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Corporate Accountability: A Time for Reform

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Corporate Accountability: A Time for Reform

Two months ago, the Congress passed legislation that is little known to the American public and is still not fully understood in corporate boardrooms and management suites across the United States. Yet this legislation may ultimately rank as one of the more significant corporate reform measures of the past 25 years.

I am referring to title I of the legislation that provided $70 billion in loans to shore up the Bank Insurance Fund of the Federal Deposit Insurance Corporation (FDIC). In covering the debate over this bill, the press concentrated on the fight over expanded bank powers and interstate banking. Largely unnoticed were provisions that include new corporate accountability reforms for the nation's 2,000 largest banks—those with assets of over $150 million. In the same legislation, the Congress mandated a set of "tripwires," which require federal bank regulators to intervene on a more timely basis to deal with problem banks before capital is depleted.

Many of these reforms track with a series of recommendations the General Accounting Office began making nearly 3 years ago.

These new legislative requirements offer an important lesson not only to the banking industry and its lawyers and accountants, but also to the securities and insurance industries and

other major segments of the corporate world.

The lesson is this: Corporate accountability has become an issue.

When the Congress adjourned late in the afternoon of November 27, the day before Thanksgiving, many members left Washington in a dispirited mood. They had been forced to work through the preceding night on the bank bill and on another installment of bailout funds for the savings and loan (S&L) industry.

In the case of funds for the S&L bailout, members of Congress left town knowing they would have to vote on still further funds within a matter of months. The $25 billion they voted in November is merely the latest installment to pay for the biggest federal bailout in the history of the Republic, a cost that GAO believes will ultimately reach $500 billion or more, not including interest on Treasury borrowing. Think of all the federal bailouts of the postwar era: Lockheed, Penn Central, Chrysler, New York City. Throw in the Marshall Plan, which rebuilt Europe. Taken together, their cost hardly makes a dent in what the American taxpayer is spending to protect the depositors of failed S&Ls. This bailout dwarfs them all!

Add the new loan for banks, and the problem is compounded.

Abroad, bankers and government leaders from Tokyo to London scratch their heads and wonder how the Americans let this happen.

It is no wonder, then, that members of Congress grimace with pain every time they are forced to vote more money. It should come as no surprise that the Congress, the press, and the taxpayers themselves are asking, "What happened?"

- Where were the boards of directors?
- Where were the audit committees?
- Where were the lawyers?
- Where were the auditors?
- Where were the regulators?

When these questions were asked 60 years ago after the stock market crash of 1929 and the banking crisis of the early 1930s, the result was a wave of reform legislation. The Glass-Steagall Act separating investment from commercial banking, the creation of the Securities and Exchange Commission, requirements for annual audits for publicly owned corporations, the institution of federal deposit insurance, and numerous other reforms date from this period.

Those reforms of the early 1930s served the nation well for half a century. Together, they imposed a carefully balanced discipline upon the financial services industry. But by the 1980s, deregulation of interest rates,

shifts in monetary policy, and corporate aggressiveness, coupled with the growth of an antiregulation atmosphere in Washington, had destroyed much of the balance that the old regulatory framework provided. The 1980s became the "go-go" decade. Junk bonds were floated to finance leveraged buyouts of America's leading corporations for staggering sums. New securities were invented, some so exotic they would make a professional gambler blush with envy. Numerous S&Ls, newly deregulated, lined up to invest in commercial real estate and various types of securities. For many of these S&Ls, loans for single-family housing, the purpose for which thrifts were created, became a secondary consideration.

The S&L Debacle: A Forerunner of Other Problems

Government didn't just tolerate this atmosphere; it encouraged it. Nowhere was this more evident than in the savings and loan debacle. Until the beginning of 1989, industry leaders and government regulators flatly denied the magnitude of the problem. There was no official recognition of the excesses—let alone the waste, fraud, and abuse—until the mess became so sticky that it could no longer be wished away.

It was only a few short years ago that "forbearance" was a guiding principle of thrift industry regulation. When thrifts couldn't meet capital requirements, compliant regulators blessed

"regulatory accounting principles," or RAP. This phony accounting allowed sick S&Ls to hide their losses so they could go on seeking brokered deposits to continue pumping money into ever-more-risky ventures, from country club resorts to office buildings no one needed. State regulators happily went along with this madness. Many outdid their federal counterparts to ensure an "anything goes" climate. After all, why worry? It was all guaranteed by the American taxpayer.

By January 1989, after the binge of the 1980s, the S&L party was finally over. But the fiscal hangover lingers on. We'll be paying for the mess for another generation. Our grandchildren will still be paying interest on the off-budget bailout bonds 40 years from now.

Sadly, while the savings and loan debacle has created the biggest financial loss in American history, it may turn out to be but an expensive forerunner of headaches yet to come.

- The Bank Insurance Fund, run by FDIC, faced insolvency until the Congress voted in November to let the Fund borrow $70 billion from the Treasury. Even if this amount is sufficient to deal with future bank failures and even if the banks are capable of repaying the loan, the federal government will still be left with a fund lacking sufficient reserves. If bank failures are higher than anticipated—

a real possibility—and if banks cannot repay the loan, then the taxpayers will be called upon to provide direct funding to protect depositors.

- The insurance industry is ailing, as evidenced by the failure of Executive Life and the decision of rating agencies to downgrade major insurance companies, many of which got into hot water because of their own risky investments. While there is no specific federal obligation to rescue a failing insurance industry, a string of bankruptcies would surely result in an SOS to the taxpayers.
- The securities industry has its own problems, ranging from losses associated with the junk bonds they sold to the recent scandal at Salomon Brothers.

The severity of the problems faced by the banking, thrift, security, and insurance industries do not, as some argue, represent temporary or paper losses that will simply fade away with an improved economy. A decade's accumulation of huge debt from the third world, overbuilt real estate, imprudent investments, junk bond losses, and bridge loans for leveraged buyouts represents real loss. It could take a decade or more to work it all out.

It is against this backdrop that the recent debate on the bank bill is of such interest.

A Call for Corporate Accountability

That debate raised all the old questions of corporate accountability versus government regulation. The banks were saying to the Congress, "Trust us and we'll work it all out if you give us new powers." The Congress took a look—and answered "No!"

If I were a lawyer or an accountant representing any segment of the financial services industry, I would find such congressional hesitation a sobering development. I believe it clearly demonstrates that the issue of corporate accountability is one that will not fade away in the foreseeable future.

Let me take the remainder of my time to discuss this issue, one that affects you as advisers as well as the companies for which you work.

The reforms I am about to suggest would be beneficial for a company of any size, but they are especially needed when it comes to the largest of our publicly held corporations. They fall into three broad categories—the responsibilities of boards of directors and the necessity for truly independent audit committees, internal controls, and the responsibilities of auditors and lawyers.

Let me take them one at a time.

Independence Is Essential for Corporate Boards and Audit Committees

First, real corporate accountability is not possible without a board of directors that is independent of management and willing to act on its own authority. A board that is merely a rubber stamp for management is not capable of protecting the interests of shareholders or of discharging its public responsibilities.

Nearly 20 years ago, the late Justice Arthur Goldberg shocked Wall Street when he called for major reforms in corporate oversight. In an article in The New York Times,[1] he said:

"Contrary to legal theory, the boards of directors of most of our larger companies do not in fact control and manage their companies, nor are they equipped to do so....Thus, the board is relegated to an advisory and legitimizing function that is substantially different from the role of policy maker and guardian of shareholder and public interest contemplated by the law of corporations."

Justice Goldberg reiterated his concerns in 1980, when he was asked to inaugurate the annual Manuel F. Cohen Memorial Lecture.[2] Noting that his 1972 article had created something of a furor, he said in 1980:

[1] October 29, 1972.

[2] February 24, 1980.

"...our corporate house is still not in order and I strongly believe that further and more fundamental reforms are required in the interest of the public and the shareholder alike."

Among other reforms, Justice Goldberg called for steps to ensure that boards of directors were truly independent and were not mere rubber stamps for management. He also urged that outside directors be provided with independent counsel, independent auditors, and an adequate staff to discharge their fiduciary duties to shareholders and carry out their responsibilities to the public. Lawyers and auditors on retainer to corporations, he added, should not serve on the boards of corporations that retain them. And outside directors, he said, should all be persons of competence and experience.

Given his warnings, Justice Goldberg would not have been surprised by the findings last October of a GAO study[3] of audit committees of the nation's largest banks. We sought to determine the extent to which these committees had the independence, the expertise, and the information needed to properly carry out their functions. GAO received responses from 40 of the 47 chairpersons of audit committees of banks with assets of $10 billion or more. These banks are located in 18

[3] Audit Committees: Legislation Needed to Strengthen Bank Oversight (GAO/AFMD-92-19, Oct., 1991).

states and account for more than $1 trillion in assets.

The results of the survey are illuminating but also disturbing. Many of the audit committees reported that they lacked the independence and the expertise they believed necessary to properly oversee bank operations. Twenty-five reported that their committees included members who were large customers, including three committees composed solely of large bank customers.

Thirteen audit committees reported their membership included no one with experience in the law. The committees never met independently with the banks' legal counsel, even though they were responsible for assessing management compliance with banking laws and regulations.

In addition, those surveyed indicated that an independent review by external auditors of banks' internal controls and their compliance with laws and regulations, beyond those currently provided, would be of great help.

These findings highlight a major problem that I believe must be addressed by corporate America.

While independence is very important for any board of directors, it is critical for an audit committee. Customers or those with close ties to the company or

the financial institution should be excluded from membership. Audit committees should have access to independent counsel and accountants. They must have the necessary expertise to discharge their responsibilities. In short, they should be independent not just in name but also in fact.

Strong Internal Controls Protect Against Abuse

The second needed reform concerns internal controls, which are essential to protect a company from fraud and abuse. Procedures to ensure compliance with laws and regulations and to guard against misappropriation of corporate resources should be routine in every corporation. At a minimum, such internal controls are necessary to protect the interests of shareholders. In the case of the banking and thrift industries, internal controls are also essential to protect the interests of depositors and taxpayers.

When GAO reviewed a sample of failed savings and loans and later a sample of failed banks, weak internal controls stood out as a major cause of the failure in a vast majority of cases.

The recent scandal at Salomon Brothers and the corrupt Bank of Credit and Commerce are two further instances where weak controls appear to have allowed irregularities to exist and then grow. One of Warren Buffett's first actions upon taking over at Salomon was to order an independent review of the controls.

One of the central provisions of the bank reform legislation approved last November is a requirement that management prepare a public statement on internal controls. While such a statement will now be mandatory for large banks, I believe that this is a practice that should be followed by the largest of our publicly owned corporations. It would ensure that management and boards of directors took seriously their responsibilities for putting in place and monitoring a policy that mandated adequate systems and procedures to prevent fraud and abuse.

Responsibilities of Auditors and Lawyers

This brings me to the third category, the role of the auditor and the lawyer in corporate governance.

To begin with, complying with laws and regulations should be a major concern of both corporate management and its lawyers. The auditor must also be aware of legal requirements in examining financial statements. Given the direct financial impact of many laws and regulations, their complexity, and the serious consequences of noncompliance, it is critical that management and its lawyers and auditors establish and implement sound compliance programs for any financial institution or corporation.

Beyond this is the special role the auditor plays—or should play—in ensuring corporate accountability.

Having an auditor review internal controls is, in my opinion, an essential part of a modern audit of a large publicly owned company. This is true especially of large financial institutions. That is why I was especially pleased that the Congress included auditor review of internal controls in the reform provisions of the new bank bill.

This provision alone should go a long way toward eliminating the problem that was so prevalent in the savings and loan debacle. Auditors gave clean opinions on financial statements when internal controls were deficient or even nonexistent. All too often, an S&L received a clean opinion only to fail a few months later. Now, lawsuits totaling over $2 billion have been filed against members of the accounting profession, most of them lodged by the Resolution Trust Corporation or FDIC.

Both lawyers and auditors need to recognize that their responsibilities extend beyond protecting the interests of management and shareholders. These professionals also have a responsibility to protect the public interest, especially where taxpayers' dollars are at risk. Unfortunately, this is a lesson often learned the hard way, as court decisions stemming from failed banks and thrifts have shown.

Accounting Standards in Need of Reform

The steps that I have outlined—the need for independent and knowledgeable boards of directors and audit committees, good internal controls, and stricter adherence by lawyers and auditors to their professional responsibilities—are essential aspects of sound and sensible corporate accountability programs.

But that is not all that is needed. There is one other problem that I believe is in need of reform—accounting standards. While this is the responsibility of the accounting profession's standard-setting bodies, it has a strong bearing on corporate accountability.

Bad accounting did not cause the S&L and banking crises, but it certainly added to the difficulty in assessing the size of the problem. I can speak from experience on this subject because GAO audits the bank insurance funds.

The fact is that S&L and bank financial statements often overstate their assets. This has an obvious impact on the exposure faced by the insurance funds when these institutions fail. GAO has issued reports on failures of both banks and S&Ls. In our most recent report,[4] we noted that over $7 billion had melted off the balance sheets when the government took over the 39 failed banks sampled for study.

[4] Failed Banks: Accounting and Auditing Reform Urgently Needed (GAO/AFMD-91-43, Apr. 22, 1991).

These banks cost the Bank Insurance Fund nearly $9 billion.

Current accounting principles of the Financial Accounting Standards Board allow management and its auditors too much latitude in avoiding the recognition of losses on troubled loans. At the same time, generally accepted accounting principles (GAAP) allow banks to avoid recording the full amount of losses when losses are recognized.

The accounting profession has been justifiably critical of the regulatory accounting principles allowed by S&L regulators. As Lawrence J. White recently wrote in The Wall Street Journal,[5] however, bank regulators' recent actions have the potential for similar disaster.

A weak GAAP is little better than RAP, and I am disappointed that many members of the accounting profession have been unwilling to stand up for adequate accounting and auditing standards in the banking industry, especially after the lessons of the S&L crisis. Good accounting practices provide management, shareholders, regulators, and the public with crucial information on the financial health of a company. Anything that distorts that information deprives recipients of

[5]March 22, 1991. Mr. White is Professor of Economics at New York University and is a former member of the Federal Home Loan Bank Board.

knowledge they need to make sound judgments. As Professor White said in his Wall Street Journal article, the dispute about accounting is not just "bean counting."

"If measured properly," he said, "a bank's capital...is the crucial indicator of its financial health and of the protection available for the deposit insurance fund—and ultimately for the taxpayers."

That is why the "tripwires" provisions of the new bank bill will work in tandem with the new accounting provisions. Auditors will be expected to share their findings on internal controls with regulators. Regulators will be expected to move sooner to protect safe and sound banking.

Conclusion

Where does this leave us?

I think it is fair to say that we are at a crossroads.

Capitalism in the United States has always worked best when corporate accountability has been strong and effective. Such a system prevailed in this country from the early days of the Great Depression until the 1980s.

Today, the system is under great strain. In the case of banks, the Congress stepped in and mandated regulatory and auditing reform because it feared a repeat of the S&L crisis.

Members of Congress listen to their constituents, and taxpayers simply do not understand how an entire industry comprising thousands of savings and loans could be allowed to disintegrate, costing them billions upon billions of dollars.

America needs to regain confidence in its financial services industry. The foreign community needs reassurance, and this is especially important as pressure grows for agreement on international standards for regulation of financial services. In short, the industry needs confidence, at home and abroad, to grow and prosper, just as the public needs confidence that those entrusted to handle its money will do so with prudence and care.

But confidence will not be regained as long as new scandals keep making the headlines. And confidence will surely not be regained as long as members of Congress are forced to vote again and again to spend billions for federal bailouts.

But confidence is something that all of corporate America needs, and I suggest that reform meant to ensure accountability is the key to instilling that confidence. This is true especially when it comes to our largest corporations, where the tone is set for much of the business world.

Many corporations that have failed to establish and implement strong

accountability programs have paid dearly for their short-sighted approach. Members of top management have been fired, and board members have discovered they face personal liability for not carrying out their responsibilities. Many corporations face multimillion-dollar lawsuits and have seen their insurance premiums skyrocket. Corporate reputations, carefully built over generations, have been destroyed.

This kind of corporate turmoil is not necessary. While it is human nature to preserve the status quo, leaders with vision have recognized that strong corporate accountability is good business. It protects the corporation while serving the interests of shareholders, the public, and even the taxpayer.

The Congress would much prefer that industry accept the need for and implement reforms on its own. As leaders of and advisers to America's corporations, where the decisions will be made, you can help make this happen.

I urge you to lend your voices and spread the message. Action is needed.

Thank you for giving me the opportunity to speak with you today. I wish you well and much success in the years ahead.