

ECONOMIC SCENE

# Accounting for badapples: Investors in the stock market render their verdicts.

By ALAN B. KRUEGER

Published: July 25, 2002

A STRING of scandals and investigations involving aggressive accounting practices has shaken confidence in corporate America and helped cause the stock market to sink to new lows despite a recovering economy.

If just a few bad apples are behind these scandals, as President Bush has suggested, his administration has surely implied that Arthur Andersen, the beleaguered accounting firm, is one of them. With unusual speed, the Justice Department sought an indictment of Andersen in March. In addition, the General Services Administration suspended Andersen from conducting new business with the federal government. In June, Andersen became the first major accounting firm to be convicted of a criminal charge -- obstructing justice for shredding documents related to the Enron investigation.

Andersen had certified the books for Enron as well as for WorldCom, Global Crossing, Sunbeam and Waste Management, companies involved in some of the largest recent financial scandals. Andersen was also the auditor for Halliburton and Harken Energy.

To much of the public, the once-venerable Arthur Andersen has become synonymous with distrust in accounting. The comedian Jay Leno joked of a new cooking show, "Cooking the Books With Arthur Andersen."

But investors in this bear market have eventually come to devalue companies that did not use Andersen as their auditor as much as they devalued Andersen's clients.

To gauge how far investors' lack of trust extends beyond Andersen, one can compare the stock market performance of companies audited by Andersen with those audited by the other major accounting firms.

After initially faring worse following disclosures concerning Enron's collapse and Andersen's indictment, the market value of companies that had been audited by Andersen fared about the same as those that were audited by rival accounting firms by the second quarter of 2002.

Specifically, the auditor of each company listed in the Standard & Poor's index of 500 stocks was identified as of November 2001. Two stock portfolios were then constructed: one consisting of the 80 companies (excluding Enron and WorldCom) that were audited by Arthur Andersen and another consisting of the balance of companies in the S.& P. 500, which were audited by other accounting firms.

The average cumulative stock market return for each group of companies -- adjusted to balance differences in the industry mix -- was tracked from Oct. 1, 2001, until last week. A report on these results that Kenneth Fortson and Alexandre Mas, two Princeton graduate students, and I prepared is online at [www.irs.princeton.edu](http://www.irs.princeton.edu).

Companies in the S.& P. 500 audited by Andersen fared about as well as those audited by another accounting firm

during October 2001, before news of the shredding of Enron documents became public.

From the end of October to early January, stocks of Andersen's clients performed about 5 percentage points worse than those of rival firms, on average. The gap narrowed briefly in late February but opened up again in early March, just before Andersen was indicted.

Significantly, the gap in stock returns between Andersen's clients and those of rival accounting firms began to evaporate in April of this year and disappeared entirely by the end of June.

The lower performance of shares in companies audited by Andersen from November through April may reflect, in part, a greater loss of confidence in those companies by investors.

Another factor, however, is that Andersen's clients tended to have lower "betas," a common measure of how closely the returns from one stock move with the overall market. Historically, it turns out that Andersen's clients had less volatile returns than those of other companies, even after adjusting for major differences in industry composition. So, perhaps it is to be expected that the market value of Andersen's clients rose less quickly when stocks rose in the post-Sept. 11 rally and fell less sharply when the market declined over the last few months.

Regardless, by June the stocks of companies that were not audited by Andersen had lost just as much value as those of companies audited by Andersen, suggesting that investors have not lost comparatively more faith in companies audited by Andersen.

Frank Vannerson, chairman of the Mount Lucas Management Corporation, stressed that the role of the stock market bubble must be remembered in interpreting these results. "We had a period of out-and-out mania, and 'corner-cutting' (as distinct from fraud) was widespread," he said. "Accounting firms were deeply involved -- all of them. In a bubble it could not be otherwise."

He continued: "Andersen fell (or was pushed) on its sword, but there is little chance that they were any more aggressive than the others in condoning corner-cutting schemes. Probably every non-Andersen firm in the S.& P. has been quietly purging their income statements of 'tainted' earnings." This might be responsible for their relatively weaker returns, compared with Andersen's clients, since April.

Rather than attributing the lack of trust to "bad apples," Mr. Vannerson prefers an analogy to a "flu epidemic -- sort of a general decline in community ethical health."

If this is the case, then restoring the patient to full ethical health will not be easy or quick. And it will probably require changes in incentives to align the interests of corporate management, accountants and boards with those of the public and investors. This is most likely to require preventing potential conflicts of interests between accounting firms and their clients, giving boards more independence, mandating greater disclosure of financial data and reducing managers' incentives to maximize short-run paper profits at the expense of longer-run profits and viability.