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Reaffirming Cynicism

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Free marketers have always known that the government rarely does a good job at providing wise regulation. That is a bleak truth, but still a truth. And the truth sets you free, financially.



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So investors are on notice: they will have to rely on their own resources—their own invisible hands, as it were—to protect themselves in a difficult market. Unfortunately, the real reforms that would help the market, such as cutting tax rates and repealing the double taxation of dividends, are not under discussion.

When corrupt and crooked executives are taken away in handcuffs and led down the "perp walk" into the courthouse, it does not go unnoticed in the boardrooms and executive offices across America. The resulting "fear factor," coupled with new laws and regulations, is fostering more rigorous corporate accounting and watchfulness. More importantly, President Bush committed to cleaning up corporate America when he spoke on July 9th to America's financial and corporate leaders and promised punishment and enforcement of corporate wrongdoing.

Yet, despite the rhetoric, momentum of indictments and investigations of financial fraud, it remains to be seen how enduring the trend will be toward cleaner accounting practices in corporate America. Indeed, we have just seen a disheartening sign that the government is not doing the job that it promised.

So what is so disheartening? On October 25th, an angrily divided U.S. Securities and Exchange Commission voted to approve five members of a new national board to police corporate accountants, with ex-FBI chief William Webster as chairman. After a damaging public political struggle for the board's top job, the 78-year-old Webster edged out the extraordinarily qualified John Biggs, the retired TIAA-CREF pension fund manager who has a long record of advocacy of real accounting reforms, including such transparency-creating, confidence-building changes as mandating the proper corporate expensing of options.

John Biggs is universally revered and respected. The eminent Wall Streeter, Peter Peterson, chairman of The Blackstone Group, called Biggs "an absolutely outstanding individual. I can't think of a better guy to do the job." And why not? Biggs, after all, had spent his career as a fund manager looking for ways to make stock prices go up, not so he could cash in quick, but so that he could distribute the proceeds to the retirees who depended on him. As Peterson said, it's hard to think of a better person for the post: someone who believes in solid economic expansion, not here-today-gone-tomorrow bubbles.

"I have tears in my eyes," said John C. Bogle, founder and former chairman of the Vanguard Group, who supported Mr. Biggs. "I just don't see how this can give the markets any reassurance. It's just more of the same old political stuff." Mr. Bogle said that investors were probably so cynical that they could not be disappointed further. "That cynicism is just going to be reaffirmed by all this," he said. "It's just a spectacular blunder."

Yet on a 3-2 party-line vote, Webster became the first chairman of the Public Company Accounting Oversight Board which is being set up under the Sarbanes-Oxley Act, the corporate crackdown passed by Congress earlier this year.

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Backers of Biggs have publicly and loudly accused SEC Chairman Harvey Pitt of mishandling the board selection process. SEC Commissioner Harvey Goldschmid, a Democrat, was quoted at the SEC meeting with saying, "As a whole, the selection process has been inept. This is not the right job for Bill [Webster]... He has no real accounting expertise." Pitt replied with the following statement: "I am fiercely independent. I am beholden to no one. At no time since this process began has any member of the accounting industry ... or any member of the Republican Party sought to influence my judgment." Yet my sources tell me that Pitt did indeed give in to pressure from the accounting industry and its allies in Congress.

So now we have Webster, a lawyer and judge named to run the FBI by President Carter in 1978 and to head the CIA by President Reagan in 1987. So yes, he has lots of bipartisan "cred" inside the Beltway, but what he really needs is Street-savvy in Manhattan. Speaking for the savvies, here's what Alan Ableson had to say in the October 28th issue of *Barron's*:

Instead [Pitt] chose William Webster, a venerable and amiable Washington type who everyone agrees has had a "distinguished career," which means he has never caused a ripple or left the slightest mark on any of the government agencies that fell his way, including the FBI and CIA. What really cinched the choice for Mr. Pitt was the persistent if unconfirmed rumor that Mr. Webster did not know a credit from a debit.

In the meantime, the accounting scandals continue to plague the headlines. Recently, media giant AOL Time Warner said that it would now restate revenues by \$190 million. The amount of questionable accounting first announced at AOL Time Warner had originally been \$49 million, but it just simply continues to grow. Another example is the now-bankrupt telecom giant, WorldCom, which first reported \$3.8 billion in fraudulent accounting on June 25th. Since then, the number has continued to grow-now it's \$7.2 billion.

In addition to concern over the appointment of Webster to head the Accounting Oversight Board is a separate concern regarding SEC funding. The Bush administration asked for \$200 million less in the agency's enforcement budget than was originally called for in the Sarbanes-Oxley law. Although subsequently, President Bush's budget director, Mitchell Daniels, Jr. has just indicated that the administration is willing to accede to a higher dollar total "if the agency needs more money to fulfill its duties."

To be sure, more funding is never a guarantee of greater bureaucratic output. The New York City public schools spend some \$14 billion a year-up a third in just the past five years, approximately \$13,000 per pupil-and yet few parents enroll their children there if they have a choice. Similarly, nobody would warranty that federal regulatory agencies automatically do a better job with funding increases. But, in this particular case, given the vital importance to the overall economy of cleaning up corporate books, it's worth a try-although of course, the need to go over the proper allocation of each of Uncle Sam's nickels is yet another argument for an experienced accounting hand at the helm, such as, say, John Biggs. My fear is that markets will conclude that barely three months after Bush's tough speech of July 9th, his approach will seem more rhetorical than real.

Still, the worst part of this controversy over Webster is that it detracts attention away from the most urgently needed reform of all: putting an end to the double taxation of dividends. That is, eliminate the economically counterproductive law, on the books, today, that taxes corporate income twice: once as it comes into company coffers and a second time when it is remitted to individual shareholders. Thus the total tax bite on profits can be as high as 61%. With such high tax rates, capital gains, taxed at a mere 20% percent, become a sort of shelter. And that's what's happened lately: corporate executives and shareholders have both agreed that it's better to have a fast run up in the stock price-even if it's only

temporary-than a genuine increase in profits. Why? Because insiders can sell the stock at a high price and pay the low capital gains tax rate, while if they take the money out of the company in dividends, they would pay roughly three times a higher rate of tax.

The point here is not to reward bad corporate behavior with a tax cut. The point here is to streamline the system, so that just as the accounting rules provide hard "sticks" to guard against bad behavior, so the tax rules provide juicy "carrots" to reward good behavior.

The stock market would likely resume a strong upward curve if the accounting rules were solid, and it would go up even further, faster, if the double taxation of dividends were eliminated.

But in the meantime, we, the shareholders, must deal with the situation as it is. Therefore, the old verities are as important as ever. Such as? Invest in companies that have been around for a while. Invest in companies that you know, such that you can understand what they do-it's easier to deceive investors about a claimed 1,000% increase in fiber optic demand than it is to misrepresent the popularity of Wal-Mart or Costco or the demand for Cheerios or Tylenol. All you have to do is look at the parking lots or in people's kitchen and bathroom cabinets and the truth will be staring back at you. And from such simple truths comes the larger truth: if people are buying the company's products, the stock will do just fine.

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