

Investigative tips from America's corporate insiders

BY STEVE WEINBERG
THE IRE JOURNAL

When corporate scandals unfold, journalists often are frustrated trying to get knowledgeable insiders to talk candidly. Journalists are outsiders when the scandal emerges, and almost always remain outsiders throughout the proceedings, whether in criminal court, civil court, or both.

So imagine the pleasure investigative journalists will derive when they read the chapters of a just-published book called "Restoring Trust in American Business." Each of the nine chapters is written by insiders from the corporate realm, followed by a critique from independent experts in corporate behavior. For a journalist, reading each chapter and the accompanying critique is like eavesdropping on previously secret conversations.

For example, the chapter titled "The Auditor as Gatekeeper: A Perilous Expectations Gap" is written by William R. Kinney Jr., a member of the American Institute of Certified Public Accountants' Auditing Standards Board, as well as a member of the Financial Accounting Standards Board's Advisory Council. He is an editor of the Accounting Review, holds a PhD and has taught accounting/auditing at major universities.

Critiquing his insider's account is John H. Biggs, former chairman of the giant retirement fund TIAA-CREF, on the board of directors

at two multinational corporations and a trustee of the International Accounting Standards Committee Foundation. How about those guys for sources?

In his chapter, Kinney addresses three questions that journalists should have been asking, and trying to answer, for decades:

1. What are the auditing profession's obligations to the public interest vis-à-vis corporate misconduct?
2. How well have auditors performed over the past decade in restraining corporate misconduct?
3. What steps should be taken to improve the auditing profession's performance in restraining corporate misconduct?

Unfortunately, too many journalists know so little about the crucial role of auditors in the corporate realm that they could not ask any intelligent questions, much less the most important ones. Kinney casts doubt on

the first word of a two-word phrase journalists often write on automatic pilot: "independent auditor." Yes, auditors of corporate accounts are hired from outside the corporation. But are the auditors truly independent when they frequently rely heavily on corporate fees, and when they know the corporation can dismiss them at will without facing legal consequences?

Picking your judge

Kinney offers a comparison from the world of figure skating, which seems like a more comprehensible world to many journalists than that of corporate finance.

Suppose, Kinney says, that Olympics officials established rules for figure skating competition, then allowed each skater to judge herself: "We would expect each skater's self-score to be higher than a score prepared by an independent expert judge." Then, Kinney says, suppose each skater could hire a reputable expert to assess whether her own scoring is fair and reasonable according to Olympic criteria. That hired judge, Kinney says, "would probably lower the skater's self-score only enough to bring it within the upper limit of a reasonable or fair range."

The corporate world is similar to his concocted figure skating scenario, Kinney says. Corporate officials grade themselves according to GAAP (generally accepted accounting principles). GAAP are shot through with flexibility, as are Olympic judging criteria. (After all, reasonable people can differ about whether a skater executed a certain routine perfectly, almost perfectly, or in a mediocre manner.) That means corporate officials (the principals in the process) exercise power and discretion when grading themselves, then hire an expert auditor in the hope she will exercise what Kinney calls "principal-serving bias." Kinney ends the example with a kicker that all journalists should be able to remember: "Of course, real-world skaters do not get to keep their own score and hire their own confirming experts—but corporations do."

Kinney educates journalists about the expanded responsibilities of auditors in the wake of gigantic

corporate scandals: "Auditors have been criticized for allowing excessive corporate misconduct risk by not correcting small biases in managers' accounting choices and by accepting (or facilitating) managers' designs for transactions specifically to achieve a desired financial statement treatment within GAAP. They have also been criticized for not reporting managers' excessive consumption of perquisites of office. In addition, they have been criticized for failing to warn investors about corporate business risk due to possible declines in business prospects that fall short of business failure, as well as for failing to warn investors about poor decisions by management, risky management decisions, and lax internal controls."

Based on Kinney's insider view, journalists are within bounds when they inquire about how supposedly independent outside auditors are performing on all such counts. But Kinney suggests a realistic view of human nature when examining auditor performance.

"How can the auditor meet these expanded responsibilities?" Kinney wonders. "What are the objective criteria (comparable to criteria for scoring a triple axel in Olympic figure skating) for reliably measuring business risks, measuring inefficiencies, and determining when reportable misconduct exists? And what substantive experience is needed to investigate and apply such criteria in practice?"

Auditors' incentives

Journalists should never forget, Kinney suggests, that auditors compete with other auditors for corporate accounts. A low bidder for an account "faces production cost pressures that limit possible investigation efforts." Furthermore, if an auditor decides she can afford to mount an inquiry that results in reporting problems publicly, "the corporation may fire the audit firm on the spot, in which case the firm loses all future income from the corporation." To add insult to injury, Kinney says, "such an auditor is often sued for not discovering and reporting the problems sooner." Journalists should never forget that auditors have little incentive to act vigilantly, Kinney is saying.

Can the system be improved? Yes, Kinney says, marginally. But if an auditor's role is to automatically encompass the watchdog function, a major revision will have to occur. As Kinney explains, "Problems will remain...if the auditor who has been hired by a corporation...and who discovers and reports bad results still loses...her income stream and faces potentially ruinous lawsuits. It seems essential to establish some mechanism for compensating auditors who act in the public's interest, as well as a more efficient system for private lawsuits."

Turning to corporate boards of directors, New York City lawyer Martin Lipton and Harvard University Business School professor Jay W. Lorsch make the case that those who serve should undergo professional training. Yes, most directors are part time, invited to serve because of the prestige they bring as much as their expertise. Yes, achieving professional-

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Restoring Trust in American Business
Edited by Jay W. Lorsch, Leslie Berlowitz
and Andy Zelleke
American Academy of Arts and
Sciences/MIT Press

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izing of directors would be difficult.

Still, Lipton and Lorsch maintain, professionalizing “would lead to a clearer understanding of what the goals of boards should be. Just as doctors are charged with assuring patient health and lawyers with acting in the interest of clients, directors should be charged with the responsibility of achieving clear, but broad, objectives. We would argue that for a large public company, the goal of the professional director should be long-term success of the company.

That goal, Lipton and Lorsch say, would benefit shareholders, as well as customers, suppliers and employees. As part of that approach, directors would do their best to see that all employees behave legally and ethically.

Professionalizing boards also would be linked to organizing directors’ tasks in a sensible manner. Each director would be expected to perform tasks that allow them to understand and oversee what are usually complex business operations.

One interesting feature of the book for journalists who are obligated to listen to all sides of an issue are essays commenting upon, and sometimes dissenting from, the lead pieces. For example, the Lipton-Lorsch proposal is followed by three commentaries. Their authors are Margaret M. Blair, a Vanderbilt University law professor; Damon Silvers, an AFL-CIO lawyer; and Michael Klausner, a Stanford University business and law professor.

Silvers, for example, comments that professionalizing directors is not as important as democratizing directors. Noting that corporate boards are dominated by insider chief executives and general counsels, Silvers wonders how true director power can exist until the power of the CEO or general counsel is diminished inside the board room. “This is like trying to solve the problem of slavery without actually freeing the slaves,” Silvers says. “You can spend all day exhorting them to be free – you can call them independent,

or even professionals, and demand that they run free – but at the end of the day, there they are, still in chains.”

Teaching future reporters

The chapters by insiders about the performance of investment bankers, lawyers and government regulators are as equally enlightening as those about auditors and directors.

The role of journalists is addressed directly, too, in a chapter titled “Journalists and the Corporate Scandals: What Happened to the Watchdog?” The author is Geneva Overholser, former *Des Moines Register* editor, former *New York Times* editorial writer, former *Washington Post* ombudsman, and now on the University of Missouri journalism faculty. Overholser is rightly critical of journalism school professors who fail to train students in covering the private sector, of newsroom managers who fail to allocate adequate resources to the business beat, and of individual reports who react instead of initiative inquiries. She mentions the hope to be found in journalism school curricular reform, in increased newsroom training, in the shedding by individual journalists of outmoded attitudes about a government beat seeming more important to the public and more prestigious in the newsroom.

Interestingly, Overholser notes that “media leaders, ironically, tend to be even less forthcoming than their peers in other businesses.”

“Even as their own organizations push for openness from others, media executives hold financial information exceptionally close to the vest,” she says. “This must change. Media executives can create greater confidence in the concept of openness by leading the way toward a culture of business transparency.”

Steve Weinberg is senior contributing editor to The IRE Journal and a former executive director of IRE.