

## Corporate Conflicts of Interest

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**A** conflict of interest arises when an executive, an officeholder or even an organization encounters a situation where official action or influence has the potential to benefit private interest. Examples include the physician who has a financial interest in a diagnostic laboratory, a congressman whose spouse is a lobbyist or corporate director, or a professor with a financial interest in a particular textbook. Empire building, nepotism and all manner of influence activities offer other illustrations. Such conflict is as old as history itself, and as an historical matter, it is important to acknowledge that conflicts of interest can and do morph into financial fraud. Consider a few examples from the fairly rich gallery of rogues and abuses over recent decades.

The Equity Funding case is noteworthy for the large number of active participants: the head of the firm, with the assistance of other top managers and numerous employees, began falsifying insurance policies in 1965, which among other steps involved company forgery parties where fake policies, medical records and even death records were created. Of course, these fake policies brought in no revenue directly. But they supported false revenue estimates that pumped up the company stock price, allowing it to make acquisitions with its stock, and the policies were often resold to other reinsurance companies. In turn, manufactured death claims for fictitious policies that had been sold in the reinsurance market were part of the scam. By the time 22 company employees were indicted in 1973, they had recorded 64,000 false policies and had issued \$25 million in counterfeit bonds—and \$100 million of corporate assets was missing. The company's auditors were found guilty of fraud for failing to detect the scam and served prison time (Dirks and Gross, 1974).

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The savings and loan crisis, which began in the mid-1970s and lasted throughout the 1980s, is noteworthy because it combines regulatory changes, financial fraud, audit failures and a parade of conflicts of interest that reached all the way to members of the U.S. Senate (for one discussion, see Pizzo, Fricker and Muolo, 1989). It also ended up costing taxpayers in excess of \$150 billion. Erickson, Mayhew and Felix (2000) provide an in-depth analysis of one such audit failure, the infamous case of Lincoln Savings and Loan that ended up with a \$2 billion price tag for taxpayers. The controlling owner of Lincoln Savings and Loan was found guilty of fraudulent land transactions in state and federal court (although the federal conviction was later overturned on the grounds of mistaken jury instructions), while three major auditing firms reached out-of-court settlements totaling \$135 million. In 1989, the Senate Ethics Committee censured one senator and cited four others for questionable conduct because they had received substantial contributions from the controlling owner of Lincoln Savings and Loan and had interfered with federal regulators who were investigating the firm.

In 1995, Barings Bank of the United Kingdom was driven into bankruptcy after 233 years of operation because a 28 year-old trader in Singapore, who was supposed to be searching for small-margin arbitrage opportunities, lost over \$1 billion speculating with huge purchases of futures and option contracts on the Japanese stock market. This case is noteworthy because of the sheer ineptness of Barings' controls: the rogue trader did his own accounting and reporting (Fay, 1996).

The novelty, then, is not the presence of conflicts of interest, but their management. Societies rely on various devices to manage these conflicts. Some activities are prohibited, such as an auditor engaged with an explicit pay-for-performance contract, while at other times we rely on disclosure of relationships, such as my university's requirement that the faculty disclose any financial interest in teaching materials. Both prohibitions and disclosure requirements are buttressed by legal requirements and remedies. In between, we seek arrangements that at least dampen the underlying conflict, as when the partner in charge of an audit is rotated or when the executive's performance is judged in part on the basis of financial results that have been audited by an independent auditor. In all of these cases, as with other economic activities, we balance tensions and shy away from attempting to create a situation of zero failures as a result of conflicts of interest, simply because pursuing such an extreme goal would be uneconomic.

I propose, then, to survey conflicts of interest in the corporate arena, with emphasis on recent events. The presence of such conflicts is not new. We still have rogues. Some use modern techniques, as in Enron's use of complex, structured finance to bolster its apparent performance. Others rely on the most mundane of techniques, as in WorldCom's capitalization of an expense, serving to spread the expense over many years instead of writing it off in total in the given year.

Yet the seemingly steady drumbeat of recent corporate improprieties leads one to wonder what is new in the corporate setting and what, along the way to modern communication, globalized organizations and markets, and structured finance, might have been overlooked. Surely, complexity has increased, and this in itself

puts more strains on our management of various conflicts. Yet I fear we have failed to appreciate, or have forgotten, the delicacy of a well-crafted web of controls for managing conflicts of interest. We tend to think in terms of a specific conflict or specific control applied thereto: for example, assuring greater independence for auditors or more outsiders on boards of directors. Yet reality is multiple conflicts among multiple players, in the context of an enlarged, interactive web of controls (for example, Fama and Jensen, 1983; Sunder, 1997). We have not invested adequately in understanding the role of multiple players and multiple conflicts, nor in understanding how the interplay of shifting institutions and herding behavior may act to unravel control systems.

## **Recent Changes in the Institutional Background**

The institutional environment for corporate governance has evolved substantially in recent decades. Changes in regulations, financial innovation and the level of business complexity have surely stressed, or even in some cases disrupted, the pre-existing web of controls over conflicts of interest.

Regulatory changes in the financial sphere in recent decades are far from minor. Until the early 1970s, brokerage houses charged fixed commissions for each stock market transaction, and some of the revenue from these commissions was directed toward stock market analysts who did research on the firms. In 1975, the Securities and Exchange Commission (SEC) abolished fixed commissions. The result was shrinking profit margins and industry consolidation, along with the emergence of discount brokerages that charged for transactions, but supported little or no analyst research per se.

This shifting of traditional patterns in the financial industry was further enhanced by repeal of the Glass-Steagall Act of 1933 by the Gramm-Leach-Bliley Act of 1999. Glass-Steagall had restricted commercial banks from combining with other financial services companies, such as securities firms, insurance companies and investment banks. Gramm-Leach-Bliley permitted single holding companies to offer banking, insurance, securities and other financial services, thus blurring distinctions across the financial sector (Barth, Brumbaugh and Wilcox, 2000).

The traditionally restrictive marketing practices in the audit industry have also seen substantial changes. The American Institute of Certified Public Accountants (AICPA) is the primary professional organization of public accountants, and its Code of Professional Conduct must be observed by its members. In 1988, to comply with a Federal Trade Commission consent order dealing with restraints on business practices, the rules in the AICPA's Code of Ethics that prohibited soliciting another audit firm's client were eliminated. Competitive bidding for audit services and even advertising became commonplace. One result was a period of enhanced competition among the large audit firms, which saw no growth in domestic auditing fees coupled with dramatic growth in domestic consulting fees, to the point that domestic audit fees declined to roughly 40 percent of total domestic revenue of the

large accounting firms. This period also saw the major audit firms move from general partnership to limited liability partnership form, to limit individual partner liability.<sup>1</sup> Previts and Merino (1998) provide a history of the domestic accounting industry.

A number of nonfinancial industries also experienced major regulatory changes, including some industries with firms that ended up mired deep in conflicts of interest. For example, the deregulation of natural gas markets dramatically altered the business climate for Enron and other energy firms, while the deregulation of telecommunications shaped the business conditions for WorldCom.

Two other factors have combined with the restructuring of financial and other industries in a way that has placed additional stress on the corporate governance function: greater complexity of business structures and greater emphasis on stock prices. In the last decade or so, business has experienced a surge of fluid organizational arrangements as well as a routinization of complex transactions. Alliances, joint ventures, multifaceted sale arrangements and hybrid, structured finance arrangements have become commonplace. The net effect is the economic boundaries of the firm have become ambiguous and extremely fluid, a phenomenon reflected in the wonderfully euphemistic phrase “off balance-sheet financing,” where the firm structures transactions and relationships to avoid their explicit recognition in traditional accounting displays. A typical example is a firm that holds a portfolio of mortgages. It places the portfolio in a free-standing legal entity with distinctly limited scope, a Special Purpose Entity, but continues the transaction processing and possibly provides credit enhancements. In different variations, inventory, research and development or even rights to future revenue cash flows are parked in Special Purpose Entities (Hartgraves and Benston, 2002).

Reporting regulations allow the Special Purpose Entity to be kept off of the firm’s formal financial statements, as long as it is disclosed, provided substantive risk has been shifted to an independent third party. General Electric (an aggressive purveyor of these arrangements), for example, reports sponsored Special Purpose Entities with assets in excess of \$50 billion in its 2001 financial report. The “independent third party” must have (among other things) a minimum of 3 percent ownership of the Special Purpose Entity’s equity and debt, although the Financial Accounting Standards Board (FASB) has recently tightened these rules. But Special Purpose Entities are only one aspect of this wave of organizational and financial innovation.

This greater degree of complexity has interacted with a corporate governance environment that has been placing heightened emphasis on shareholder value (Holmstrom and Kaplan, 2001), including an explosion in the use of option-based compensation. A substantial portion of the greater complexity appears to be motivated by a concern for financial presentation, for example, “beautifying” one’s

<sup>1</sup> In addition, the 1995 Private Securities Litigation Reform Act replaced the joint and several liability rule with a proportionate liability standard in dealing with violations of federal securities statutes.

balance sheet. In some cases, the effect may be as simple as a matter of timing: for instance, the timing of selected expenditures and shipments can affect current period financial results, just as can the time at which a sale is formally booked or a loan is consummated. With the assistance of hybrid financial and organizational transactions, a lease can be structured so it does, or does not, show up on the lessee's balance sheet, thereby affecting the total debt that a firm reports. Enron, for example, used a Special Purpose Entity organized by Citigroup to disguise significant amounts of debt as commodity prepay transactions.<sup>2</sup> Through a series of circular or round-trip prepaid transactions, this Special Purpose Entity was the centerpiece in "allowing" Enron to borrow money but to record the amount borrowed as cash generated by operations, because prepaid commodity contracts are generally booked as trades, not loans (Sapsford and Beckett, 2002).

Recent institutional changes, then, are far from benign, and, among other things, have stressed existing arrangements for managing conflicts of interest. Indeed, these institutional changes have outpaced our understanding of the subtleties of managing the flow of information within and across organizational boundaries, an understanding that is essential to managing properly the various players' conflicts of interest.

For example, it is appealing and fashionable to call for transparent financial reporting; yet the underlying organizations and transactions have become astoundingly complex, and considerable judgment is required to measure a firm's income reasonably well in any given period, not to mention its stock of assets and liabilities. This, in turn, increases the firm's ability to manage its earnings, to exercise that reporting judgment opportunistically, a theme explored by Lev (in this issue). How this sorts out depends on the various players in the corporate governance arena, and even then how we would prefer it play out is ambiguous. Claiming that full, unfettered disclosure provides a solution is naive, but where to draw the line depends on a variety of conflicts among a large number of players.<sup>3</sup>

## **Players in Corporate Governance Arrangements**

The players in the corporate governance game include auditors, boards of directors, analysts and investment bankers, regulators, management and still others

<sup>2</sup> I will often use Enron in the pages that follow to illustrate various conflicts. Though that saga continues to unfold, considerable documentation is available in Powers, Trough and Winokur (2002), the "Powers Report," Benston and Hartgraves (2002), Fusaro and Miller (2002) and various Congressional hearings. McGill and Outslay's (2002) analysis of Enron's federal tax filings is also instructive.

<sup>3</sup> To illustrate, using accounting variables to manage earnings has the effect of reporting "less" than the firm knows, of garbling the information that is made public, relative to the firm's full stock of information. In turn, the mere fact that compensation contracts for managers can be renegotiated creates an interest in endowing the firm with an ability to garble its performance reports, because managing the flow of information is the key to efficiently dealing with the renegotiation option. See, for example, Demski and Frimor (1999) and Christensen, Demski and Frimor (2002). Arya, Glover and Sunder (1998) link earnings management to settings where the revelation principle is not applicable, due to limited commitment, aggregate reporting or less than fully optimal contracts.

such as attorneys and investors. Conflicts of interest are unavoidable among these parties; the issue is how well these conflicts are managed. Yet the formal analysis of these situations is complex. One would like to have a framework that incorporates both the interactions of the players and the institutional framework for managing their conflicts of interest. With clearly identified exogenous variables and endogenous responses, it would then be possible to examine how changes in institutional arrangements might lead to different manifestations of conflicts of interest. But in reality, both the institutions for managing conflicts of interest and the responses to those institutions are choices and must be regarded as endogenous variables. In addition, observation of the techniques for managing conflicts of interest and the actual behavior responses by the players are inherently biased. The strength of a control system resides in the threat of what might be reported or what might take place were off-equilibrium play to occur. So to the extent the controls are functioning well, we do not observe their full import. Likewise, when we do observe their failure, or their full import, it is likely something has gone amiss and we are dealing with an out-of-equilibrium setting, as the system copes with exogenous shock or inexorable change.<sup>4</sup> The discussion that follows will focus on identifying recent theory and evidence on key conflicts of interest.

### **Auditors**

The auditing industry has received considerable attention in the last few years, both as a bulwark against conflicts of interest and as an industry subject to its own conflicts. It often isn't recognized how small this industry is relative to the corporate sector. Total domestic accounting fees are about \$6 billion per year; as my colleague Karl Hackenbrack points out, the U.S. economy spends more on potato chips than on audit fees each year. Similarly, auto theft in the United States tops \$6 billion annually, and shoplifting ("inventory shrinkage," as it is called in polite circles) is routinely estimated at just under 2 percent of sales, and U.S. retail sales total about \$3 trillion.

Auditors deal with a variety of reporting regulations that fall, broadly, into auditing (generally accepted auditing standards, or GAAS) and accounting (generally accepted accounting principles, or GAAP) categories. The Securities and Exchange Commission (SEC), in turn, has historically relied on closely monitored self-regulation, with the FASB presently the primary source of generally accepted accounting principles and the AICPA, through its Auditing Standards Board, the primary source of generally accepted auditing standards. For a brief period, the Independence Standards Board was in place, a roughly parallel arrangement to that between the SEC and Financial Accounting Standards Board, but focused

<sup>4</sup> This is why information useful for valuation purposes is not necessarily useful for control purposes (Gjesdal, 1982; Kim, 1995). Christensen and Demski (2002) stress this possibility in documenting and managing the financial reporting industry. More broadly, the concern for identifying carefully the endogenous variables and the nature of equilibrium versus off-equilibrium play is reminiscent of Koopmans' (1947) insistence that measurement be guided by theory.

on auditor independence. The Sarbanes-Oxley Act of 2002 establishes a Public Company Accounting Oversight Board, under the auspices of the SEC, with explicit responsibility to regularize these various arrangements further, along with the regulations themselves (for discussion, see <http://www.fei.org/advocacy/sarbanesoxley.cfm>).

Accounting firms, in turn, offer a variety of services, broadly grouped into auditing, tax and management consulting. Though the practicing auditor is required to “be independent in fact and appearance” and to “serve the public interest” in these matters, this arrangement has long been contentious. A reporting firm’s management hires the auditor (usually subject to shareholder approval). Long-term relationships between accounting and client firms are common, sale of nonaudit services is routine, and personnel often move from the accounting to the client firm. Indeed, the “engagement partner,” the accounting firm’s lead or partner-in-charge on a particular engagement, is probably best thought of as a sales engineer, with a keen interest in understanding and exploiting a multiplicity of sales opportunities with the client. Arthur Andersen’s Enron account, for example, delivered an average weekly billing of \$1 million, over half being for nonaudit services. Andersen also housed a number of its staff in Enron facilities, was a routine supplier of accounting staff to Enron and counted numerous members of the Enron management team among its alumni.

That said, the auditor is required to be independent and is thus forbidden to have any explicit economic interest in the client. This prohibition even includes, for example, stock holdings in a client firm by an accounting firm partner who is otherwise totally disconnected from that particular client. Yet the possibility of employment by the client as well as the opportunity to sell nonaudit services arguably compromise this stark separation. On the other hand, scope economies are often alleged to be crucial in understanding why this relationship persists and has expanded: for example, understanding the client’s business model and information system are essential to providing high-quality audit work and at the same time provide a springboard to productive consulting services, just as understanding the client’s business is essential to providing high-quality consulting service and thus provides a knowledge foundation for higher-quality audit work.

Bazerman, Morgan and Loewenstein (1997) and Bazerman, Loewenstein and Moore (2002) argue that the very idea of auditor independence under current arrangements is a myth, that auditors’ information processing and judgments are biased away from the public interest simply because close affinity with the client renders the desired independence psychologically impossible. Yet context also matters; and accounting firms have developed elaborate internal structures to police and manage this apparent conflict (even to the point many have become official AICPA quality control standards). For example, it is routine (and required) to rotate a partner in charge on an SEC client engagement, just as thorough review of an engagement is routine and a central authority inside the auditing firm is relied upon to have final word on reporting issues at the client level. Inexplicably, Arthur Andersen weakened the authority of this central authority in its own firm

and allowed the Enron partner in charge to have final say on a number of reporting issues.<sup>5</sup>

Portions of the Sarbanes-Oxley Act of 2002 deal with this independence issue by prohibiting some activities, such as bookkeeping or actuarial services and internal audit outsourcing, and allowing others, provided they are preapproved by the client's audit committee. (The act also mandates that the audit committee explicitly manage the relationship between the firm and its auditor.) Tax service remains acceptable, presuming the necessary preapproval, despite the fact this is clearly a client advocacy service and thus potentially in conflict with the public interest perspective one hopes is at work in an audit engagement.

Explicit evidence on how well this conflict of interest is or has been managed is difficult to come by, because such evidence is not directly observable. Some indirect evidence is provided by litigation and by SEC enforcement actions. For example, Heninger (2001) links litigation to deteriorating financial condition and unusual patterns in the accounting accruals. Bonner, Palmrose and Young (1998) connect the "type" of fraud reported in an SEC enforcement action with subsequent auditor litigation. More broadly, auditors are sued at the relatively low rate of about three cases per 1,000 audits, and SEC enforcement actions against auditors occur at a rate of about two cases per 10,000 filings. Also, about 1 percent of these filings are restated (Elliott, 2000), though their number has grown in recent years.<sup>6</sup> Alternatively, survey data routinely document a concern for auditor independence (for example, Swanger and Chewning, 2001), and the contextual nature of this concern has been demonstrated in experimental settings (for example, Hackenbrack and Nelson, 1996). Studies of whether audits are unduly influenced by client purchases of nonaudit services have found mixed results. Frankel, Johnson and Nelson (2002) find that unusual patterns in the reported financial numbers themselves at times appear to be associated with unusually large purchases of nonaudit services. In contrast, Antle et al. (2002) simultaneously estimate audit fees, non-audit fees and unusual patterns in the reported financial numbers and find no such problematic connection. (They do, however, document a connection between audit fees themselves and unusual patterns in the reported numbers.)

<sup>5</sup> Moving the final authority closer to the client has the competitive advantages of faster client response and, in principle, more client influence. It has the disadvantage of weakening the force of reputation, and thus the audit firm's control system, as the central authority manages that reputation from the point of view of the firm as a whole while the decentralized authority sees but a portion of the firm-wide issues.

<sup>6</sup> Palmrose (2000) provides summary data on auditor litigation. Also, another possible source of indirect evidence on audit failure might be found in data on auditor replacement. DeFond and Subramanyam (1998), for example, link unusual patterns in the accruals to auditor replacement. Divestiture of consulting groups and failure per se should also be noted. In fact, two large audit firms have failed in recent years, Arthur Andersen (following a series of high profile audit failures and document shredding associated with the Enron investigation) and Laventhol & Horwath (in 1990). Laventhol & Horwath filed for bankruptcy in the face of numerous lawsuits and at that time was the seventh largest accounting firm in the United States. Ironically, a major issue in its demise was Arthur Andersen's claim that L&H's performing payroll services for the client in question led to a lack of independence, yet a decade later we find that Enron had outsourced its internal audit function to its auditor, Arthur Andersen (Crenshaw, 1990).

The economy of scope issue, though, is central to understanding the strain between auditor independence and nonaudit services. Here, Antle et al. (2002) also find economies of scope in the auditor-client relationship, a finding consistent with a continuing tension between independence and breadth of services.

### **Boards of Directors**

Boards of directors perform an important oversight function and thus take us into corporate governance issues more broadly (for example, Bushman and Smith, 2001; Shleifer and Vishny, 1997). Important potential conflicts here concern whether the board, as an entity, is sufficiently independent of management and whether it is sufficiently dedicated in pursuing its oversight responsibilities. Often this concern focuses on the “outside” or “independent” board members who have no other direct connection to the firm. But even an outside director is not totally independent; for example, the continued presence of an outside director on a board depends on that director’s behavior in the board room. Interlocking outside directors where top executives from two different firms serve on each other’s boards are far from uncommon. Moreover, outside directors usually own shares and options in the firm. Equally clear, the outside director is a part-time overseer and faces other demands on time and attention. Again, the question in such a setting is not whether conflicts of interest exist, but how well they are managed.

The Conference Board’s annual survey, for example, reports that the median size of a board is nine members, that they meet about six times per year, four hours per meeting and that they receive basic compensation (excluding benefits and stock compensation) ranging from about \$10,000 to \$70,000, depending on size of the firm and committee assignments (all for nonfinancial firms). Stock compensation is also the norm, with about 90 percent receiving some form of stock compensation, usually in the form of options (Peck and Silvert, 2001).

Hermalin and Weisbach (2002) review the governance issues associated with boards of directors. As they emphasize, the evidence is difficult to interpret because choices about board governance are both interdependent and endogenous and will also reflect a mix of equilibrium and out-of-equilibrium behavior. With that caveat, the data are consistent with the claim that larger boards are less effective, due presumably to free rider issues. In general, issues with the independence of the board do not jump out in their review of the data. However, Peasnell, Pope and Young (2002) report that less independent boards of U.K. firms do appear to be associated with firms that display unusual patterns in their financial data. Relatedly, Klein (2002) reports lessened independence of the board’s audit committee is associated with more unusual patterns in the reported financial data.

A deeper issue here is the question of conflict with respect to what. It is common to worry whether the board is doing an adequate job of protecting the shareholders (for example, Shleifer and Vishny, 1997), and a commonly proposed mechanism to address this potential conflict has been stock-based compensation for outside directors. However, one can question whether short-term shareholder value is the appropriate goal of corporate governance or, as Tirole (2001) stresses,

the protection of other stakeholders should play a role. In a mixed economy, we surely have concern for employees, suppliers and so on. But the very notion of measuring value is problematic in a mixed economy; indeed, market value maximization is not even guaranteed to be in the best interest of the shareholders themselves in a mixed economy simply because with limited markets the shareholders are not likely to be optimally insured (Ekern and Wilson, 1974).

Enron's board of directors exemplified many of the potential difficulties. It was relatively large (with 17 members) and used equity-based compensation for its outside directors. This board knowingly allowed a member of senior management to act as general partner in a venture doing business with Enron, a clear conflict of interest that according to the board's Code of Conduct required explicit approval. To help manage the conflict, Enron's board put in place a variety of controls aimed at monitoring transactions between Enron and the venture. But there is no evidence the board subsequently investigated whether those controls were either adequate or even functioning. Moreover, the same interlocking pattern was apparently repeated in other transactions without the board's knowledge, let alone approval. It also turns out Enron employees who held partnership positions in the related Special Purpose Entities collected unusual, to say the least, compensation from their partnership positions. While it appears that Enron management withheld considerable information from its board, I can find no evidence this possibility was ever of concern among the individuals on the board. Of course, while a board of directors can be more or less diligent in demanding information from management, it may ultimately have little defense against a management that is committed to subterfuge.

Reflecting provisions of the Sarbanes-Oxley Act of 2002, the New York Stock Exchange enacted new corporate governance standards in August 2002 that require independent directors to comprise a majority of the board (as opposed to earlier independence requirements that applied only to members of the audit committee) and also ban performance-based compensation for those on the audit committee. The standards also call for the firm to have an explicit policy prohibiting conflicts of interest, related to, say, improper personal benefits that accrue to one as a result of their position in the firm.

### **Analysts, Brokers and Investment Bankers**

Analysts report on and forecast earnings for selected firms. Brokers play a more direct role in trading activities. Investment bankers provide services in designing and floating securities. Conflicts of interest can arise in how these parties relate to each other. After all, the brokerage firm benefits from trading recommended by the analyst, just as investment bankers and their clients benefit from favorable coverage by the analyst.

The parallels between a full service financial services firm and a full service accounting firm are striking (Schipper, 1991). In both cases, the issue centers on the information function—whether auditing or analyst work—becoming entangled with other parts of the firm. For example, might the prospect of a firm selling

investment banking services to a client cloud the objectivity of its analyst who is rating the same client? Just as in the case with auditors, numerous regulations are in place, such as a mandatory “quiet period,” when an initial public offering of securities is being conducted during which the investment bank’s analysts are precluded from issuing new forecasts or recommendations for a client “in registration.”

A number of studies have examined analysts’ forecasts of corporate earnings, controlling for different effects. One general finding is that analysts’ forecasts are upward biased, though still more accurate than forecasts derived from simple time series models (for example, O’Brien, 1988; Abarbanell, 1991). Analyst recommendations are also typically skewed toward the “strong buy” and “buy” categories, rather than to “hold” or “sell.” For example, almost 61 percent of the recommendations in Lin and McNichols’ (1998) sample of seasoned equity offerings and almost 96 percent of those in Bradley, Jordan and Ritter’s (2003) sample of recent initial public offerings are in the “strong buy” or “buy” categories. Censorship also appears to be present: when an analyst begins to cover an additional firm, the associated recommendation tends to be high, while poorly performing firms tend to be either not added to the list in the first place or simply removed from that list (McNichols and O’Brien, 1997).<sup>7</sup> In addition, analysts routinely follow firms with whom their firm has an investment banking relationship; and when that relationship is present, they tend to issue more favorable growth forecasts and recommendations (Lin and McNichols, 1998). Moreover, an important reason for switching underwriters appears to be access to coverage by a “star” analyst (Krigman, Shaw and Womack, 2001).

Digging deeper into the institutional fabric, we also find potential for conflict of interest in the reputation and career concerns for investment analysts (for discussion, see Hong, Kubik and Solomon, 2000; Li, 2002; Michaely and Womack, 1999). For example, the annual *Institutional Investor* poll, based on opinions of various money managers and institutions, appears to be a well-watched form of relative performance evaluation for investment analysts.

Recent regulatory changes, beginning with the Sarbanes-Oxley Act of 2002 and extending to rule changes by the National Association of Securities Dealers, impose limits on communication between a firm’s investment banking and research group. They also impose new disclosure requirements, forbid analyst compensation being tied to explicit investment banking transactions, and also forbid offering a favorable research rating while soliciting a client. The National Association of Securities Dealers is a self-regulating organization, under the auspices of the SEC, that registers, governs, monitors and disciplines virtually all securities firms doing business in the domestic economy.

<sup>7</sup> Evidence based on market reactions to these recommendations is mixed. Michaely and Womack (1999), for example, find less reaction to a lead underwriter’s positive recommendation, while Lin and McNichols (1998) find similar reactions to lead and nonlead underwriter recommendations.

## **Regulators**

Regulatory institutions provide an additional set of players and potential conflicts. The Securities and Exchange Commission, which has statutory authority to prescribe financial reporting, deals with over 170,000 reporting companies, 700,000 brokers and 8,000 brokerage firms; and the fees it collects vastly exceed its own expenditures, even with the recently legislated increase in its operating budget. Although the SEC exercises considerable oversight, the task of setting financial reporting standards has been delegated to the seven-member FASB, which in turn relies on a 40-person staff. The Financial Accounting Foundation (FAF) exercises oversight over the FASB, appoints its members and provides its financial support, though the Sarbanes-Oxley Act of 2002 calls for user fees collected by the new Public Company Accounting Oversight Board to fund any board whose standards are to be recognized by the SEC. There are also more focused subgroups within the FASB. For example, the Emerging Issues Task Force (EITF) is an interpretive body that supplies authoritative answers to reporting issues under the auspices of the FASB and as such serves as a stopgap between practice and the FASB itself. For example, the rule that a Special Purpose Entity needed to have 3 percent outside ownership arose from an EITF ruling (with SEC concurrence) and gradually spread in use beyond the original ruling.

For all the talk of “delegating” authority to the SEC, or how the SEC delegates authority to the FASB or AICPA, congressional involvement in their decisions, explicit and implicit, is a routine event (Zeff, 2002). The most recent example, mentioned earlier, is the Sarbanes-Oxley Act of 2002 that establishes an “independent” board between the SEC and the audit industry—though regulation of both reporting and auditing activities were and remain the province of the SEC. But the agenda and priorities of financial regulators are often influenced by political pressures. For example, politics may well explain why the SEC chose not to vet various Enron filings, despite the firm’s growth, glamour status and its unprecedented use of structured financial transactions. Several years ago, the U.S. Senate played an important role in discouraging the FASB from passing a rule that would require treating stock options as an expense; now, key senators have reversed their positions, and the FASB may well enact such a rule. Johnson and Swieringa (1996) provide a fascinating glimpse into the FASB’s extensive due process and attendant lobbying, including that by the Federal Reserve.

Regulators face several interrelated conflicts of interest. One is that regulators rely on industry for both information and often for future job opportunities, though FASB members are typically appointed late in their careers. Moreover, loud industry complaint may make a regulator’s position politically untenable. FASB members, for example, are drawn from professional accounting, finance, industry and academia. Balancing the need for their technical skill with a broader social perspective is an ever-present concern. In fact, the SEC recently orchestrated an enlarged public interest membership in the FASB’s oversight body, the Financial Accounting Foundation (Zeff, 1998). The FAF has also altered its trustee appointment procedures in an attempt to increase its independence.

Much of the recent concern over financial regulation has centered on accounting standards, especially dealing with the Special Purpose Entities that have allowed firms to move debt and risk off their books or whether stock options should be treated as a current-year expense. Thus, attention has focused on the FASB, and two general criticisms have surfaced: slowness in reaching decisions, with some agenda items lasting over a decade, and overly detailed, complex reporting standards. Both traits might be interpreted in terms of regulatory capture. Slowness may arise where various interests are successful in blocking a particular reporting requirement. The complexity of FASB rules results from a high level of detail and various exceptions, and with the very complexity they implicitly provide (desired) guidance on how to structure transactions to achieve some particular reporting objective. While the FASB is presently considering a move toward less detailed standards, and thus more responsibility for the reporting firms and their auditor, the reporting industry and the large firms who are their clients often clamor for detailed rules. For example, the aforementioned EITF is heavily influenced by large firms and offers a steady supply of detailed guidance; and only recently has the FASB decided to sign off explicitly on EITF decisions. Consolidated databases of the various rules and regulations are regarded as proprietary, and two-thirds of the FASB's budget is currently financed by sale of its own publications.

This slowness and complexity might also be interpreted as reflecting a self-preservation motive. The FASB and its staff exist at the sufferance of the SEC. Many of those involved with the FASB have a strong desire to retain the regulatory function in the "private sector," and bold moves, I suspect, are tempered by this self-preservation concern.

Recently, the FASB has encountered the threat of entry, with the emergence of the London-based International Accounting Standards Board, or IASB (Dye and Sunder, 2001). The IASB, though similarly structured but with a much larger board, is focused on reporting standards on a global basis, and its standards must be followed by, for example, European Union members (beginning in 2005). The two boards are coordinating various projects, with the hope that a single set of standards will eventually emerge. So-called "harmonization" would increase comparability on a global basis. To date, however, the IASB offers reporting requirements of a more general nature, so-called "principles-based standards."

The issues here, however, ultimately come down to independence. By analogy, important data sources in the economy, such as cost-of-living indices or economic statistics from the Bureau of Economic Analysis, are managed by professionals who are reasonably well shielded from heavy lobbying or political intervention. Management of corporate reporting is much less independent, and the Sarbanes-Oxley Act of 2002 does not offer improvement on this score.

## **Management**

Management, of course, is the nexus of corporate conflicts of interest. We worry about shareholders, debtholders, employees, customers, suppliers, stark

self-interest and so on. We also must contend with the usual litany of “consumption at work” or “value diversion,” as exemplified by empire building, career concerns, power politics and prestige. Into this usual milieu, the recent debates over corporate governance add concern for managing the firm’s risk profile, marketing the firm’s securities, including issues of opportunistic disclosures and market expectations of earnings, and rationalizing executive compensation.

The compensation numbers themselves are eye catching. Data from Standard & Poor’s Compustat’s “ExecuComp” database (based on proxy statement data for top executives in nearly 2,000 companies) indicate median total executive compensation has quadrupled in the last decade, while that of the largest firms has increased nearly eightfold, thanks in part to heavy use of stock options in compensation packages and the robust stock market during this period. In addition, median total compensation is about \$2 million in 2001, though much larger for large firms, and options now dwarf either base salary or bonus as a source of executive compensation. In turn, Conyon and Murphy (2000) report compensation for U.S. chief executive officers is nearly double that of their U.K. counterparts, with the bulk of the difference attributable to share option grants.

Understanding these patterns, and documenting the possible role played by conflicts of interest, is a difficult and unsettled task. For example, are the data reflective of carefully designed, efficient incentive programs that are carefully managed by the compensation committee of the board of directors, or are they reflective of a compensation function that has been captured by management? Again, both the methods chosen to address managerial self-interest and the ways in which those interests are expressed are endogenous; and the behaviors and financial outcomes observed will be a mix of equilibrium and off-equilibrium outcomes. To this ever-present list we also encounter serious measurement error issues here. While theory stresses the connection between “pay” and “performance,” neither is readily observable. Performance, for example, includes private information in the hands of the compensation committee. Executive pay comes in a wide variety of forms, at a variety of times (such as deferred cash compensation and retirement perquisites) and involves complex issues of risk from a market perspective, from the executive’s perspective and from the perspective of the incentives that the compensation provides. Varying adjustments for these risks can produce remarkably different patterns in the data (Abowd and Kaplan, 1999; Hall and Liebman, 1998; Hall and Murphy, 2002).

Tax issues also enter. For example, current tax law disallows a firm from deducting compensation in excess of \$1 million, at least if performance goals are determined by a compensation committee that includes inside directors. Presumably, this rule invites substitution from salary to performance-based pay like stock options, but for a variety of reasons the data are ambiguous (Rose and Wolfram, 2000). As one example, Enron’s chief executive officer received total compensation in 2000 in excess of \$140 million; and his base salary was slightly in excess of \$1 million, with the amount above the \$1 million deductibility cap deferred.

The primary focus of research on managerial conflicts of interest has been the

possibilities for managers to use their positions to enrich themselves. This may happen in a number of interrelated ways: through a not-very-independent compensation committee on the firm's board of directors, through opportunistic use of option instruments, through overemphasis on personal career enhancement or through the manner in which firm's prospects are marketed through forecasts, pro forma announcements, earnings management and the timing of disclosures.<sup>8</sup>

The evidence itself is mixed. Consider the use of options as one example. Focusing on oil and gas firms, where we expect risk to be a major issue, Rajgopal and Shevlin (2002) document a positive relationship between exploration risk and use of employee stock options in the compensation package, a finding consistent with the idea that options play a useful idiosyncratic role in connecting the risks perceived by managers and shareholders. On the other hand, Aboody and Kasznik (2000) provide evidence consistent with management opportunistically timing disclosures to influence market expectations around the time of stock option awards. Alternatively, earnings management suggests self-serving manipulation of reported results (Lev, this issue), yet measurement issues, exactly what we mean by earnings management, and endogeneity issues cloud the documentation.

Despite extensive work on career concerns, turnover, incentive intensity, relative performance evaluation, shareholder expropriation and so on, the patterns and trends in executive compensation, and the documentation of potential conflicts of interest and their management, continue to offer many open issues. Abowd and Kaplan (1999), Bushman and Smith (2001), Lambert (2001) and Prendergast (1999) provide recent reviews and assessments of this literature.

### **Other Players**

Other players in corporate governance beyond those already named include management consultants, attorneys, employees, investors and academics. Consultants, including compensation consultants, and attorneys have, presumably, an interest in maintaining and expanding their relationship with the buying firm, and this depends on keeping the firm's management happy and maintaining the perceived financial health of the customer firm. A firm's employees may often share with its managers an incentive to pump up short-term financial performance. For that matter, numerous accounting professors benefit from the largess of accounting firms, holding endowed chairs and benefiting from departmental slush funds supplied by major accounting firms.

The Enron debacle provides a glimpse into how this web of corporate governance, with multiple players, can go off track. Enron carried out countless highly complex and carefully crafted financial transactions. These all involved selling of additional financial services by consultants, attorneys and investment banks. In

<sup>8</sup> We also have concern for the "level" of incentive intensity, for example the connection between changes in wealth of shareholders and of chief executive officers. It is also important to remember compensation consultants are active players in the larger governance game and that regulations are far from minor; for example, see the analysis of value diversion statutes in Bebchuk and Jolls (1999).

many cases, these transactions were designed with no apparent purpose other than manipulating recorded debt and earnings and often provided an opportunity for a financial institution to collect fees on both sides of a transaction. The ability to continue to sell these services rested on the reputation and prestige of all the parties involved; that is, these various transactions reflected the joint work of management, the board, the accountants, the attorneys and the financial institutions (Healy and Palepu, this issue). Arthur Andersen had scores of staff working full time at Enron; and “opinion letters” provided by Andersen were critical in legitimizing the various Special Purpose Entity transactions. Many Enron employees must have had some personal evidence on what the firm was doing, yet many of these same Enron employees also chose to skew their 401(k) holdings and ride the stock price bubble (testimony of the Comptroller General before the Senate Finance Committee, February 27, 2002). Enron’s outside council, Vinson & Elkins, was paid in excess of \$30 million in 2001, roughly 7 percent of its total revenues (as compared to Enron’s payments to Andersen being less than 1 percent of total Andersen revenues). Commercial lenders were also involved in providing finance in many cases.

Both institutional and individual investors were also players. The California pension retirement system Calpers, for example, simultaneously held Enron shares and positions in at least one of its off-balance sheet ventures, which could easily be taken as an implicit endorsement that the off-balance venture was a reasonable institutional innovation from the point of view of a sizeable shareholder. Likewise, increased use of the Internet by various individual investors, accessing analyst reports and trading aggressively, arguably reinforced less attention to fundamentals.

In short, any attempt to blame the Enron meltdown solely on secretive or even fraudulent behavior by a handful of top Enron and Arthur Anderson executives does not hold water. Surely deceit and obfuscation were in play. Yet just as surely, the breadth of Enron’s shortcomings and financial obfuscations was known by more than a select few. Certainly, many of Enron’s activities were almost indescribably complex, yet they were shrouded in a plethora of hints, such as the complexity itself, the pure number of Special Purpose Entities, the lavish management compensation and the arrogance of its visible management. Yet no one wanted to know. It was as if a cult of Enron had emerged, one that believed in hype, growth, the new economy and that taking items off a balance sheet could make shareholders rich.

### **Herding in a Market with Multiple Players**

Were the case of Enron a singular anecdote, it could be filed on the list of inevitable occasional failures that attend any system for balancing conflict of interest concerns. After all, it contains many familiar elements, being a story with a large number of players, as in the Equity funding story, less-than-aggressive controls, as in the Barings story, and regulatory changes, as in the savings and loan

story, that ends in disaster. But the larger picture is a sea of possible conflicts of interest combined with numerous checks and balances, checks and balances that failed in a number of other cases, which brings a suspicion that we are not dealing with an isolated case or two, but rather with a systemic problem.<sup>9</sup> Moreover, this systemic problem may involve an element of contagion, where poor business practices spread to otherwise healthy firms. For example, Enron's so-called "pre-pay" transactions, which were structured to make a loan appear like a sale, were marketed by the investment banker to other customers. When one firm used aggressive accounting, others felt pressure to use the same techniques or to invent even more aggressive approaches of their own.

In this setting, the theory of herding is a natural lens to apply. It has been used in structuring our understanding of such diverse phenomena as clustering by competitors, crime, medicine, valuation, newsletters, forecasts, bank runs and executive compensation.<sup>10</sup> At the risk of herding on the use of herding models, herding has something to teach us about corporate conflicts of interest (Hirshleifer and Teoh, 2001). The basic idea in a herding model is learning from the behavior of others, learning that leads to coordinated behavior or clustering: actors act sequentially, and their actions are observed and interpreted by those who follow. Emulating others thereby substitutes for acquiring and analyzing information on private account. In this sense, emulation substitutes for circumspection.

As a simple example of herding, imagine that a series of people privately and sequentially observe the flip of a potentially biased coin and then announce to a group, based on both the prior group announcements and their own private observation, whether in their opinion the coin is more likely to be biased toward heads or tails. If several people have announced that the coin is biased toward heads, then even if you privately observe a flip of "tails," the string of prior announcements favoring heads will outweigh your individual observation. Of course, your announcement that a bias toward heads is likely, even though you observed tails, will in turn cause others who observe "tails" to announce to the group that "heads" is a more likely bias, too. Hans Christian Andersen's fable "The Emperor's New Clothes" is perhaps the classic fable about herding. First, everyone (including the emperor) observes that everyone else is praising the emperor's new clothes and emulates that praise rather than believing their own eyes. But when one

<sup>9</sup> I also sense an episodic, if not cyclical, pattern in these types of events. For example, the 1977 Foreign Corrupt Practices Act was passed in response to corporate behavior concerns in an earlier era. Among other things, it introduced an explicit internal control requirement that may well have led to substitution of internal for external audit services (Previts and Merino, 1998)—in effect rebalancing the mix of client and audit firm personnel more in the direction of client personnel performing the overall audit function. And the Sarbanes-Oxley Act of 2002 mandates an audited internal control report now be included in the annual report.

<sup>10</sup> For an introduction to the theory of herding in this journal, see Bikhchandani, Hirshleifer and Welch (1998). For other useful introductions, see Hirshleifer and Teoh (2001) and Devenow and Welch (1996). Evolutionary analysis provides a complementary if not parallel model of these events (for example, Ania, Troger and Wambach, 2002).

person speaks the truth that the emperor has no clothes at all, everyone immediately switches positions.

Thus, if it is known that several players have tested the waters with an innovative, highly complex structured finance transaction and concluded it is “within the rules” and provides benefits to the firm’s shareholders, a subsequent player may well follow suit. After all, the earlier choices reveal information that those who went before apparently concluded the transaction was appropriate. Moreover, it takes enviable sophistication to design and execute these transactions, so emulation conveys sophistication and is far easier than inventing a new transaction from scratch. Diverging from prior choices has the effect of rejecting the information they carry, as well as signaling the requisite sophistication may be in short supply. As a result, the choices of followers cluster together, and without the benefit of added scrutiny.

A web of corporate governance arrangements with multiple parties may exacerbate and reinforce this pattern of herding. For example, it is not only a situation of investment bankers learning from a transaction pioneered by other investment bankers. The learning and herding will also take place among analysts, fund managers, commercial banks and investors in their interpretations of these transactions, as well as by business schools and accounting programs. The multiple parties may cause the herding effect to spread more quickly and to be reinforced more powerfully, but not to be examined any more carefully.

Putting together a model of herding with multiple parties and a web of interlocking devices for managing conflicts of interest has two important implications. First, as is usual with these types of models, fragility is an issue. This fragility is displayed in the declining stock market, and its effects on certain large firms such as Enron, in recent years.<sup>11</sup> But the fragility also refers to how institutional arrangements may shift rapidly. Once the stock market bubble burst, we witnessed a stampede to alter corporate reporting requirements, executive compensation and the regulatory apparatus itself. Even if this rearrangement of corporate governance institutions addresses some existing conflicts of interest, it may prove in a few years, under different stresses, to be just as fragile as the previous set of arrangements has proven to be. A second implication is that the convergence on behavior and downplaying of local information as a cascade develops—for example, the aggressive use of Special Purpose Entities and their financial interpretation—leads unwittingly to an upward-biased assessment of the control system’s effectiveness. This conclusion is partly driven by the inefficient behavior associated with a herding equilibrium, which is not being detected by the control system. But the situation is arguably made worse because herding can mean that the web of monitors and

<sup>11</sup> For that matter, Enron’s implosion was accelerated by the fact it used its own stock as a “credit enhancement” or guarantee in various Special Purpose Entities, so when the stock price weakened following a restatement of an SEC filing, the bank run was on, so to speak. It was also forced to restate its 1997–2000 financial reports because some of its Special Purpose Entities did not warrant off balance sheet treatment in the first place.

controls is dependent, rather than independent. This argument is a variation on Harrison's (1977) identification of calibration error in reliability assessments. Suppose a transaction must be vetted by three gatekeepers: call them the accountant, the attorney and the investment banker. Further, suppose each has an error rate of 5 or 15 percent, with equal probability. If the gatekeepers are statistically independent, the overall failure rate where a poor transaction is not spotted is 1 in 1,000 (that is, the expected value of the error rate is 10 percent at each level, and  $0.10^3 = .001$  overall). But if the error rates are dependent, as would happen in a cascade, the expected failure rate is 75 percent higher (that is, the error rate has a 50-50 chance of being either  $0.05^3 = .000125$  or  $0.15^3 = .003375$ , and the average of these two is .00175). This higher error rate is driven by the uninvited coordination among the parties' assessments.

Thus, I interpret the Enron saga and other recent failures of corporate governance in terms of a governance system with multiple parties, unavoidable conflicts of interest, a web of controls for addressing these conflicts of interest and herding issues that inadvertently tax and disrupt this web of controls. However, such a framework begs a number of questions. For example, can empirical methods differentiate this explanation from competing interpretations, such as an unexpected group of random rogues? What are the potential public policy implications of this perspective, such as the role of disclosure regulations, increased independence requirements or institutional training programs? The task of putting together and exploring such a model largely remains to be accomplished, but it does highlight the key facts that corporate conflicts of interest are widespread, that they are managed with an interlinked web of control arrangements and that the system is susceptible to a correlated failure of those arrangements.

## **Conclusion**

Conflicts of interest in the corporate arena are neither new nor avoidable. The issue is how they are managed. As a society, we rely on an elaborate web of control devices, and we are long experienced in the importance of refining and redirecting these devices as relationships and technology change. We should also be accustomed to the reality that these control mechanisms involve striking various balances and thus will never be perfectly effective. Yet our understanding of the larger picture is limited.

The shallowness in our understanding of these phenomena is, in my mind, driven by our lack of investment in adequately understanding the role of multiple players, multiple conflicts and potential cascades in unraveling control systems. To be sure, we have examined certain combinations of controls (like board structure and turnover of the chief executive officer) as well as substitutes for formal controls, such as socialization. But we have not invested adequately in understanding the role of multiple players, multiple conflicts and potential cascades in unraveling control systems. We know fragility is part of the story; after all, the

current gallery of corporate governance rogues was identified only after the economic downturn took place. We know rogues may benefit from temporary voids in the web of controls. We know empirical assessment is unusually difficult in this area because of endogeneity and off-equilibrium issues. But we do not understand how the pieces fit together.

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