Failure of the antitrust policy is the key to what happened

I believe the markets even now are higher than they should be

Increasing punishment will induce crooks to spend more money on evasion

Shyam Sunder

The Yale professor in a candid discussion with Managing Editor **Prem Panicker**

An accounting authority, a perceptive analyst, and an excellent teacher. And one who minces no words. Indeed, Shyam Sunder, James L Frank Professor of Accounting, Economics and Finance, School of Management, Yale University, New Haven CT, belongs to a rare species.

He holds an MS and a PhD in Industrial Administration from Carnegie Mellon University. He has won the American Accounting Association Manuscript Award in 1975; AAA-American Institute of CPAs Notable Contributions to Accounting Literature Award in 1982 and 1998; and the Alpha Kappa Psi National Accounting Award in 1982. He also holds various offices of repute, and is a visiting professor at many institutions.

His name features in the Dictionary of International Biography and in various Who's Who directories. He has written more than half a dozen books and over a hundred articles on accounting, business, economics, and finance.

In an incisive interview to *India Abroad*, he dwells on the reasons for the Wall Street meltdown and how well-meaning legislations fail due to want of implementation.

President Bush has just signed a reform bill that calls for stiff punishment for corporate fraud. How would you rate this legislation?

When you have an extensive breakdown in corporate governance, accounting, management and regulation, you have to ask what is the source of the problem. Is it because of misbehavior of some people, or is there a broader failure of policy? It is difficult to admit failures of policy, and to formulate a better policy. Arresting a few people and branding them as villains attracts more attention, even a media storm.

In other words, this legislation doesn't cut it...?

Well, look at the situation. What we see now is not merely the result of bad behavior of some people. I am not saying they were not at fault, but the roots of the problem go much deeper. To trace the roots, we need to go back a quarter century. Until the mid-1970s, it was not US policy to enforce antitrust laws against professionals. The antitrust laws existed, but were not enforced against doctors, engineers, accountants, et cetera. The argument was that if you force professionals to compete through advertising and other means, you induce them to cut corners on quality of services. Their customers find it difficult to distinguish good from bad when they buy the services.

In a mid-1970s decision, the Supreme Court ruled that lawyers could not be prohibited from advertising their services. In the late 1970s, the government forced the professions to change their codes of ethics, and remove barriers to competition. It was argued that any tendency of professionals towards lowering the quality of their services under competitive pressures would be counter-balanced by their desire to preserve their reputations, and that this was the public's best guarantee of quality.

Extension of this argument to auditors, however, proved to be problematic. With doctors and lawyers, for instance, quality can be assessed – good doctors cure patients, and good lawyers win cases. But in the case of auditors, such assessment is not possible because there is no yardstick to judge their competence. The rate at which audits fail is so low that even after the audit, there was no way for their customers to learn if they had done what they were supposed to do. Introduction of competition in the auditing profession exerted a strong downward pressure on audit quality, price, and profitability.

Congress, the American Institute of CPAs and the profession tried to control these pressures by setting up a Public Oversight Board to monitor quality of work, but it proved to be ineffective. And this set the stage for major audit failures, and large penalties against auditors, in the eighties.

Which had an impact on today's crisis, how?

When auditors found themselves being penalized, they realized the system was not working for them. They then decided to follow the example of doctors and lawyers in financing political campaigns, beginning the late 1980s. And the payback was the Private Securities Litigation Reform Act of 1995 – interestingly, the only law for which the Congress successfully overrode a presidential veto during Clinton's eight years.

Basically, this act significantly reduced the liability of audit firms, reducing their risk. And the safe harbor provision permitted corporations to issue 'forward looking' projections in their financial statements without the fear of being sued. And that started it all.

Enron, for instance, issued its rosy projections under the 'safe harbor' provisions of this law. With auditors forced to compete in a market that could not sustain both quality and competition, combined with reduced auditor liability and safe harbor rules for painting rosy futures, the stage was set for the extensive failures of corporate governance reported in the last few months.

Thanks to increased scrutiny, plus the new legislation, have we seen the last of that?

Actually, no – the deterioration of the accounting and auditing systems is not limited to these few reports; under a quarter century of competitive pressure, the termites have spread deep and wide beyond the plain view. The policy of encouraging competition was well intended; but it had some terrible unintended consequences.

So your argument is that rather than the new law, what is needed is a review of, and better implementation of, existing laws?

Yes, the primary rule is that when quality is not observable – and it is not observable in the auditing industry – encouraging unfettered competition in a profession is a recipe for disaster. Relieve auditors from some of the antitrust provisions to let them earn a decent, not extravagant, living from their profession.

President Bush said he would ensure that existing laws are implemented – which is nice. I do wonder though why were these not implemented thus far, in the first place? Failure of the antitrust policy is the real key to what has happened, and the solution lies in looking at the policy itself. It may be difficult though for lawmakers and regulators to admit the responsibility for bad policy. So I don't see such a review happening, at least until after the Fall elections – right now, what we see is media play, meant for electoral consumption.

Another point is that increasing punishment for fraud will in most cases merely induce crooks to spend more money and resources on evasion. Rather than punishment after the event, I would like to see the laws written so most people do not find it in their own best interest to commit fraud, in the first instance.

On the subject of stricter implementation of laws, wasn't that the substance of President Bush's speech?

A large part of that speech consisted of moral exhortations to the heads of public corporations to be less greedy.

Moral persuasion may have a half chance of succeeding, depending on the credibility of the person. If you believe the preacher, you may listen – but will you listen if the preacher has questions hanging over his own head?

For instance, President Bush made his speech a day after he refused to make public the record of his own transactions at Harken Energy Corp and its investigation by the Securities and Exchange Commission. If you are a CEO sitting in that audience, listening to that speech, I could not blame you for wondering why someone who is not willing to practice it is preaching you transparency.

What other factors would you say are necessary for the market to regain investor confidence?

We need to be precise about what we mean by investor confidence. At its peak, for example, Enron was selling at around \$85 – and people were buying. Is that investor confidence? In order to support that price, Enron would have needed to double its earnings every year for six years, followed by a sustained average rate of growth – a highly unlikely event for such a large corporation.

So when investors bought into Enron at that price, to cite one example, was that confidence, or overconfidence? We can think of investor realism, overconfidence, and pessimism. With 20/20 hindsight, what we saw earlier was overconfidence, what you see now may be pessimism – neither may be justified. I believe that the markets even now are higher than they should be.

With investors suffering huge losses will we now see a tightening of consumer belts, which may have a long-lasting impact on the economy?

Fortunately, when deciding how much to spend, most people do not count their stock portfolios as if it were money in the bank. It is not money in the bank until it has been converted into cold cash. Thus, even during the boom, while spending did go up with the portfolio values, it did not go up proportionately with the values of their portfolios – and now, the same applies, the fact that portfolios are down is not likely to decrease spending to the sort of levels that could impact on the economy.

Finally, you mentioned that even today the market is higher than it should be. So where should it be?

There is no single magic figure where the market as a whole should be. I prefer a more pragmatic approach towards each individual firm. As an investor, ask yourself some hard questions – don't go by the company's own valuations and projections. Ask yourself, what are the actual earnings, without all the shenanigans, the forward projections.

Ask yourself what is the rate of return you expect from the investment, and calculate the maximum amount the stock is worth to you on that basis. Use this evaluation of the firm to guide your investment decisions, if you want to make them yourself. Evaluate each company or industry from that perspective. If such a pragmatic approach is applied, then the market will automatically find its ideal level.