Government and Corporate Governance in a Free Society

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Introduction

The indictment of Arthur Andersen LLP, following the collapse at Enron (and after Global Crossing) has brought discussions of corporate malfeasance and accounting standards to front pages and cocktail parties, and calls for increased government regulation to the op-ed pages and talk shows.

Frequently pundits call for legal changes or increased regulations, new rules, and expanded oversight to "promote the free flow of information" to "protect investors." [1] Of course, one might ask why investors, in particular, need more government protection: no one *forces* them to entrust any particular groups or individuals with any part of their accumulated savings -- except when the government collects taxes.[2]

As a sound bite, the "free flow of information" sounds nice, but as a concept for serious policy discussion, it is ambiguous and essentially useless. Doubtlessly, defenders of a right to privacy must view "free information flow" as a threat rather than a goal. Moreover, subtle issues would complicate the design of policies to promote any well-defined version of "free information flow." And answering the more fundamental question is just as difficult: Are additional flows of information *beneficial* or *harmful*? Certainly, reasonable arguments have been presented against the free flow of "information" on Napster, and whatever one's ultimate position on that issue, few thoughtful people would deny the complex tradeoff between *use* of existing information and incentives to *create* of new information.

It is simply untrue that "more information" is always "better." Even more *accurate* information is not always better. Information in the hands of whom? (Terrorists?) Better for whom? If a firm cannot limit information about its production process from competitors, it may suffer losses to those competitors. Although customers may gain from a resulting price decline, a failure to

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[1] I ignore here the more extreme, semi-socialist calls (e.g. from Naderites') for curbing a vaguely defined "corporate power" by expanding the government's use of force.
[2] Fortunately, few people would advocate increased government involvement in the finances of local bridge clubs or ski clubs. What is different about the corporations for which such involvement is now recommended? Size, perhaps: the larger the financial budget of an organization (for any given structure – club, partnership, corporation, etc.), the greater the potential rewards for improper behavior (i.e. theft, in its various forms) and the larger the size of the organization in some other dimensions, the greater the problems with internal information-flow and control, so the lower the expected costs of that behavior.

enforce property rights in information (by preventing firms from restricting its flow) reduces the incentive to innovate and *create* information. These reduced incentives consequently inhibit the production of goods and services that people value. In the end, *everyone* may lose from those reduced incentives. After all, that argument – applied to digital music and video files rather than to accounting statements – has been the key policy argument against Napster and newer firms that have replaced it.

Most information is costly to create. It may involve costs of writing, performing and recording music, or costs of developing and implementing a new technology for bioengineering pharmaceuticals. Or costs of developing a useable relational database (Oracle) or improving management techniques (Wal-Mart). Or even the costs of developing and trading financial derivatives in energy markets (Enron).[3] Costs of creating information can be substantial, and frequently it is impossible to separate the costs of developing a technology (or management technique) from the costs of developing information *about* that technology. In contrast, the costs of *re*producing that information, like the costs of copying a digital music file, are frequently much lower. Consequently, once created, a technology's value often depends partly on its owner's ability to restrict information about it.

If no other issues were involved in government policy toward corporate governance, then that policy should be twofold.[4] First, seek the "best" legal definition of intellectual property rights, balancing expected costs and benefits in the tradeoff between promoting use of existing information and creating incentives to develop new information. No policy based on only *one* side of this tradeoff is likely to be best, whether it involves placing no restrictions on copying of digitally-transmitted entertainment; or extending, *ex post*, the life of copyrights, or requiring corporations to disclose financial information without regard for the effects of such mandatory disclosure on firm's incentives.[5]

There is no simple answer to the question of the "best" legal definition of property rights. When transactions costs are sufficiently low, the Coase theorem helps by removing considerations of resource allocation, reducing the issue to one of wealth distribution. But with the higher transactions costs involved in many situation, the answer depends on details of the case, and the answer can change as technology evolves (e.g. improved mpeg compression technology reduced the costs of transmitting and using existing music data). Finally, the answer is history-dependent: the status quo definition of property rights should not be changed without overwhelming reason, because when "property rights" are frequently changed, they cease to be property rights at all. When owners cannot count on continued legal protection of their resources, they have little incentive to invest in conserving and improving those resources, and higher incentives for squander and waste.

Second, public policy (if no other issues were involved) should support the legal institutions to enforce property rights efficiently. This simple statement hides complicated issues, such as deciding what "best" means (e.g. best for whom?). It also includes imposition of expected penalties that are sufficiently high to function effectively as deterrents. That probably entails raising penalties for white-collar crime. Those penalties appear to have been inefficiently small in recent years: SEC fines have been small (witness Arthur Andersen and Waste Management Inc.), particularly considering that probabilities of punishment also appear small. Because U.S. attorneys find investigating and prosecuting white collar crime difficult, they often avoid it and concentrate their scarce resources on other, higher-return types of cases. And the American Institute of Certified Public Accountants admits that it lacks an effective process to disciplinary corrupt auditors. Consequently, policy reform should focus on finding new methods to raise the

[3] Even criminal behavior within a firm would not imply that the firm's product lacked value.
[4] Those are essentially the fundamental policy issues related to Napster and similar firms.
[5] There are multiple channels through which such requirements would distort firms' decisions; for example, some public firms would go private to avoid disclosure regulations.

probability of detection and punishment for white-collar crime, as well as the severity of punishment.

These, however, are not the only issues involved in government policy toward corporate governance and financial management. New issues arise because corporate financial information, unlike digital music files, is not a direct input into final consumption (entertainment). Instead, financial information (a) involves a larger cost of *conveyance*; (b) requires *analysis* for its use; (c) can gain value through costly *verification*; and (d) often requires other resources, such as additional information, for its use.[6] While copying a digital file with all of a firm's financial records is virtually costless, those records would provide little *information* to most people. That, after all, is a key role of accountants: to extract key information from a vast array of data and concisely convey it. This extraction and conveyance entails substantial costs. The most basic level of analysis, perhaps, involves the ability to read and interpret a financial statement – a skill for which many MBA students pay handsomely. The value of verification is most obvious in creating a demand for auditors. And financial or market data that mean little to most people – even to the well-informed – may speak volumes to someone with a piece of complementary data.

Information is often too complex to convey with a single number. A distribution cannot typically be described fully by only its mean, or only its variance. Consider the issue of whether firms should expense options issued as employee compensation (as Alan Greenspan and Warren Buffet, among others, have advocated). Proponents argue that the such options are clearly compensation, hence an expense that reduces earnings. Opponents argue that the issue isn't as simple as it seems. Those options frequently lack observable market values, and their long terms preclude any simple and accurate calculation of their values. In any case such options are usually subject to important contingent restrictions, such as continued employment at the firm; those restrictions make accurate valuations of the options essentially impossible. Consequently, no simple procedure exists for firms to summarize the value of such an option with a single number (that it could then subtract from earnings).[7] Policy should recognize that both arguments are correct. The real question is why shareholders have not already demanded that information from firms. One possibility is that shareholders are sufficiently unaware of firms' practices to seek that (and perhaps other) information. That explanation would be consistent with evidence for "non-neutrality" of accounting statements (that changes in financial statements affect equity prices even in the absence of any real changes at firms). The other possibility is that shareholders don't expect that information to have sufficient value to justify paying for its production.

This kind of situation is complicated further by the fact that people differ in their demand for information, depending on their intended use of that information. For the decisions that *some* people will make, some piece of data on a firm's finances may be irrelevant, while for others it may be important. (Think, for example, about the difference in the information most relevant to owners of a firm's equity, or to its debt holders, or to holders of call options on the firm's stock.)

Yet the other extreme is also useless: providing people with a huge quantity of data gives them no *information* at all. Providing information requires *modeling*: extracting key features that can

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[6] Of course, people require hardware to listen to digital music files. But the cost of that hardware to any potential user is small compared to the costs of the additional information required to use (to process and act on) corporate financial information.

[7] Another argument, e.g. by economists Burton Malkiel and William Baumol writing in the *Wall Street Journal* ("Stock Options Keep The Economy Afloat"), asserts that "stock options must be recognized as only a redistribution of benefits between initial stockholders and the new, prospective management stockholders. It does not result in any reduction in the overall size of the firm's total earnings pie -- it only affects the way in which that pie is sliced and divided up." However, this fact is obviously irrelevant for valuing existing shares, because newly-issued options dilute the value of existing shares. Consequently, initial shareholders should properly want information about the issuance of those new options.

aid decisions, just as a map provides a useful representation of roads, for purposes of planning a trip, but not a fully detailed and accurate picture of the actual grounds and roads.

Public policy debates have recently focused on questions such as "What financial information, and in how much detail, should firms provide?" But that is the wrong question. It is like asking what dinner, or how well-cooked, a restaurant should provide to its customers. The firm, and the people who contract with it, can jointly determine how much information they provide to each other. Like *your* dinner, *I* am probably uninvolved, and it's probably none of my business. Public policy should then focus on how best to enforce the contracts that people choose. The legal system can promote clarity in contracts and confidence in their enforcement. (That implies, of course, enforcing common-law or contractual penalties for fraud and deceit, with explicit contracts permitted to override common law.)

Applied to expensing options, this argument would mean that the law should not impose any specific answer, but allow firms and investors to determine this for themselves, on a case-by-case basis. However, the main reason for *standards* – such as standard accounting practices – is to reduce information costs by preventing every firm from valuing things differently. Standards have features of public goods – they are essentially nonrival and nonexcludable. That does not imply, of course, that the government should *produce* those standards (any more than the government should necessarily produce any other public good). However, if incentives for private parties to offer those public goods lead those private parties to offer alternatives that are inefficient, then there are benefits for the government to produce an alternative. Private parties may have incentives to produce alternative standards that effectively transfer wealth from groups with diffuse interests (and small individual stakes in the standards) to groups with concentrated interests (and higher individual stakes in the standards). To accomplish this transfer, they may create standards that sacrifice efficiency.[8] However, there is no guarantee that the political process performs better, since ultimately the same forces operate in the political arena. Nevertheless, a *desirable* government policy would seek to implement the efficient standards.

If transactions costs were sufficiently low, the Coase theorem would apply to these standards. For example, it would not make much difference whether the standards involve expensing options (in some particular way, despite the difficulties mentioned above) or not, because firms can always contract voluntarily with their investors to provide the alternative set of numbers. However, the costs are often large. Some information requirements that courts and government regulators have imposed on firms involve substantial costs to those firms with little benefit to anyone. Clearly, the government should not impose legal standards (for expensing options or anything else) that impose high costs without concomitant benefits. Moreover, courts should enforce voluntary contracts that choose to override those standards.

That said, how should the government choose the legal standards? In the absence of externalities, standards should attempt to mimic the terms of contracts that parties would sign if transactions costs were low. That reduces costs by allowing parties to sign the "standard" legal contract rather than spending resources to specify all the terms of that contract themselves. With externalities, the one additional feature involves including the affected non-contracting parties in the analysis, trying to mimic the broader contract that would result if transactions costs were low and those parties were also involved in the contract. However, it is hard to see the importance of externalities in corporate governance. Despite the rhetoric of those who distinguish a broad class

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[8] Accounting has, as its critics contend, moved slowly away from broad principles aimed at fair and accurate presentation of firms' financial statements toward rules and practices that tend to shield auditors and firms from legal liability and that can produce distorted pictures of reality in financial statements.

of “stakeholders” from a narrower class of “shareholders,” parties who are linked by voluntary contracts are unlikely not to be able to internalize any of the alleged externalities, as long as courts will reliably enforce those contracts and legal remedies exist for victims of fraud.

One solution, in the case of expensing options, would be for the government to require, for a limited time of perhaps five years, firms to report earnings calculated in two ways: the standard way, and an alternative with adjustments for options. The adjustment could be based on the standard option-pricing model, despite the pricing problems cited earlier. Firms could note problems with option-valuation along-side the second figure. Despite these valuation problems, it is not clear that they affect the resulting earnings figure any more than other similar valuation problems (e.g. for existing capital) that are already included in calculating earnings. After the requirement period ends, shareholders and firms would be free to choose whatever information they deem cost-effective and appropriate for reporting. This solution would impose only temporary costs on firms while providing a partial solution to the potential problem of stockholder ignorance. As Alan Greenspan has argued, "If investors are dissuaded by lower reported earnings as a result of expensing, it means only that they were less informed than they should have been. Capital employed on the basis of misinformation is likely to be capital misused." After a longer period of time, standards could be adjusted if most firms have chosen the adjusted-earnings alternative.[9]

Any changes in accounting standards, legal requirements, or regulation should recognize that such changes often have unintended consequences. Legal changes intended to increase the flow of accurate information by penalizing impediments to that flow can have the *opposite* effect. They can reduce the production of information. They can – and do – induce costly changes in economic structure designed to avoid providing information (e.g. some corporate managers might reduce their liability of their corporations by taking them private).

Economic forces tend to punish many forms of misbehavior even without regulations and legal requirements. Reputation plays a powerful role in discipline. Actions that reduce an auditor’s reputation, for example, tend to lead to lower future income for that auditor. Auditing firms, like Arthur Andersen, who engage in misbehavior see their business decline and their equity prices decline. These economic penalties occur automatically, if the flow of information is unimpeded, without the need for litigation or courts. Firms that hire auditors with better reputations can raise their own equity prices.

Limited information, of course, can limit the role of reputation. Agency problems (separation of ownership and control) in firms may favor auditors who enable actions by managers that exploit those agency costs (that separation). And shareholder-monitoring of those actions may simply be too costly to pursue. However, there is little that regulators or the law can do about these problems (since regulators also face monitoring costs that are likely to be even higher than the costs of shareholders), except to provide legal institutions for *ex post* remedies against fraud, theft, and so on. The possibility of suffering those remedies provides *ex ante* incentives for managers to avoid gross misbehavior.

The proper role for government in all issues associated with corporate governance is mainly to enforce voluntary contracts, to define property rights efficiently and clearly, to provide well-designed standard contracts, and to operate a legal system that efficiently provides enforces property rights and contracts, and efficiently offers civil remedies for violations of (explicit or implicit) contracts and intrusions on property rights. Some experimentation in policy, as suggested above, would likely help with these goals. The government’s role in defining property

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[9] Paul Volcker and the International Accounting Standards Board have already "tentatively agreed that, in principle" grants of options to employees should be reflected in financial statements.

rights, designing standards, and operating an efficient legal system necessarily call for decisions that involve details of corporate governance. However, policy should avoid extending that involvement beyond these proper roles.