MARKET DISCIPLINE ACROSS COUNTRIES AND INDUSTRIES

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Chapter 27

Interaction of Market Discipline and Public Policy: Discussion

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The remarks in this paper consist of two parts. The first part concerns the linkages established in the three excellent papers among accounting, corporate governance, and market discipline. The second part discusses the possible uses and abuses of market discipline to define and develop efficient accounting institutions. Several speakers have referred to the choice of whether we look at the glass of market discipline to be half full or half empty. Experience with the promise and failure of market discipline in accounting suggests that we would be best off if we keep an open mind, and assess the efficient application of market discipline on a case-by-case basis. Neither general reliance on, nor the avoidance of, the market discipline offers the prospect of developing efficient accounting institutions.

1. Accounting, Corporate Governance, and Market Discipline

Benston examines five hypotheses about the recent reports of inappropriate corporate financial reports. First, perhaps these failures are not as important or excessive as they appear to be. It is unlikely that the frequency of such failures can be efficiently reduced to zero. The question posed by this hypothesis can be addressed only in relation to an appropriate—and as yet elusive—standard for the optimal number of failures complicated by the problem of changing environment and enforcement policies. It is true that the number of corporate financial restatements increased markedly after 1998. However, this increase cannot be attributed to idiosyncratic change in the behavior of the Securities and Exchange Commission (SEC) without careful examination of the factors that may have led to such the changes in SEC's enforcement policy in the first place. It is possible, indeed likely, that SEC reacted to an increase in abuses in corporate financial reporting. Whether an average 0.1 percent to 0.2 percent loss in the market value of all firms during the few days surrounding the announcement

of accounting restatements is an acceptable trade-off for the cost of additional auditing remains an open question. The evidence establishes, beyond reasonable doubt, that the late nineties saw an unprecedented rise in the frequency of such restatements.

Evidence on the second hypothesis yields some support for the idea that executive stock options lead chief executive officers (CEO) and chief financial officers to adopt aggressive accounting practices. It is reassuring to learn that, as elsewhere in economics, compensation systems yield no free lunch. Attempts to motivate managers and align their incentives with the shareholder interest through performance-contingent compensation carry a cost of their own—the risk of corrupting the accounting system which is operated and controlled by the managers.

Benston rejects a third hypothesis that the consulting fees, through their influence on incentives of independent accountants, may have caused the accounting failures. I do not disagree with the data, or the inference drawn from it. He does not consider the possibility that the failure of the accounting market may have caused the accountants to resort to consulting in the first place. Under this alternative hypothesis, the oft-repeated cause and effect relationship between consulting and accounting failures is reversed.

The fourth hypothesis is that inadequacies of generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) may have caused the financial reporting failures. Benston concludes that the principles-based (instead of rules-based) accounting standards and statistical sampling in auditing might have saved the day. I am skeptical on both accounts.

Rules versus principles, in spite of its rhetorical appeal, is a false dichotomy. No rule-maker sets out to write detailed rules instead of broad principles, or to choose form over substance. With best of intentions, rule-makers get drawn into making detailed rules. The answer lies not in the incentives and behavior of individuals but in the institutional structures we create to write and enforce standards.

Under pressure from their clients, auditors return to the rule-maker for clarifications. It is difficult and costly to say no to a client, and the rule-makers exist to make more rules. It does not take long to move from "Thou shalt not steal" to "Thou shal not steal X, Y, and Z," etc. It is not fair to set up a rule-making body such as th Financial Accounting Standards Board and then to criticize it for writing rules whicl are too detailed. Without structural changes, any rule-maker would be driven in th same direction with time and resources.

Whether the technical device of statistical sampling can help auditors to detec errors and fraud efficiently depends on their willingness to use such devices. Statisti cal sampling has been available to the auditors for some time; it is all too easy for a unwilling auditor to appear to use statistical sampling without extracting its benefit of efficiency. Statistical sampling cannot help an auditor who does not want to detec errors in fraud.

Finally, Benston examines the hypothesis that punishment imposed on errar auditors is insufficient and infrequent, and reaches an affirmative conclusion. I agre I am less sanguine than Benston and Elson are about the beneficial effects of recer reforms. The newly created Public Company Accounting Oversight Board will hav little permanent effect on ensuring that auditors deliver high quality work. The inherer

quality of auditors' work is unobservable ex ante, and barely observable ex post after great cost and delay.

Barth's paper suggests the motto that measurement should be as precise as possible, but no more. No reasonable person should disagree. Yet, the old images of accountants burning midnight oil to match accounts to the last penny has not faded away, and many the accuracy of bookkeeping is easily confused with the accuracy of accounts. Consequently, many people hold an exaggerated view of how precise accounting is and ought to be. Accounting rule-makers are constantly hounded by those who ask: Why can't you accountants just tell the simple truth?

The problem is that what is true is not simple; what is simple is not true. If you don't believe it, ask yourself how much wealth you have.

Over the recent decades, accounting theoreticians have worked out the difficult trade-offs that are possible on the Pareto frontier between our conflicting desires to produce financial reports which are more relevant as well as less error prone. Our wish to cross such frontiers is understandable. But standards and statutes, no matter how much power of enforcement lies behind them, cannot annul the laws of economics.

Elson's comments focus on the key issue of corporate governance and carefully analyze elements of both director independence as well as equity ownership needed to support better governance. I agree with his analysis and suggestions. However, the governance theory has emphasized independence at the expense of other, equally important, factors such as directors' competence, knowledge and experience, connections, trust in the eyes of the CEO, and most of all, a positive motivation to protect the minority shareholders—the small investor who is not in the room and cannot price protect himself or herself. In corporate governance debates, independence of the directors from the senior management is promoted at the expense of these other considerations.

Some other features of the directors-independent-of-managers model of corporate governance being popularized these days raise questions about its potential effectiveness in addressing the governance problem. With the directors and officers' insurance policies bought by publicly held firms, directors have little liability to shareholders. Despite frauds amounting to billions of dollars, not a single non-executive director of a corporation has been charged with wrongdoing. While voting to select the directors, shareholders have little choice but to vote for the slate proposed by the nominating committee. They have no information about the past performance of the individual directors in governance of the corporation. Without choice or information, the shareholder voting as a governance mechanism is largely an exercise in futility except in those rare cases where a well-publicized proxy fight is on.

In spite of all the attention showered on it in the recent years, the corporate governance problem is hardly new. The British East India Company, the first major multinational corporation chartered in 1601, faced severe governance problems throughout the two and a half centuries of its existence. The minutes of its Court of Governors are replete with not-always-successful efforts to solve the governance problem over long distances that had not yet been spanned by telecommunications or air travel. In spite of their promise, the modern communications do not seem to have made much difference. The problem arises from human nature, not technology, and has no easy fixes.

2. Uses and Misuses of Market Discipline in Accounting

In banking, the use of market discipline to address the governance problems has a long history, and is taken for granted today. The idea is relatively new to accounting, and it is possible to use the market discipline to devise better practice, standards, and institutions of accounting. To this end, I shall mention a few possible uses, and an example of misuse of market discipline in accounting.

Development of better accounting rules and standards can be facilitated by allowing two or more sets of rule-makers compete openly for the allegiance and royalty revenues of the reporting firms who are left free to choose any one set of standards for their financial reports. At a small additional cost of competing rule-makers, corporations could save hundreds of billions of dollars each year in lowered cost of capital. Comparability of results does not obtain even when a single set of rules is applied across different economic environments. Market reactions to firms that choose different standards will inform better decisions by rule-makers. Allowing competition among sets of standards increases the chances that each firm will choose to report by rules that minimize its own cost of capital, giving rise to different sets of accounting rules for different kinds of firms and different kinds of economic environments.

Instead of creating a chain of watchmen to "watch the watchman," implicit in the recent legislation to create the Public Company Accounting Oversight Board, we could resort to help from market discipline. Removal of the mandatory audit requirement of the SEC would allow better-run companies to use auditing as a costly signal to convey a sense of confidence in their information to the shareholders. Some proposals for the use of market discipline include combining the audit function with insurance and allowing reporting firms to buy any amount of fair financial representation insurance from a company that will conduct its own audit to limit its own exposure to risk.

A third example of the use of market discipline in accounting concerns executive stock options. Under this proposal, the firm would be free to attribute any value to the incentive options granted to the employees. This value will be announced and expensed in the financial reports and deducted from the tax return of the firm. The firm would be obligated to sell similar options to its shareholders at a price equal to this value; the market will ensure that any undervalued options get diluted down to the stated value.

The 1970s changes in the public policy to push for more competition in the market for audit services is an example of misdirected use of market discipline. Until the 1970s, the U.S. government had refrained from pushing for greater competition in markets for professional services (for example, doctors, lawyers, dentists, and accountants) for the fear that such action may cause failures in markets where the customers could not observe the quality of the services provided. By the mid-seventies, theoretical arguments by Stigler and others about the robustness of competition had eased such qualms. The Supreme Court decision on Bates vs. the Bar of the State of Arizona in 1977 led the U.S. Department of Justice to force professional associations to remove anticompetitive provisions (for example, no advertising, no solicitation of competitors' clients or employees, etc.) from their respective codes of ethics. The unobservability of the quality of services rendered in auditing is extreme; unlike the

results of the endeavors of doctors and lawyers, the consequences of auditors' efforts are rarely observable ex post. The increased competition led to a rapid decline in the price and quality of audit services within a short period of time. The major accounting failures of the past few years can be traced back to this misguided attempt to use market discipline in a market which could not be sustained under the forces of competition.

To summarize, careful use of market discipline can effectively address many problems of accounting and auditing that have surfaced in the recent years. It would be prudent to have such use guided by economic analysis. Ideological commitment to market discipline independent of the specific circumstances can be just as harmful as ignoring the market forces.

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OF RELATED INTEREST

ASSET PRICE BUBBLES

THE IMPLICATIONS FOR MONETARY, REGULATORY, AND INTERNATIONAL POLICIES

edited by William C. Hunter, George G. Kaufman, and Michael Pomerleano

In the industrialized and developing world, a distinctive feature of the last two decades has been prolonged buildups and sharp collapses in asset markets such as stock, housing, and exchange markets. This book examines asset price bubbles to further our understanding of the causes and implications of financial instability, focusing on the potential of central banks and regulatory agencies to prevent it.

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