Back to the Agency Problem

Back to the Agency Problem

- How do you motivate the CEO to work hard?
  - Board of directors
  - Profit Sharing
  - Auditors

Board of Directors

- In theory supposed to Monitor the CEO, but they sometimes get “captured”.

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- Make boards external.

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- And how do you motivate persons to go on a board?

Board of Directors

- In theory supposed to Monitor the CEO, but they sometimes get “captured”.
- Make boards external.
- And how do you motivate persons to go on a board?
  - Time and effort
  - Risk

Profit Sharing

- Pay the CEO with generous profit sharing, and stock options. That way when you make money, he makes money. (Maybe)

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Back to the Agency Problem

Profit Sharing

- Pay the CEO with generous profit sharing, and stock options. That way when you make money, he makes money. (Maybe)
- Two issues
  - If you don't pay him, he will cheat you with inattention.
  - If you do pay him, he may still cheat you with phony books.

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Back to the Agency Problem

The Basic Idea

- The Accountants were supposed to prevent fraud, like the bank supervising your Saturday employee from conspiring with the bank teller.
- Things did not work as planned.

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Back to the Agency Problem

So What Else is New

- "Behind every accounting standard there lies a fraud"
- The McKesson Robins fraud of the 1940's

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Back to the Agency Problem

The Accountants

- Some cases
  - Enron
  - Global Crossing
  - World Com
  - Tycho
  - Xerox
  - Health South

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Back to the Agency Problem

Enron

- Enron would enter into a contract to sell power at (say) $50 a MWH.

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Back to the Agency Problem

Enron

- Enron would enter into a contract to sell power at (say) $50 a MWH.
  - If power went to $500 a MWH, Enron stood to lose a lot of money; good accounting required disclosure.
  - But Enron had contracts with other companies to cover this risk. Someone else was "naked". No disclosure.

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Back to the Agency Problem

Enron

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There were secret deals where Enron was responsible for the risk.

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Back to the Agency Problem

Taking in each others wash

- Global Crossing signed a contract to purchase $100 of services from another company.
- The other company signed a contract to purchase $100 of services from Global Crossing.

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Back to the Agency Problem

Taking in each others wash

- Global crossing counted the $100 of sales as revenue, and expensed the $100 it was to pay over (say) next 20 years.
- Thus net profits of $95 this year.

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Back to the Agency Problem

Taking in each others wash

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Back to the Agency Problem

Taking in each others wash

- Global crossing counted the $100 of sales as revenue, … pay over …
- Thus net profits of $95 this year.
- So did the other company.

This seems curious.

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Back to the Agency Problem

Taking in each others wash

- Global crossing counted the $X of sales as reve… ay ove… d $5 … 20 years)
- So did the other company.

The two companies were audited by different accounting companies.

World Com

- Took $4 billion of expenses and treated them as capital expenses.
- That is

$4,000,000,000

World Com

- Took $4 billion of expenses and treated them as capital expenses.
- That is

$4,0…

No one caught it.

Arthur Andersen

Securities Analysts

The Accountants

- Some cases
  - Enron
  - Global Crossing
  - World Com
  - Tycho
  - Xerox
  - Health South

End