December 24, 2002

Via Electronic Delivery

Art Berkowitz
Richard Rampell
Wall Street Journal

Re: Rules v Principles

Art and Richard:

I have a few comments to add to the "rules v principles" debate. Basicially, I agree with one of your readers who suggested that the problem is one of corporate governance. But, I suggest that current tax law and lamentable ethical standards in the accounting profession are significant contributors to the problem.

Corporate Governance

In summary, I believe that boards of directors are ineffective because they have inadequate information. I also believe that the current audit system under which management prepares the financial statements, hires the auditors to vet those statements, and then certifies the statements relying in part on the opinion of the auditors creates perverse incentives. In my opinion, both of these problems can be addressed by having the audit committee of the board hire the auditors. [This proposal is discussed in greater detail in my comments – both attached – on the following two articles: *Why Good Accountants Do Bad Audits,* **Harvard Business Review**, Vol. 80 No. 11 (November 2002) and William O Douglas' famous 1934 **Harvard Law Review** article, *"Directors Who Do Not Direct"*. These comments presume familiarity with the articles.]

"113002 Comments on HBR Audit Quality

"112102 Douglas - Directors Who Do Not

An additional problem is the limited scope of audits. Currently, auditors do not consider issues that are not material, either individually or in the aggregate. The problem, of course, is that if the auditors are not looking at the individual issues or how many of them there are, they do not get the opportunity to come to a conclusion as to whether all of the individual issues would be material in the aggregate. And, management's financial statements are based on financial data reported by the business units and this data is usually never audited because it is not material. I flesh this idea out in point 5 of my correspondence, also attached, to Brad DeLong, a Clinton Administration economic advisor now at Berkeley. [The other matters addressed in this correspondence are irrelevant to this debate.]

"DeLong Correspondence..pdf"

Tax Law

There is an on-going debate over the corporate income tax and the double taxation of dividends. Whatever the proper tax policy should be, I think we must recognize that the inability of corporations to deduct dividends is a significant contributing factor to the current problems we are experiencing with the quality of financial statements.

The current tax law incentivizes corporations to retain earnings. When the corporations reach the point at which they cannot use these retained earnings to grow their core businesses, they acquire new businesses. As the corporate enterprises get larger and larger and their corporate structures become more complex, their financial affairs become extremely difficult to monitor, even by management.

Auditor Professionalism

From my somewhat biased perspective as a lawyer, accountants seem to have abandoned any aspirations of professionalism. In their engagements, they seek every limitation of liability and every disclaimer of responsibility like so many landscape contractors. The bar is no paragon of professional virtue, but lawyers do subscribe to professional standards that would not allow them to limit their obligations to their clients and the public in the same manner as accountants.

I hope these comments contribute to the debate.


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