

CAN WE BREED FIERCER WATCHDOG INSTITUTIONS FOR USE IN CORPORATE  
GOVERNANCE?

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Corporations produce, collect, verify, analyze, store, and transmit pieces of information that, when properly presented, can accurately describe their periodic performance and financial condition. Because insiders have an inherent informational advantage over outside stakeholders, common sense dictates that governance systems should empower independent parties to monitor corporate behavior and reports. Accounting standards and corporate controls are supposed to flag irregularities in corporate reports for close follow-up review by inside and outside “watchdogs.” A watchdog’s job is:

“to probe, to uncover, to check, to expose, to unveil, to question, to interrogate . . . to disbelieve, until that which we are being told can be proved to be true.” (Forsyth, 1999).

Watchdogs lower stakeholder coordination costs by designing and enforcing disclosure requirements and by policing managerial behavior. Internally, a firm’s board of directors and auditing team are tasked with developing sound and comprehensive reporting safeguards and detecting deviations from them. Externally, the reliability of the work of internal watchdogs is tested by other specialists. These external watchdogs include: outside auditors, stock analysts, credit-rating agencies, standard-setting professional organizations, regulators, government examiners, law-enforcement personnel, and information media (the “press”).

Recent corporate scandals show that corporate officers are often reluctant to communicate adverse information about a firm’s performance and risk-taking either to their boards or to public watchdogs and other outside parties. In many countries, flaws in the ethical codes of watchdog professions encourage their members to cunningly abet the manufacture of misinformation.

In the U.S., the Sarbanes-Oxley Act of 2002 placed strong truth-telling obligations on corporate officers and increased penalties for misrepresenting material facts. However, the Act did nothing to increase accountability for accountants that help dishonest officers by offering to search out reporting loopholes that provide defensible ways to certify deceitful claims. This asymmetry is no accident. As Robb (2003) points out, the accounting profession has a worldwide history of opposing meaningful reform.

As long as auditors can mask malicious or fraudulent *intent*, they can weasel out of civil liability for abetting client concealment. An accounting firm can do this by requiring clients to accept covenants in audit-service contracts designed to limit its responsibility to affirming that any figure its employees bless was constructed by one of several professionally “approved” techniques. Professional norms and codes do not require auditors either to highlight particularly aggressive assumptions, to use statistical methods to double check the reliability of dodgy facts and projections against the implications of relevant other evidence, or to express specific suspicions they may have about potential bias or distortion.

Treating information and disinformation as fluids pumped from corporate pumping stations, Figure One illustrates what happens when a gap exists between the accountability for truth-telling imposed on corporate insiders and the accountability assigned to producers of watchdog services. The conflicts of interest such a gap creates undermine the career prospects of conscientious accountants who might otherwise be disposed to accurately inform outside interests. This accountability gap makes it possible for an opportunistic auditor to generate concealment revenues for his or her firm and disguise them as payments for ancillary services. In many countries, a successful revenue rainmaker can advance more rapidly in the accounting industry today than an equally talented, but conscientious employee. Career ladders that advance unscrupulous individuals help to explain the industry’s resistance to reform, because highly placed, but unscrupulous rainmakers must be expected to lobby for professional standards that protect the rents their firms can earn from abetting deceitful behavior.

While philosophers find it impossible to formulate universal moral principles, in the U.S. and other former British colonies, common-law theories of corporate contracting impose broad duties of competence, loyalty, and care on all stakeholders. Although hard

to enforce, these duties require insiders and outsiders alike to explore the economic perspectives of outside stakeholders and to avoid doing net (i.e., insufficiently compensated) harm to any of them.

This principle of nonexploitation expresses a “Golden Rule of Corporate Governance.” This rule can serve as a touchstone by which to pinpoint conflicts in the incentive systems under which real-world corporate managers and watchdog professions operate.

In formulating and enforcing standards that define conscientious performance, every profession courts the respect and confidence of the general public. A profession’s incentive system is “evenhanded” or “impartial” if it minimizes temptations for its members to engage in inefficient, dishonest, or exploitive behavior. Until the ethical code of any nation’s accounting industry firmly embraces two Golden Rule duties—to avoid corrupting forms of compensation and to assure the economic meaningfulness of the income and net-worth figures corporations publish—the profession will find it hard to garner the authority and prestige its members covet.

The issue is not whether accounting standards should be rules-based or principles-based. Nor would it make much difference if audit firms were banned from performing a few specific types of nonaudit services. As long as deception is profitable, the rents generated by opportunistically creating and widening reporting loopholes will support career ladders that penalize the exercise of principled behavior by individual watchdogs.

The most reliable way to improve accounting transparency is to make loophole mining less profitable. A reform that could do this would be to insist that any firm that supplies external auditing services either directly insure end-users against provable harm from its work or write the directors and officers liability insurance policies in force at each and every firm whose corporate reports it certifies. By requiring these products to be produced in tandem, a government could ensure that whatever the auditing arm might earn from hiding poor performance or bad behavior at a client firm would be closely offset by the liability it creates for the organization on its insurance book.

**REFERENCES**

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Robb, Alan, 2003. "Reluctant Reformers Fall Short," *The New Zealand Herald* (June 17).

**Figure One:  
Age-Old System for Transmitting and  
Imperfectly Purifying Data on  
Corporate Condition and Performance**

