Impact of Governance on
Financial Reporting and Markets

A Forum Hosted by

Vincent C. Ross Institute of Accounting Research
NYU Stern School of Business

April 29, 2008

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Dean Thomas Cooley welcomed the participants to what has emerged as the NYU Stern School of Business "*center of dialogue*" between business and society. The Dean commented on the important role of the Ross Institute Forums and Roundtables in bringing together members of academe, the professional and business communities, and regulation to discuss the compelling issues that are at the forefront of business in the U.S.

Seymour Jones, Associate Director of the Ross Institute and Clinical Professor of Accounting, provided the introduction and framework for discussing a broader application of "SOX"[1] to the private and not-for-profit sectors. As a springboard for discussion of future application, the panelists were asked to review the economic and behavioral impact of SOX since its legislation in 2002. A review of both the positive and negative consequences, and what changes could be made to improve the current legislation.

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Mark S. Lilling, Chief Executive and Managing Partner of CPA firm Lilling & Company LLP[2], and founder of the Audit Committee Consulting Team LLC, provided an overview of SOX, emphasizing its goal of protecting investors by improving the accuracy and reliability of financial reports. SOX increased corporate responsibility and correspondingly the penalties for "white collar" crimes.

The requirement for improving internal control procedures, the auditor's opinion on management's assessment of internal control, and additionally the auditor's opinion on the effectiveness of these controls have all been key factors leading to improvements and increased disclosures. COSO[3] provides a framework for dealing with issues that cannot be legislated, e.g. management style, tone at the top, risk assessment policies, etc. Mr. Lilling noted that the COSO framework is readily adaptable to both the private and not-for-profit sectors.

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One of the unique and outstanding features of the Vincent C. Ross Institute of Accounting Research is the integration of academe with members of the so-called "real

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[1] Sarbanes-Oxley Act
[2] Sponsor of the Forum
[3] Committee of Sponsoring Organizations of the Treadway Commission.

world". Academic research has no private agenda; it is non-partisan. Scholarly research provides the foundation upon which intellectual discourse can thrive. The *foundation* was provided by Daniel Cohen, Assistant Professor NYU Stern.

Professor Cohen[4] presented the results of his academic research on the impact of SOX. His research investigates the change in both *real* and *accrual-based* earnings management in the pre- post-SOX period. *Real* earnings management includes discretionary spending, e.g. R & D and advertising; whereas *accruals* include provisions for bad debts, depreciation, etc. The findings provide evidence that earnings management increased steadily over the sample period, and meeting or beating prior year's earnings number, analysts' forecasts, and avoiding losses continued to be important incentives to manage earnings. Subsequent to the passage of SOX, although the level of earnings management returned to the pre-SOX trend, *accrual* management declined, whereas the level of *real* earnings management increased. Their analysis cannot attribute the changes exclusively to SOX, as there were other events, e.g. the highly publicized enforcement actions by the Department of Justice, that may have contributed to reducing the incentives to manage earnings.

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John Biggs[5], Executive-in-Residence NYU and Boeing Audit Committee Chairperson, shared his personal observations on the impact of SOX comparing his experiences to the observations and related commentaries of others. To set the stage for where he stands in the post-SOX sound off, a rich medley of quotations was provided, including comments such as:

> "*…There has been a shift in the board's role from guiding strategy, running the business and advising management to insuring compliance and performing due diligence….. Board members have become so risk averse they are losing the entrepreneurial spirit that has made American business so great….due to rampant, unrestrained, unregulated, shareholder activism…." Martin Lipton*[6]

Has the boardroom become a battle ground for political issues? Has the notion of *shareholder democracy* been detrimental to the long-term growth of our country"? Mr. Biggs noted that although his personal philosophy lies somewhere in the middle, his experiences have provided solid evidence that there have been dramatic improvements in the post-SOX era. The enormous power of the PCAOB, which includes asking questions heretofore off limits, digging into areas never thought of as part of the financial reports, the increased scope and penalties have all been instrumental in improving financial reports and circumventing fraud. Admittedly at the outset there was both misinterpretation and fear-induced overreaction. But he believes that these issues are being resolved, and that the audit function has returned to reasonable levels. To his

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[4] "Real and Accrual-Based Earnings Management in the pre- and Post-Sarbanes Oxley periods", Daniel A. Cohen, Alyesha Dey, and Thomas Z. Lys, The Accounting Review, May 2008.

[5] Former Chairman TIAA-CREF and member of the board of General Motors.

[6] "The Eclipse of the Public Corporation"

knowledge, Boards are not spending all their time on compliance issues. However, SOX has increased their sensitivity to these issues.

Although not directly related to SOX, Mr. Bigg's concern about the complexity of today's transactions and the knowledge required to understand and recognize them, remains an issue of concern. Designing complex derivative contracts to reduce the risk inherent in business should not be viewed as an undertaking designed to confuse auditors, nor should they be dictated by the ability of the Board to understand them. This is an area that requires our attention as the economic consequences can be severe.

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Lynn Turner[7] currently serves on the Standing Advisory Group of the PCAOB, as a senior adviser to Kroll, Inc., and is an appointee of the U.S. Treasury Department's Advisory Committee on the Auditing Profession. Mr. Turner stated that although the PCAOB has not yet fulfilled its mission, it has made substantial inroads. Of major concern is the fact that audit committee chairs, financial institutions, and other responsible individuals remain clueless in the area of risk management. In 2000, a working group of the Federal Reserve put forth an excellent document on how banks and financial institutions should approach risk. Members of this group included senior executives from financial institutions that recently reported the 10 ten losses. Bottom line, the recommendations were totally ignored. Mr. Turner was optimistic that given the current regulation, we would not see a recurrence of the current sub-prime loan crisis.

He noted that expanding SOX to the private sector was not only viable, but currently underway. Insufficient internal controls in the nation's capital resulted in billions of dollars of fraud. This debacle has been a catalyst that has put into motion a Section 404 audit in Washington and in other cities around the country in an effort to either uncover or avoid fraudulent activity.

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The not-for-profit sector was represented by Dr. Joel M. Levy, CEO YAI/National Institute for People with Disabilities. A sector, which according to Dr. Levy is held to much higher standards and government scrutiny than public corporations. A positive reputation is key for success. A pervasive positive culture has to start at the top and through education, written rules of conduct, and reinforcement, permeate the entire organization.

The report of the Senate Finance Committee on the Nonprofit Sector underscored the need for charitable institutions to remain independent. Self-regulation with full disclosure and transparency will maintain the integrity and credibility of the organization and avoid government intervention at both State and Federal levels. Medicare fraud investigations, often triggered by clerical errors, have cast a shadow on legitimate organizations and damaged their fund-raising efforts.

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[7] Former U.S. Securities and Exchange Commission (SEC) chief accountant

A culture of excellence and achievement of an organization's mission can be met with the incorporation of compliance directors, confidential whistle-blower procedures, on going self- performance evaluation, and other self-correction procedures. In the not-for-profits, it is the Board that governs the organization and determines its mission. Dr. Levy stressed that it is incumbent upon both members of not-for-profits and business organizations to serve the interests of society. Whether the outcome is the fulfillment of an altruistic mission or enhancement of the bottom line—the goal should be to serve their communities with dignity, honesty, and integrity.

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Michael G. Babiarz, Clayton, Dubilier & Rice, highlighted some key issues facing the private-equity sector that directly impact the governance process. Although not required, conventional wisdom dictates meeting public company standards in anticipation of monetization by a sale or IPO. Being out of the spotlight and the pressure of meeting or beating analyst's quarterly forecasts, enable long-term investment strategies. This provides an opportunity to recruit the best and brightest managers, creating more efficient capital structures wherein the interests of management and equity sponsors are fully aligned. The focus is on building a better company, cash flow, and improving the balance sheet. Leverage can be used more effectively when increasing debt is not subjected to market scrutiny and ratings.

The interactions between the Board, the CEO and management, provide opportunities and incentives that do not exist in public companies. Directors directly contribute to the company's management and performance. The pool of talent enhances performance and builds value that is adequately rewarded with equity. Emphasis on adequate internal controls is on par with public companies. However, in the private equity sector substance rather than form dictate financial reporting.

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The cogent comments of one participant[8] speak for a vast majority of individuals engaged in both business and not-for profit entities. Corporate governance is not equivalent to fraud detection. Methods of detecting fraud are very different than managing and conducting an entity. And yet, the lines have become totally blurred. Fraud detection has replaced the emphasis on the "how to" of running a successful entity.

Arthur Felsenfeld, Andrews Kurth LLP, discussion of the real problems associated with fair-value accounting served as a reminder that imprecise measurement does not imply the willful perpetration of fraud perceived by many investors and regulators. Securitization of financial instruments has made it difficult, if not almost impossible, to determine precise value at a specific moment in time.

Professor April Klein, NYU Stern, noted that a bigger and more fundamental problem than measuring the fair value of complex instruments is understanding risk.

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[8] Fred Modell, of the Jeffrey Modell Foundation a non-profit organization dedicated to early diagnosis and cure of Immunodeficiency disease. .

The “risk bundle” is transferred between parties that vary in sophistication and comprehension. Understanding risk can perhaps be taught, but not regulated.

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The complexity of financial transactions pales in comparison to the complexity of the issues that are of major concern today, tomorrow, and for future generations. What will the future hold, if as the evidence provides, management has replaced *accrual based* with *real* earnings management? R & D postponed, maintenance deferred, avoidance of complex hedging instruments to reduce risk, etc. Professor Seymour Jones raised the question, “what is the opportunity cost to society of managers making decisions based on fear of reprisal?” History provides evidence that efficient markets require both regulation and enforcement thereof. However, to maintain our free markets, we must be careful not to permit a few well-publicized scandals to result in invasive legislation that has debilitating effects.

The combination of the promotion of principle-based accounting by the IASB, increasingly complex business transactions, and the movement towards fair-value accounting at a time when regulators and investors have become increasing skeptical and suspicious, leaves us in un-chartered and turbulent waters. It is time to stop the blame game; it is time for concerted efforts; compromises will have to be made; caution the rule; but inaction is not an option.