly reflect improved shareholder returns. If it is a system that

management has to apologize for or is uncomfortable discussing, it needs to be changed. Hadley should be working with management to define its position on the issue, including any planned revisions to the bonus plan, and then beat the leak by publicly issuing a statement.

Managements seldom start down the we-own-the-business road purposely. Usually they arrive there as a result of a string of improper reactions to events or because of carelessness. But as investor relations officers who have been in the job during a period of crisis can attest, when they look back for the root cause of the problems, they usually find the force of imperceptible relentlessness at work.

That's a big term. Let me illustrate it this way.

When I was a boy, my neighbor's yard contained a retaining wall. It was put in place to keep a large tree and about five tons of dirt from slipping into the back yard. It was very sturdy. My friends and I walked and played on it. I never noticed the tiny cracks developing in the mortar. A loose capstone once in a while should have signaled the weakening. But it didn't. After all, it was one big wall!

One morning I found the wall and lots of dirt sitting in the middle of Mr. Jones' back yard. (Yes, that really was his name.) Only then did my neighbor know that he had a problem. The imperceptible relentlessness of growing roots rendered useless what was once strong.

Unfortunately, Bradford's investor confidence is lying in the middle of its back yard. Why? Hadley's lack of initiative in counseling management on known and emerging investor issues, the absence of developing communication plans that proactively address them before they are raised and his personal preference to avoid confrontation. Investor relations is not for the timid.

Maybe I'm being too harsh, but I infer from the case study that Bradford's earnings release and management's comments during the conference call

were perfunctory and lacked meaningful discussion about what management knew to be key issues. Certainly they contained no forward-looking discussion.

The quarterly earnings disclosure exercise—the press release, conference call and 10-Q filing—is a prime opportunity to address tough issues and position management as being able to meet the challenge. Use it wisely and leverage it as much as possible. Often a management team thinks that the best communication strategy is to acknowledge a problem only when it has the solution. Not true. Candid discussion of tough issues instills investor confidence. Importantly, it reinforces that management is looking out for the shareholders' interests.

Bradford's management needs to come clean on all the challenges it is facing and articulate strategies for dealing with each if the executives have any hope of turning around investor sentiment—not to mention living up to the company's code of ethics. It will not be pretty. It is likely to be painful. And it certainly will be humbling. But short of a wholesale change in management mandated by angry shareholders—which is where Bradford is heading, in my opinion—it is the best option to demonstrate that management is in control and not just reacting.

In the end, most investors will give management time to propose solutions and implement plans that address problems. But no investor has confidence in a sit-on-its-hands management. When that is management's style, the signal is clear—the company clearly belongs to management, not to shareholders.

Jay Gould is senior vice president and director of investor relations at Columbus, Ohio-based Huntington Bancshares, Inc.

STOP ACTING LIKE VICTIMS

While it may be tempting for Hadley Gaines to convince himself that the issues facing Bradford Inc. come from the post-bubble stock market

and sluggish economy, he needs to realize that his company must change how it communicates with investors—and do so rather quickly—before uneasy investor perceptions become Bradford’s harsh reality.

Hadley and the members of the senior management team should stop acting like victims and recognize that certain issues warrant full disclosure with the investment community. Knowing what these issues are and why they are so important should not be difficult. The executives also need to understand that these issues are best addressed in a proactive rather than reactive manner. This is especially true in light of a number of recent examples of corporate malfeasance, which have fueled investor uncertainty in the equity markets as a whole.

[61]

One could argue that many of the issues facing Bradford could have been nipped in the bud had they been addressed in an open and proactive manner.

Bradford appears to face a growing lack of investor confidence—not because of any one particular issue but rather because a number of smaller issues have snowballed into a larger problem. Hadley and the company’s senior management can be criticized for not being proactive enough on each of these issues. By being reactive, they come across as defensive and appear to be trying to cover something up, even though this may not be the case.

Let’s look at how each of these issues may have been handled differently.

On the earnings conference call, it appears that the company should have been more forthright on several issues and should have used the call to address other issues that seem to be the subject of rumor and speculation within the investment community.

On the subject of quality of earnings, it appears that the company could have characterized its results more clearly and addressed whether results were bolstered by increased revenues in one particular city with a weeklong sports event. If they were, say so. If not, explain what happened.

Secondly, the conference call provided a clear opportunity to explain the resignations of two board members. More important, the company should have explained the process for filling the board seats and provided some sense of timing for the selection. In addition, the company should be mindful of the added attention being placed on corporate governance matters and be cognizant of issues such as director independence and qualifications.

The investor comment about service quality presented an opportunity to explain the importance of customer service and the amount of attention paid to customer feedback. Rather than get emotional or defensive about the comment, the company could have taken the opportunity to explain that the results of the most recent customer satisfaction survey were to be reviewed and acted upon at an upcoming meeting of key executives.

Last, Bradford should have considered addressing expense allocation and executive compensation concerns on the call. Rather than have rumors abound, the company may have been better off acknowledging the speculation and speaking to it in a proactive manner. In this instance, Bradford could have described what audit committee actions were being taken to assure investors that nothing was out of line in either accounting or compensation.

Hadley Gaines and Bradford Inc. need to begin communicating in a different manner. By being proactive instead of reactive, they stand a much better chance of restoring investor confidence in management and in the integrity of the company's governance and accounting practices. If they communicate more openly, investors will recognize that management understands the issues and is doing something about them. That's more productive than sitting back and getting frustrated that investors just don't understand.

Kevin Tarrant is executive director of investor relations at Verizon Communications Inc. 

Big Issues for Small Caps

INVESTOR CONFIDENCE

CHRIS FABER

The breakdown in investor confidence due to the abundance of corporate scandal represents the greatest threat to capitalism since the rise of communism. Karl Marx must be laughing in his grave at the irony that capitalists seem to pose the greatest threat to capitalism. Greedy corporate management, sleepy boards, dishonest accountants, self-dealing brokers and irrational investors all share the blame.

For small-cap stocks, the issue of investor confidence is particularly important.

Because small caps often are thinly traded, lack of confidence due to news about senior management's unethical behavior or aggressive accounting practices can accelerate a stock price decline. More important, a decline in confidence can affect access to capital, thereby threatening a small company's long-term viability to a much greater degree than is the case for a large-cap company.

Indeed, waning investor confidence threatens the very existence of many small companies that require access to capital for investment today that will benefit society tomorrow. For example,

many biotech companies teeter on the brink of insolvency and need capital to fund clinical trials for promising new products that offer cures for cancer and other cruel diseases. The price of continually waning investor confidence is huge, because many small companies may never get the opportunity to reach their full potential.

To address flagging investor confidence, Congress enacted the Sarbanes-Oxley Act of 2002, which requires the chief executive officer and chief financial officer to sign off on the authenticity of financial accounts and subjects them to monetary liability or possibly jail time for submitting misleading information. This act is unlikely to produce higher investor confidence for small or large companies because trust cannot be regulated. It must be earned. Earning trust takes time.

Restoring investor confidence is likely to occur over time as both investors and companies incorporate lessons that were learned from recent events.

Companies that seek capital will improve the quantity and quality of their

disclosure, improve the quality of their boards and re-examine executive compensation packages. Otherwise, access to capital will be expensive—if not impossible. Investors will learn to view financial statements with more skepticism, to understand the nuances of accrual accounting better, and to improve their understanding of corporate valuation. As investors improve their research skills, they will rely less on Wall Street research.

At IronBridge, we avoided sell-side research because it was clear that the analysts who prepared it represented a distribution arm for investment banking. We also viewed reported accounts with a high degree of skepticism because, clearly, companies try to present results in the best possible light within GAAP standards. We always have paid attention to the footnotes in companies' 10-Ks and 10-Qs. For example, in early 2001 we sold—at a profit—a company based on a related-party transaction in which members of senior management sold a majority of their holdings through a blind trust while simultaneously announcing that they were buying a fraction of that amount in the open market. We smelled a rat and sold. Three months later the company was delisted because the Securities and Exchange Commission discovered fraud.

Even so, we have been digging a little

deeper into the 10-Ks and 10-Qs of late and scrutinizing issues related to revenue recognition, capitalization of certain expenses, reclassifications of receivables to long-term assets, reserve accounting, acquisition accounting, debt classification and other potential accounting torpedoes. What we find is that most companies are clean but enhance their results where generally accepted accounting principles permit.

The best proposal that we have seen for helping investors understand the quality of reported accounts comes from former Treasury Secretary Paul O'Neill. He proposed that, as part of the audit process, the accounting firm be required to grade elements of the income statement and balance sheet on a scale ranging from most conservative to most aggressive. GAAP allows revenue to be recognized in different ways. An aggressive revenue-recognition policy helps flatter earnings, while conservative recognition tends to hold back earnings growth. Such a grading system would help investors quickly understand to what degree earnings are being flattered. The proposal would improve investor confidence for both small and large companies and does much more for restoring investor confidence than the Sarbanes-Oxley Act.

On the corporate side we have seen more disclosure and a move toward more

conservative accounting practices. For example, we own one company that used to sell its receivables to a wholly owned, special-purpose subsidiary. Today, after Enron's implosion, investors are concerned about companies that maintain such subsidiary relationships. The company whose stock we hold closed its subsidiary and brought all of its receivables back onto the balance sheet.

The market system is working. Investors are getting smarter. Companies are becoming more honest. Over time confidence will return. So will the bull market, and many of today's small companies will evolve into tomorrow's mega companies. ■

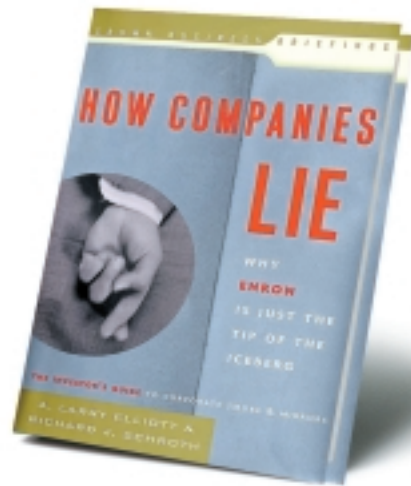
GOOD TIMING, RUSHED ANALYSIS

MARK GILBERT

While timing is not everything, few of us doubt its importance. That maxim applies to the informative but overheated book, *How Companies Lie: Why Enron Is Just the Tip of the Iceberg*.

In March 2001 Richard J. Schroth and A. Larry Elliott started to write a book about the lack of internal corporate governance, the often immense difference between pro forma earnings and earnings based on generally accepted accounting principles, and the general malfeasance that seemed to appear many places in corporate America in the bubble of the late 1990s. The authors were finishing the book when the Enron story broke. Knowing a “bad” story when they saw one, they give an excellent overview of what made Enron tick and what triggered its explosion. Lady Luck further graced the authors’ efforts as deepening problems at several large companies continued to provide illustrations for their topics.

The authors spend no time warming up in the book. The first chapter uses a fictitious company called Red Rocket International to display time-tested tricks:



How Companies Lie Why Enron Is Just the Tip of the Iceberg

A. LARRY ELLIOTT AND
RICHARD J. SCHROTH

CROWN BUSINESS, NEW YORK
ISBN: 0-609-61081-3

pro forma numbers where pro forma, like the words used by the Queen of Hearts in *Alice in Wonderland*, means what the speaker says the numbers mean; special-purpose entities and, of course, announcing something—anything—to get the analysts on your side.

Had the authors given us the same number of examples without a political agenda, they would have made their case much stronger. Instead, they go after what they call the coverup from “big

tobacco.” No matter where one comes down in the tobacco debate, it was evident that cigarettes were not healthy products long before the office of the surgeon general issued its advisory. Yet the authors profess to be shocked that executives, on behalf of their shareholders, would continue to maintain, and if possible increase, profits from a legal product. The authors seem to be saying that since we don’t like the products of certain companies, we will put the companies in the same accounting hall of shame occupied by Sunbeam and Waste Management.

In the same chapter, “The Art of Artful Dodgers,” the authors state that the “big chemical corporations have a track record approaching that of ‘big tobacco’” and cite a book titled *A Civil Action* that confirms their theory. Not having read that book, I cannot comment on how valid or politically motivated that comment may be. But that is the point. Rather than giving examples of what chemical companies have done, the authors simply make it appear self-evident, and that is that.

The book addresses investor relations and public relations in a subchapter called “Surrogates in the Service of Lies.” The authors say, “If we characterize this process in the worst possible way, we would call it propaganda.” It should come to

no one’s surprise at this point that they do characterize the practice in the worst possible way, forgetting that propaganda was a neutral term from the time of the ancient Greeks into the 20th century, when it derived its current negative connotations from its use in the Third Reich.

The authors also seem to find it odd that among the techniques that corporate communications specialists practice are to coordinate messages and apply them in persuading particular audience segments. Looking up the word demographic in the dictionary would go a long way toward educating the authors not only in how the world works but also to the fact that few of us are so easily led as to take everything we see and hear as gospel.

The final two chapters, like the first few pages of the first chapter, present a fine and well-crafted argument, with plenty of nonpolitical or philosophical examples, for why we need a change—now—in corporate governance. Had the writers done as well in their arguments and proposed changes in the rest of the book, I could close this review as I opened it—by alluding to how important timing can be. Instead, I wish they had taken more time simply to write a better book. ■

IR Bookshelf

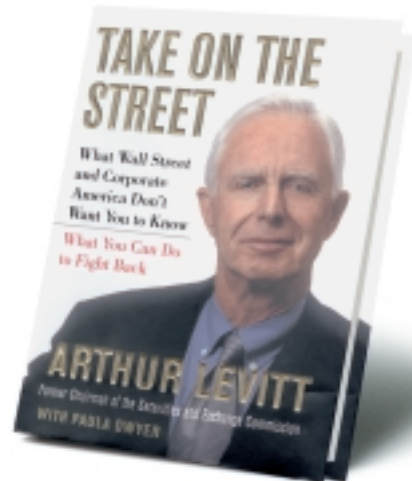
STREET TALK

MICHAEL KLODNICKI

Having served as chairman of the Securities and Exchange Commission under President Clinton, Arthur Levitt—as promos for his book proclaim—is the “ultimate insider who reveals Wall Street’s culture of collusion and distortions and what you can do to safeguard your financial future.”

In the book, *Take on the Street*, Levitt does tell tales. He does name names. He dishes some dirt. He does offer advice—some of which is even practical. But this book is mostly about Arthur Levitt as a crusader against the evils of big corporations and investment banking and friend of the mom-and-pop shareholder. Unfortunately, like the president who appointed him, there seems to be much more style than substance here. In short, it’s Arthur Levitt against the world.

Those he takes on make up a long list, including what was then the big five accounting firms; analysts with financial incentives to gain investment banking for their firms; auditors with incentives to gain consulting business for their firms; the expensing of stock options and good will; CEO John Chambers of Cisco; Citigroup CEO Sandy Weill; chairman of



Take on the Street

What Wall Street and Corporate America Don't Want You to Know

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the Senate Banking Committee Senator Phil Gramm of Texas; Home Depot founder Bernie Marcus; Merrill Lynch’s Henry Blodgett; Apple founder and CEO Steve Jobs; Disney’s Michael Eisner; Lou Gerstner from IBM; Barry Melancon, president of The American Institute of Certified Public Accountants; Representative Tom Biley, Chairman of the House Committee on Commerce, which oversees the SEC; Representatives Michael Oxley

and Billy Tauzin, and many others.

Although Levitt's advice to individual investors offers some great tips, it is not easy or practical. To acquire, read and analyze the information that Levitt suggests would require an individual's full time. It's hard to do, especially considering that most investors have full-time jobs, families and leisure interests.

Levitt's advice to individual investors regarding how to learn about a company also provides little help. He writes, "The best way to do this is by ignoring the glossy annual report that comes in the mail. Instead, go right to the dry, but far more informative, Form 10-K, or annual report, on file at the SEC." Here's Levitt—claiming to be a champion of individual investors, full disclosure and the now trendy transparency—sending common folk to an unwelcoming and often incomprehensible legal and financial document that was never really intended for the mass audiences he is trying to help. He does talk about the need to use plain English in annual reports and other financial communications. But while that's an improvement—financial documents that use plain English are clearly better than those that don't—it doesn't solve the problem.

For all of those investors who are

not attorneys or financial professionals, a Form 10-K is still a Form 10-K—a challenge to read and understand. The challenge becomes greater as more and more companies choose to distribute the Form 10-K to individual investors rather than compile financial sections in their traditional annual reports. In this sense, full disclosure and transparency benefit only attorneys and financial professionals.

Throughout his book, Levitt says that his every thought, action and intent as SEC chairman was to help the individual investor. So it's somewhat odd that it never occurs to him that when you want to communicate something complex in a way that individual investors can understand it, you ought to call on professional communicators to help do it. Even if the Form 10-K and other financial communications are prepared in plain English, they are stuck in the closed loop of CFOs, analysts, accountants, auditors and attorneys. And so is Levitt—despite any protests otherwise.


Still, it's easy to find value in this book.

Levitt claims a couple of successes and says he has a lot of regrets. Among the successes are that investors have benefited from Regulation FD and switching the trading prices on common stock to decimals from fractions.

One of Levitt's best stories is how he found out that he would be SEC chairman. "I first heard that I was under consideration, not from anyone in the White House, but from a *Wall Street Journal* story," he writes. "No Clinton insider had ever interviewed me about my policy ideas, or asked me if I was interested in the job."

He goes on to explain the qualifications that he feels got him the position. "I'd like to think my Wall Street and Washington experience recommended me. But I suppose the \$750,000 I raised as one of 22 co-chairmen of a New York dinner for Clinton just before the 1992 nominating convention was not lost on the president's inner circle."

Great stuff. And there's plenty of it in this book.

Whether or not you buy into Levitt's positioning himself as a lone ranger against the evils of the investment banking and financial professionals, his insider perspective and naming of names and details make this book a good read. 

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