What Is a Gatekeeper?

1) a third party whose consent, approval or rating is necessary to effect a transaction (narrow definition)

2) a reputational intermediary who pledges its considerable reputational capital to assure investors (or others) as to representations or claims made by its client that it verifies (broader definition)

3) Social Utility: A Gatekeeper Can Be Deterred More Easily Than the Client, Because It Derives Little Gain and Faces Disproportionate Loss From Involvement In Fraud or Crime.

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Who Are Gatekeepers?

1. The Traditional Gatekeepers
    1. Auditors
    2. Securities analysts
    3. Investment bankers giving fairness opinions
    4. Securities attorneys [?]
    5. Credit rating agencies

2. The New Gatekeepers
    1. The "lead plaintiff" in class actions
    2. The Nomad ("nominated adviser") under the AIM market
    3. The Research Marriage Broker (NRE and IRE)

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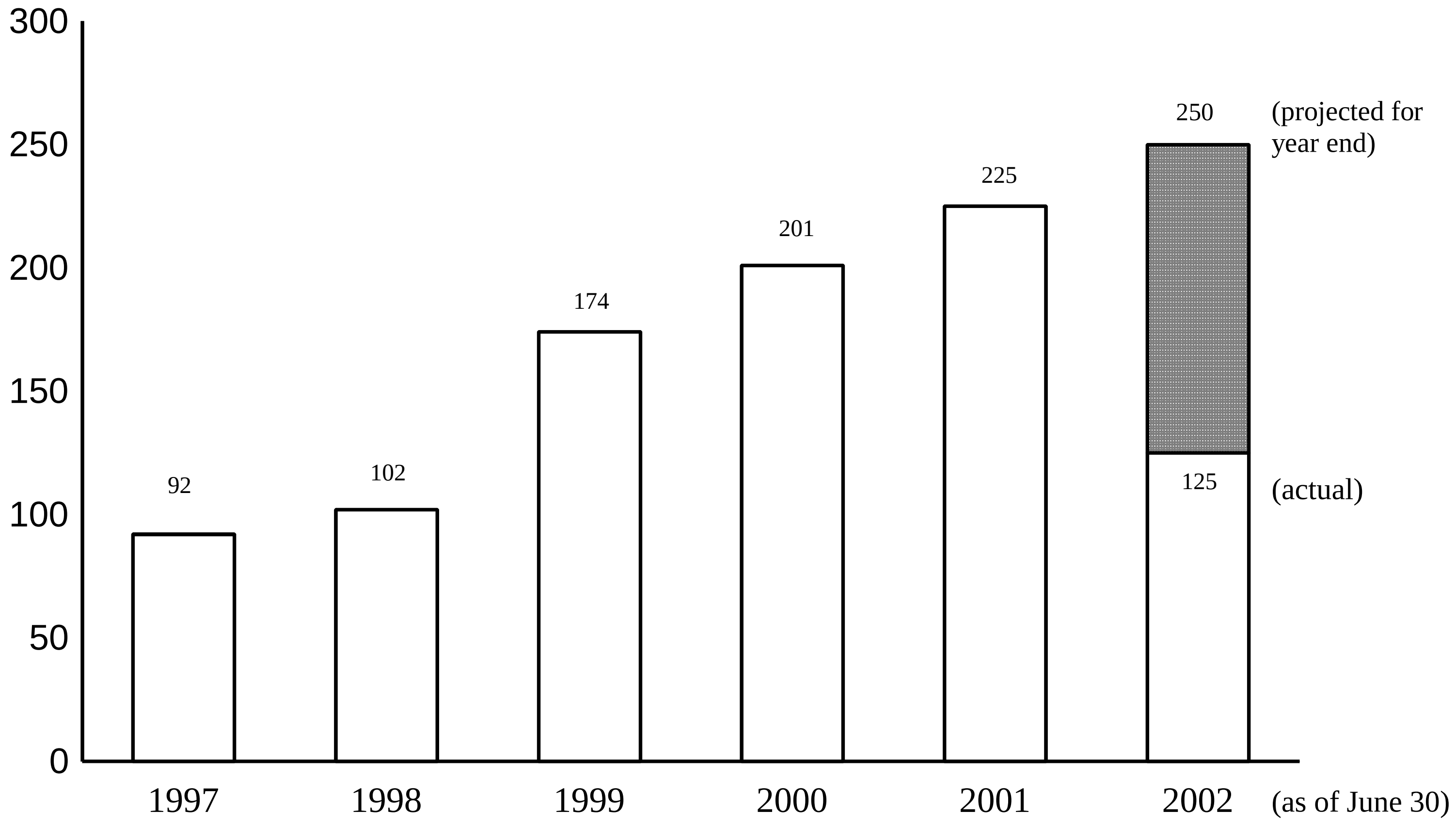
What Happened to Gatekeepers in the 1990's?

Figure 1: Total Number of Restatement Announcements Identified, 1997-2002



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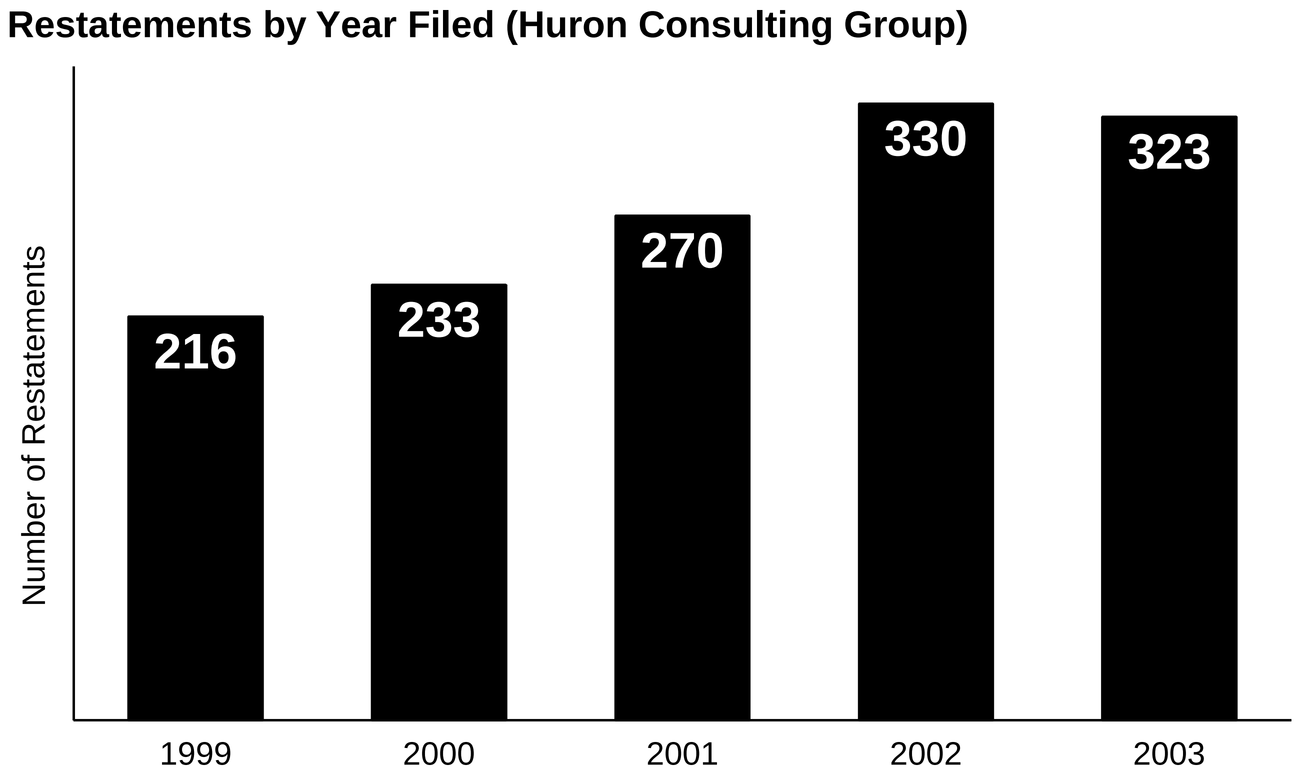

Restatements by Year Filed (Huron Consulting Group)
Number of Restatements
216
233
270
330
323
1999
2000
2001
2002
2003

Do Restatements Matter?

1. Restatements were pervasive. Between 1997 and 2001, between 10% and 12% of all U.S. corporations listed on a stock exchange restated their financial statements at least once. (This may be only the tip of the iceberg because corporations resist restatements, which trigger litigation and SEC investigations).

2. But are restatements meaningful? For example, they could reflect simply heightened SEC formality which could have produced many "technical", but meaningless, restatements. Also, many restatements actually increased earnings.

3. The best answer is that the GAO study found that the typical restating firm lost 10 percent of its market capitalization over a 3-day trading period surrounding announcement. GAO estimate of total loss: $100 billion for just the restating firms. Thus, even if some restatements increase value and others are meaningless, the average impact is highly negative.

4. Other studies:

   Richardson et. al. (2002) – from 1971 to 2000, restating firms lost 11% over 3 days but 25% over a window period starting 120 days before to 120 days after.

   Anderson and Yohn (2002) – The most negative market reactions are associated with those restatements involving revenue recognition issues.

   GAO – revenue recognition issues were the most common cause of restatements, accounting for almost 38% over 1997 to 2001.

What Lurks Behind "Revenue Recognition" Issues?

1. Revenue recognition issues have always been common and a major issue in U.S. accounting, but during 1990s, their character changed.

2. Formerly, the dominant problem was the "rainy day reserve," as corporate managers held back and delayed the recognition of income in order to have a cushion for a future period in which there was an earnings shortfall. The goal was "income smoothing" – avoiding a jagged series of peaks and valleys in favor of steadily, but slowly, rising earnings. This masked volatility and reassured investors.

3. But in 1990s, managerial behavior changes. The new pattern became premature recognition of income, as contingent sales (or consignments) are recognized directly into earnings. Other abuses: "channel surfing"; side letters regarding buy backs, etc.

4. What explains this change in behavior?

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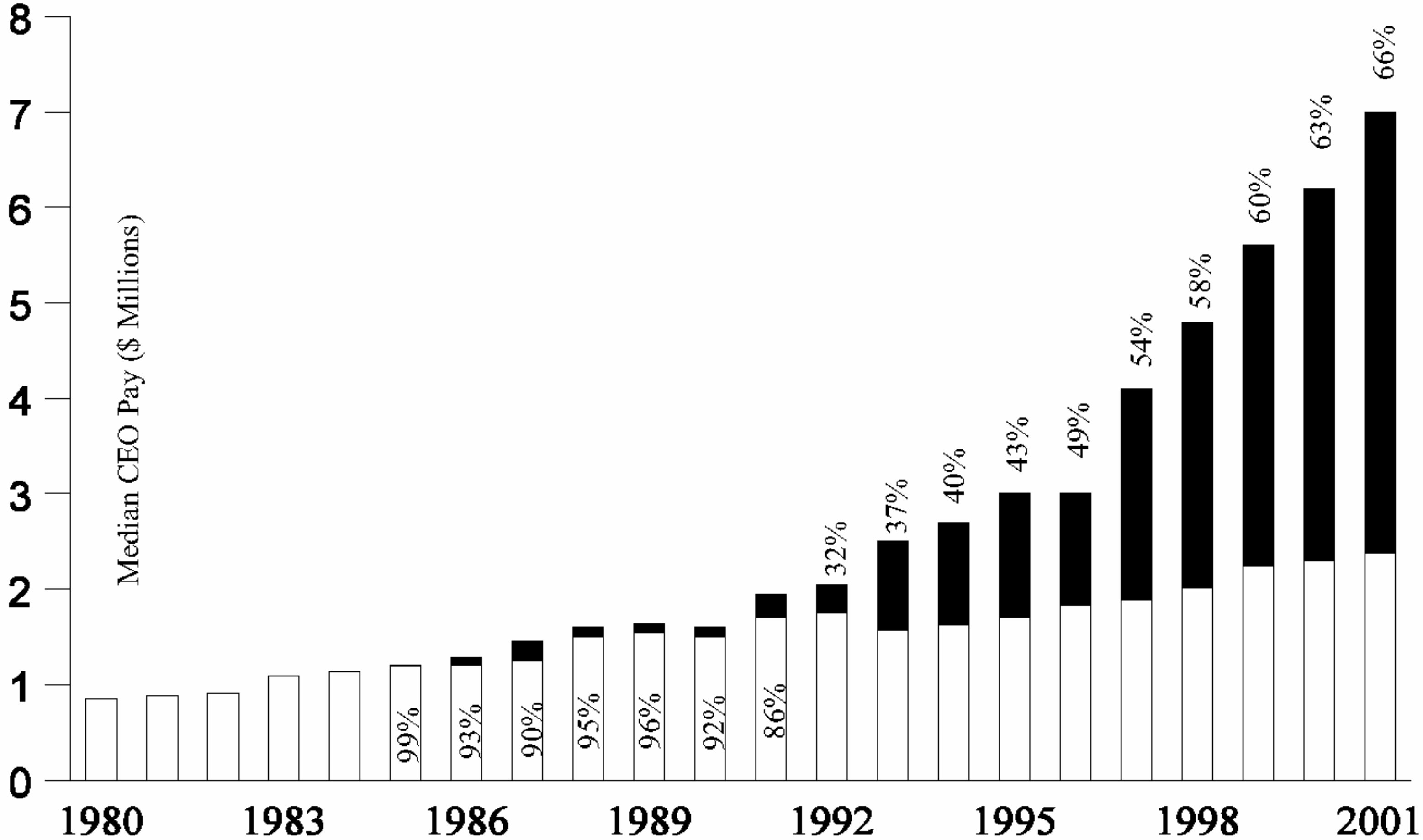

(Source: Brian J. Hall, Harvard Business School)

Cash Versus Equity Compensation

1. Under a system of cash compensation, managers have less incentive to maximize stock price, but greater incentive to pursue growth maximization. Why? Increased firm size correlates both with higher salaries and a lesser risk of bankruptcy.
   Result: Inefficient Empire Building and Over-diversification.

2. Under a system of equity compensation, managers have an incentive to inflate earnings and take greater risk. Even unsustainable earnings spikes make sense, because managers can exploit inside information and bail out in advance of a stock price decline.

3. Illustration: Assume a CEO holds options on 2 million shares of company stock, and company's P/E ratio is 30 to 1 (both reasonable assumptions for 1990s). If CEO can cause earnings to be increased by an additional and unexpected $1 per share through premature revenue recognition, market price should soar by $30, and CEO becomes $60 million richer.

4. Leading characteristic of firms that restated versus similar control group: CEOs of restating firms held "in the money" options of $30.9 million while non-restating CEOs held similar options of $2.3 million – a 14 to 1 difference. (Efendi et. al. 2004).

Securities Analysts

Buy to Sell Recommendations

1991	2000
6:1	100:1

What Explains This?

1. Hong and Kubik (2003, J. Fin.): accuracy counts, but career advancement depends more on optimism.

2. The tendency for optimism to outweigh accuracy as a predictor of a career success increased over the period from 1996 to 2000.

3. Tendency to be more optimistic than the consensus of analysts was most pronounced in analysts covering firms underwritten by their employer.

Analyst Stock Recommendations, 1996-2000

	No. of Recommendations	No. of Companies	Strong Buy/ Buy	Hold	Sell/ Strong Sell
1996	22,409	5,480	65.2%	31.3%	3.5%
1997	29,647	6,390	66.4%	30.1%	3.5%
1998	42,321	6,783	66.4%	30.1%	3.5%
1999	43,248	6,806	70.1%	27.1%	2.8%
2000	41,965	6,666	72.1%	26.3%	1.6%

WHAT EXPLAINS GATEKEEPER FAILURE?

1. During 1990s, Changes in Executive Compensation Motivated Corporate Managers to Pressure Gatekeepers Into Acquiescing in Risky Accounting Policies and Inflated Projections.

2. So Motivated, Corporate Managers Found a Variety of Techniques to Increase Their Leverage Over Gatekeepers:

    1. Auditors: Use and Withdrawal of Consulting Income (the "Implicit Bribe" Theory).

    2. Attorneys: The Rise of In-House General Counsel As a Manager of Legal Services Implied Replacement of the Principal Outside Law Firm With a Competitive Auction Market; Outside Attorney Became More of a Technical Specialist With Tunnel Vision.

    3. Analysts: Underwriters Competed for Clients By Promising Favorable Reports From Their "Star" Analyst; Underwriters (and Indirectly Issuers) Subsidized Inflated Analyst Salaries.

3. Common Denominator: Leverage Shifted from Gatekeeper to Corporate Manager.

GATEKEEPER REFORM: The Possible Options

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1. <u>Increase Gatekeeper Liability</u>

    1. Restore Aiding and Abetting Liability
    2. Issue: Can We Afford to Lose Another Accounting Firm?

2. <u>Increased Regulatory Oversight</u>

    1. PCAOB
    2. Issue: Regulatory Capture

3. <u>Gatekeeper Empowerment</u>

    1. Paradigm: SEC's Mandatory Explanation of Auditor Resignation Enhances Auditor's Leverage
    2. SOX 307: Attorney's Leverage is Also Enhanced
    3. Regulation AC: Firm Cannot As Easily Pressure Analyst
    4. Global Settlement's Chinese Wall Between Analysts and Underwriters
    5. Bottom Line: Marginal Effect

4. <u>Revising the Principal/Agent Relationship</u>

    1. SOX Assigns Control Over the Auditor to the Audit Committee
    2. Financial Statement Insurance: Creating a New Principal
    3. Lead Analyst Proposal
    4. Analyst Research Vouchers: Letting Investors Choose Their Own Gatekeeper
    5. Credit-Rating Agencies: Once Funded by Subscribers, not Issuers

5. <u>Antitrust Divestiture</u>

    1. Rationale: Reputational Capital Is a Weak Constraint in Highly Concentrated Markets