Editorial

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Time to crack down

One of our nation's greatest strengths is the integrity of our financial markets, but now, thanks to the collapse of Enron and the criminal indictment of Arthur Andersen, the public doesn't know which corporate earnings reports to believe and which CEOs to trust. Investors have lost billions in the scandals enveloping companies like Enron, Global Crossing, WorldCom, Adelphia Communications, and Tyco. The flurry of headlines produced 50 pieces of legislation in Congress. Most have been quietly declared dead on arrival.

Where is the outrage?

One day Enron is considered a 21st-century paradigm, recommended by the best investment minds. Within a few months it goes belly up, taking with it the retirement benefits of employees but not the compensation of top executives. And Enron only tops the list. Let's look through the trash bin:

- The cable company Adelphia guaranteed over $2.3 billion in debt to firms owned by the founding family, who used the money to buy company stock and pursue personal ventures.
- The earnings of stellar companies like Xerox have had to be drastically restated.
- The CEO of WorldCom borrowed nearly $400 million from the company.
- Nearly half the Edison Schools Inc. revenues had never even gone through the company's hands, even though they were on its books.

> We need new rules to deal with wayward accountants and a culture of corporate governance that has, quite frankly, run right off the rails.

Obsession. The public record is rife with instances of accounting malpractice, conflicts of interest, excessive executive compensation, especially for terminated CEOs, and lax boardroom supervision. All the while top executives have been enriching themselves with stock option awards, with stocks that boomed in the bubble but were exposed in the bear market. The CEO of Goldman Sachs is putting it mildly when he says American business has "never been under such scrutiny [and], to be blunt, much of it is deserved."

Yes, the vast majority of America's corporate executives are people of integrity and confidence, committed to the long-term success of these companies, but Wall Street's obsession with quarterly earnings has been costly. The resulting pressure on CEOs to defy economic gravity in an attempt to produce these kinds of increases quarter after quarter puts more pressure on in-house financial staff and on outside auditors. As the evidence now shows, many responded by exploiting the complex rules underpinning the so-called generally accepted accounting principles by either bending them or in some cases ignoring them altogether. The problem wasn't just what was illegal. It was what was *legal*. Accountants went about "selling" creative tax avoidance and creative financing structures, using the GAAP rules to structure transactions that formally complied with the rules but lacked a true business purpose—all to maximize perceived earnings and minimize perceived debt.

As economist John Kenneth Galbraith once noted, recessions catch what the auditors miss. Obviously what the auditors missed during the 1990 stock market boom was the willingness of some executives at the top of some of the largest companies to abandon ethical behavior.

There is talk now of self-regulation and "peer review" for the profession. It won't do. We need new teeth to deal with accountants who are supposed to be watchdogs but have become advocates and salespeople, promoting their various consulting, tax-planning, and advisory services. If we can't get appropriate regulations through Congress, we must at least have an independent self-regulatory organization—a body with rule-making, inspection, oversight, and disciplinary powers. It should have an independent board of directors, most representing the public interest, and report to the Securities and Exchange Commission. If even this bare minimum can't be established, the SEC must impose accounting standards of its own device. This must be supplemented in corporate governance by audit committees that are completely independent and financially literate, without any unrevealed ties to the company. The auditors must be hired by the audit committee and understand that they are working for the shareholders—not for board members who tend to rubber-stamp management decisions.

Integrity is the bedrock of our financial markets, but it has been compromised before, and we have responded. The robber barons of the 19th century gave rise to the Sherman Antitrust Act. The banking excesses of the Gilded Age led to the Federal Reserve System. The crash of 1929 gave us the financial reforms of the 1930s and the establishment of the SEC. It is inconceivable that the current scandal will not stir action in Washington.

Where is the outrage? •