43. Major Policy Lessons from the Corporate Scandals

Congress should

- clarify that the criminal penalties in the Sarbanes-Oxley Act (SOA) require proof of malign intent and personal responsibility for some illegal act;
- address the potential problem of the delisting of foreign and small firms from the American stock exchanges, maybe by exempting such firms from the regulatory requirements;
- *eliminate* the expensive and wholly unnecessary Public Company Accounting Oversight Board, preferably before it establishes new precedents and creates some special interest;
- consider the wholesale *repeal* of the SOA on the basis that it is unnecessary, harmful, and inadequate to address the major problems in the U.S. corporate economy;
- *eliminate* the current roles of the Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC), and Congress in setting accounting standards, allowing each stock exchange to set the accounting standards for corporations listed on that exchange;
- delay implementation of the FASB ruling that would require the expensing of stock options until the issue of the authority to set accounting standards is resolved;
- encourage the development of a parallel system of the primary *nonfinancial* indicators of the earnings potential of a firm;
- allow each stock exchange to set the disclosure rules for corporations listed on that exchange, to select and monitor the independent public auditors of those corporations, and to establish a market for the voting rights in the shares of those corporations;

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- consider broadening the certification provisions of the SOA to include the accountants, bankers, and lawyers who abet the misrepresentation of a corporation's financial condition;
- consider a rule that a lawyer must report a possibly illegal act by a corporate client to a senior partner in his firm and to the board of the corporation;
- eliminate the authority of the SEC to designate credit-rating agencies as nationally recognized statistical rating organizations (NSROs);
- reduce and eventually eliminate the reliance of regulators on credit ratings;
- reduce the standard-setting role of the SEC but increase its effectiveness by modernizing its reporting and review process;
- repeal the $1 million limit on the salary and bonus that may be deducted as a current expense, and repeal the SOA ban on loans to corporate officers;
- *replace* the corporate income tax with a broad-based tax on the net cash flow of all nonfinancial businesses; and
- *repeal* the Williams Act of 1968 and other restrictions on the market for corporate control.

The Flawed Governmental Response to the Corporate Scandals

A $7 *trillion* decline in the value of American equities, a wave of corporate accounting scandals, and the bankruptcy of Enron, WorldCom, and several other large corporations led Congress, the Securities and Exchange Commission (SEC), and a gaggle of state attorneys general to implement the most comprehensive new regulation of corporate behavior since the 1930s. Unfortunately, most of the new regulations authorized by the hurriedly assembled Sarbanes-Oxley Act (SOA) are unnecessary, harmful, or inadequate to address the major problems of the corporate sector.

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Unnecessary

Because the stock exchanges had already implemented most of the SOA changes in the rules of corporate governance in their new listing standards, the SEC had full authority to approve and enforce accounting standards, the requirement that CEOs certify the financial statements of their firms, and the rules for corporate disclosure; and the Department of Justice had ample authority to prosecute executives for securities fraud. The expensive new Public Company Accounting Oversight Board (PCAOB) is especially unnecessary. Its role is to regulate the few remaining independent public auditors, but it has no regulatory authority beyond that already granted to the SEC. Moreover, the audit firms still have a potential conflict of interest, because they are selected by and paid by the public corporations that they audit. The PCAOB may also be unconstitutional, because it is a private monopoly that has been granted both regulatory and taxing authority.

Harmful

The SOA is harmful because it substantially increases the risks of serving as a corporate officer or director, the premiums for directors' and officers' liability insurance, and the incentives, primarily for foreign and small firms, not to list their stock on an American exchange. The ban on loans to corporate officers eliminates one of the more efficient instruments of executive compensation. And the SOA may also reduce the incentive for corporate executives and directors to seek legal advice.

Inadequate

The SOA failed to identify and correct the major problems of accounting, auditing, taxation, and corporate governance that have invited corporate malfeasance and increased the probability of bankruptcy.

Unfortunately, the Sarbanes-Oxley Act, the new SEC regulations, and the extortion suits by the state attorneys general are better examples of the incentive for public officials to be seen doing something about a perceived problem than of a patient and informed reflection about the origins of the problem.

The Major Policy Lessons from the Corporate Scandals

The major policy lessons that were illustrated by the collapse of Enron and other corporate scandals are the following:

Don't Count Too Much on Financial Accounting

Financial accounting is backward looking, unusually complex, subject to subjective interpretation, vulnerable to several controversial accounting doctrines, and an invitation to manipulation. More important perhaps, many changes in nonfinancial conditions, which are never recorded on the balance sheet, may affect the value of a firm for better or for worse. For these reasons, corporate financial accounts do not provide accurate or sufficient information to corporate managers, investors, or regulators. This leads us to recommend that the SEC allow each stock exchange to set the accounting standards for all firms listed on that exchange and to promote the development of industry-specific nonfinancial accounts to complement the financial accounts.

Don't Count Too Much on Auditing

The most important lesson of the Enron collapse is that *every* link in the audit chain—including the audit committee and the board, the independent public auditor, the bankers and lawyers that aided and abetted the misrepresentation of Enron's financial condition, the credit-rating agencies, and the Securities and Exchange Commission—failed to deter, detect, and correct the conditions that led to that collapse. Although not a part of the formal audit chain, most of the market specialists in Enron stock and the business press were also late in recognizing Enron's financial weakness. Moreover, this is a characteristic pattern in many other bankruptcies.

This leads us to recommend that most of the audit functions be assigned to the stock exchanges, the only institution with the potential to capture the third-party benefits of a good audit. Each stock exchange would set the disclosure rules for the corporations listed on that exchange and select, monitor, and compensate the independent public auditor of each firm.

I also recommend new rules for the accountants, bankers, and lawyers that contribute to the misrepresentation of a corporation's financial condition, a reduced role for the credit-rating agencies, and a more focused role for the SEC.

Our Tax System Is a Major Part of the Problem

Our tax system encourages too much debt and overly risky investments, the characteristic conditions that lead to bankruptcy. American corporations use too much debt because interest payments are a deductible expense but returns to equity are not. Until the implementation of the 2003 tax

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law, retained earnings and investment within the corporation were too high because the individual tax rate on long-term capital gains was much lower than on dividends. The effects of those characteristics are magnified by the fact that the combined federal and state U.S. tax rate on corporate income is now among the highest of the industrial nations, second only to that in Japan. The limit of $1 million for salary and bonus as a deductible expense, combined with the increase in the top marginal tax rates on earnings and the reduction of the long-term capital gains rate, strongly increased the incentive to compensate corporate officers by stock options, a form of compensation that encourages risk taking. Our tax system, much like the Generally Accepted Accounting Principles (GAAP) and for much the same reasons, is extraordinarily complex, inviting attention to the many types of legal tax shelters used by Enron. Those characteristics of the current tax system lead me to recommend that the $1 million limit on the deductibility of salary and bonus be repealed and that the corporate income tax be replaced by a broad-based tax on the net cash flow of all nonfinancial corporations.

The U.S. Rules of Corporate Governance Do Not Now Adequately Protect the Interests of General Shareholders

Over the past four decades, beginning with the federal Williams Act of 1968, the combination of federal and state legislation and court rulings and rules approved by corporate boards has led to an accumulation of takeover defenses, even though firm performance is negatively related to the number of such defenses. This has increased the power of incumbent managements relative to their boards and general shareholders, increased the number of unprofitable acquisitions by large corporations, increased executive compensation, and almost destroyed the market for corporate control. The primary policy lesson that we can draw from this experience is that the federal government should withdraw from *any* role in establishing the rules of corporate governance and disclosure, returning this role to the state governments and stock exchanges. The policy actions that would be most helpful in restoring an effective market for corporate control would be for Congress to repeal the Williams Act and for the SEC to allow a market for the voting rights of shares that are separable from the ownership rights.

Conclusion

The corporate scandals illustrated by the Enron collapse were a serious problem, undermining trust in the accounts and the behavior of all corpora-

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tions and the political support for free-market policies. At the same time, it is important to recognize that the more serious corporate malfeasance was apparently limited to a few dozen of the 12,000 U.S. public corporations and that the general performance of the stock market and the U.S. economy has been better than that of most other industrial nations, both in the last several years and in the last two decades. So it is important not to overreact by such measures as the Sarbanes-Oxley Act.

This chapter, in contrast, advocates addressing the problems illustrated by the Enron collapse by *reducing* and *focusing* the role of government.

Suggested Readings

Culp, Christopher L., and William A. Niskanen, eds. *Corporate Aftershock: The Public Policy Lessons from the Collapse of Enron and Other Major Corporations.* Hoboken, NJ: John Wiley & Sons, 2003.

Litan, Robert E., with George Benston, Michael Bromwich, and Alfred Wagenhofer. *Following the Money: The Enron Failure and the State of Corporate Governance*. Washington: AEI-Brookings Joint Center for Regulatory Studies, 2003.

Niskanen, William A., ed. *After Enron: The Major Lessons for Public Policy*. Lanham, MD: Rowman & Littlefield, 2005.

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