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The Government Should Not Try to Promote "Investor Confidence"

By Alex J. Pollock

Efforts to encourage investor confidence are fundamentally misguided. A skeptical disposition—including a skeptical approach to GAAP accounting results—is much better for investors and for the proper functioning of securities markets and the economy as a whole.

A common theme in public statements about financial markets is that the government should try to promote "investor confidence." In a typical example, James S. Turley, the chairman of Ernst and Young, wrote in a *Wall Street Journal* commentary that the corporate compliance requirements of the Sarbanes-Oxley Act, despite their gargantuan cost, are beneficial because they will create "enhanced investor confidence."[1]

Like many other commentators, Turley assumes, without developing an argument to support the idea, that the government should induce investors in general to be confident. But this is far from self-evident.

Indeed, the endlessly repeated "investor confidence" mantra needs to be rejected. What is the prime virtue of a good investor? *No one* thinks it is confidence. In fact, it is the opposite—skepticism.

For example, a *Barron's* eulogy of a master investor describes him as "the complete analyst, hewing to reason, avoiding emotion like the plague. . . . He loved the hum, the buzz, the special white noise, the gossip, the stories . . . *never for a moment relaxing his skepticism*."[2] This is what ordinary investors need to emulate.

Consider this pithy truth: "Financial professionals make a living by trading against misinformation."[3] This might be called the essence of practical skepticism. But who are the professionals trading against? The confident public, of course.

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The un-argued assumption that the government ought to be promoting confidence justifies large, intrusive bureaucracies—including the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), and the Financial Accounting Standards Board (FASB)—not to mention the public accounting firms now enjoying huge windfall enrichment from Sarbanes-Oxley requirements. The historical low point of the confidence slogan was the now-defunct Federal Home Loan Bank Board, which devoted its 1986 annual report to promoting confidence in the insolvent savings and loan deposit insurance corporation. The cover of this memorable annual report displayed the words "PUBLIC CONFIDENCE" carved in stone.

Government-inspired confidence led the public to make deposits in failing savings and loans, which allowed these S&Ls to continue their disastrous speculations. It is more than dubious that confidence leads to efficient resource allocation—give me skepticism any time.

Accounting

As a general statement, it is a certainty that confidence is *not* a virtue for investors. What

well-meaning voices ordinarily have in mind when they speak of promoting "investor confidence" may be something pretty fuzzy and unclear. However, sometimes they are focused specifically on making the public "confident" that financial statements are "transparent" and "reflect reality." In other words, they are trying to induce confidence in accounting.

Indeed, accounting is a particular focus of the confidence slogan and rationale of the SEC, Sarbanes-Oxley, the PCAOB, and the FASB. But consider this: should anyone have confidence that a single number called "net profit" is a precise measure ("the bottom line," as they say) of the results of an enterprise? No sophisticated investor believes this for a second. They all know that "net profit" is at best a reasonable estimate within a range of plausible results, and in a complex company is subject to a great many component estimates, judgments, and conventions. These include the results of models which themselves are driven by estimates and judgments.

As Professor Baruch Lev has written, "Despite widely held beliefs that corporate financial statements convey historical, objective facts, practically every material item on the balance sheet and income statement, with the exception of cash, is based on subjective estimates about future events."[4] This is well known to the professionals.

A more detailed, ponderous, and typical disclosure of this reality runs like this:

> Critical Accounting Estimates
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> The preparation of these financial statements requires the company to make estimates and judgments that affect reported amounts of assets, liabilities, contingent assets and liabilities, and revenues and expenses. These estimates are based on historical experience and on other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions of conditions. The following estimates are particularly dependent on management's judgment about matters that are uncertain: revenue recognition; accounts receivable allowance; contingencies; goodwill; pension and other post-retirement benefits; stock-based compensation. In addition, there are other accounting estimates within the financial statements, including recoverability of deferred tax assets, anticipated distributions from non-U.S. subsidiaries, realizability of long-lived and intangible assets and valuations of investments in affiliates. Management believes the current assumptions and other considerations used to estimate amounts are appropriate.

These statements appeared beginning on page 24 of an actual 10-K filing. One wonders if a confident investor would ever get this far in the fine print. The real message of this disclosure has been stated more succinctly by an authoritative writer: "Accounting estimates are management's ideas about unknowable future events."[5]

Moreover, and more important, every calculation of net profit reflects choices from among competing theories of accounting. None of these theories is simply the truth. Like theories of politics, they depend on inherently imprecise ideas such as fairness, reasonableness, value, being appropriate under the circumstances, and future usefulness. They are in important respects matters of opinion and philosophy, not matters of fact or mathematical proof. They can be and are endlessly argued about, and are subject to large shifts in current fashion. For example, the SEC evolved historically from an original ardent insistence on historical cost accounting to a current inclination to market values, especially for derivatives. By the very nature of accounting, it is impossible for financial statements to be simply matters of "objective fact."

This leads to another uncomfortable reality—that "accounting standards continue to lack a fully developed and convincing intellectual foundation."[6] This is not for lack of great efforts to develop one over eight decades. The reason it has not been discovered is that such a foundation does not exist—what exists are competing theories representing various mutually inconsistent proposed intellectual foundations.

In practice, accounting standards are often hotly contentious among the interested parties and the final form of accounting standards is the result of complicated political compromises. As another expert observed, the "setting of accounting standards is as much a product of political action as of flawless logic."[7] Debates over accounting standards often involve corporations, trade associations, accounting firms, and academics split among opposing sides, splits within the FASB itself, pressure from the SEC, interventions from Congress, and, occasionally, legislation. Arguments made against FASB proposals by companies are typically described by FASB supporters as "lobbying"; efforts by FASB to promote its proposals to Congress and the public are not described by accounting writers as "lobbying," but of course do constitute lobbying. In short, accounting

standards are to some degree political results of competing interests and competing theories.

Hence the eternal verity of the investment proverb, "Profit is an opinion; cash is a fact." No professional investor is unclear about the difference between what, under Generally Accepted Accounting Principles (GAAP), gets reported as profit on the one hand and net operating cash flow and free cash flow on the other. Still, even cash can sometimes be deceptive, as the recurrence of Ponzi schemes throughout history attests.

A sister idea to "confidence" is that adherence to a set of official accounting standards will lead to accounting statements being "transparent." Note the metaphor: you can look through them to the reality. Unfortunately, accounting standards can never achieve this even in principle. This reflects the fact that they are—as noted above—often the result of competing theories and a lengthy process of politics and negotiation. Over time, the result has been notable growth in the length and ever-greater complexity of the official GAAP rules which the preparation of financial statements must follow.

Has this expanding complexity generated more "transparency" or less? Walter Schuetze, a charter member of the FASB and a former chief accountant of the SEC, surveyed the history of accounting standards over the last three decades and concluded that

> In the 1970s, after the surprise collapse of Penn Central, the auditing profession instituted peer reviews—where one auditing firm reviews the work and quality controls of another auditing firm. In the 1970s, auditing firms also instituted concurring partner reviews where a second audit partner within the public accounting firm looks over the shoulder of the engagement partner responsible for the audit. These procedures have been ineffectual. . . .
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> The Financial Accounting Standards Board also came on the scene in the 1970s; it was going to write accounting standards that would bring forth financial statements based on concepts. What happened was that the FASB wrote a mountain of rules that produce financial statements that nobody understands.[8]

Schuetze commented further:

> Following today's FASB accounting rules produces financial statements that are understandable only to the very few accountants who have memorized the FASB's mountain of rules. "Indecipherable" is the word. . . .[9]

It is a certainty that ordinary individual investors have not memorized FASB's complex rules. Being happily confident as they set about investing would require a pure (and unwise) act of faith.

Financial statements are not like transparent windows. They are more like distorting mirrors, or the projection of a solid object onto a plane. They contain a great deal of important information but should never be confused with reality. They can reveal many things, but should always be approached skeptically. Discussing the nature of accounting, the head of Global Valuation and Accounting for Morgan Stanley recently argued for the need to "force people to become much more skeptical about GAAP income" and "no longer rely on GAAP income statements and balance sheets."[10]

In short, the government should never try to promote "investor confidence" that financial statements are "transparent," because they are not.

Sophisticated investors know all this and look for misinformation to trade against. Who is on the other side of the professionals' trades? Can it be anyone other than the retail public, assured by various well-meaning official voices that they ought to be, due to all the worthy diligence of the various bureaucracies, "confident"?

When such confidence is induced in the public, we can consider among its probable results:

- Optimism—not a virtue in investing
- A tendency to overpay for securities and inflate bubbles
- A belief that accounting statements are something precise and true, rather than approximations reflecting estimates, conventions, and compromises among competing theories
- A willingness to make deposits in insolvent financial institutions

Practice a Jaundiced Eye

If one had a mind to conspiracy theory, the thought would arise that "public confidence" is the ideal way to ensure that the professionals have an easier time making money and unloading unwanted securities. In a less

paranoid view, it seems likely that the pursuit of confidence will lead to misallocation of resources and less general economic welfare.

The right idea is to have the public understand that *skepticism*, not confidence, is the key investing virtue. In this, ordinary investors should emulate the professionals. If they can help it, they should never let their skepticism slip while listening to the stories, the gossip, the hum, the buzz, the earnings releases, the Wall Street pontifications, the official government assurances—and in the meantime, they should study financial statements with a jaundiced eye.

Most of all, everybody should look with special skepticism at any official figure who announces the intent to make the public "confident," let alone one who believes that financial statements can really be made "transparent." If such skepticism makes retail investors careful and cautious buyers of securities or makers of deposits, instead of confident ones, it will be all to the good.

Notes

1. James S. Turley, "Warning on the Dashboard," *Wall Street Journal*, November 26, 2004.

2. Allan Abelson, "What's New?" *Barron's*, November 29, 2004, emphasis added.

3. Eric Kraus, "Russia in Future," *The Gloom, Bloom and Doom Report*, 2004.

4. Quoted in Gene Epstein, review of *Intangibles: Management, Measurement and Reporting*, by Baruch Lev, *Barron's* (December 13, 2004): 40.

5. Walter P. Schuetze, "Auditing: Objective Evidence vs. Subjective Judgments," (working paper, Foundation for Accounting Education, New York State Society of CPAs, September 9, 2003).

6. Ross Skinner, "Why Detailed Rules Will Never Replace a Chartered Accountant's Professional Judgment in Financial Reporting," in *Reading & Notes on Financial Accounting*, ed. Bala G. Dharan and Stephen A. Zeff, 41 (New York: McGraw Hill Companies, 1995).

7. David Solomons, "The Politicization of Accounting," in *Financial Accounting Theory*, ed. Thomas F. Keller and Stephen A. Zeff, 34 (New York: McGraw Hill Companies, 1978).

8. Testimony of Walter P. Schuetze, Senate Committee on Banking, February 26, 2002.

9. Ibid.

10. Trevor Harris, "Roundtable," *Journal of Applied Corporate Finance* 16, no. 4 (2004): 57.