percent of its value. Even though the S&P 500 is up more than 30 percent since March 2003, it is still 30 percent below the peak in 2000 and many investors are reluctant to dive back into the market. As the economy continues to improve, we expect to see the stock market also continue to make gains, although at a less spectacular rate than the experience this year. In the long run, we expect the stock market will offer returns 6 percent to 8 percent above treasury bonds, which is in line with the market’s historical average performance since 1926, but well below the returns investors were experiencing in the 1990s. As always, prudent investors should continue to diversify their portfolios, guarding against too much exposure to any individual stock, market, or asset category.

Summary
The financial markets have clearly changed in the past decade and a new reality must be accepted. We cannot remain passive—action must be taken to align our business and investment strategies with this new reality. As that great philosopher Yogi Berra once said, “When you come to a fork in the road, take it.”

So far, the SEC’s answers are weak, perhaps demonstrating the depth of the problem...

In the meantime, companies and auditors continue the journey without a good map.

Financially, company financial statements and tax returns are prepared with integrity by honest managers and audited by competent professionals with proper skepticism. Fraud and misleading reporting barely impact economic projections. Confidence in financial statements has been damaged, though, because a few people took advantage of trust and position, supported by others who did not carefully guard company assets and the sanctity of financial reports. Unfortunately, examples have been prominent and the media properly made certain we did not miss any.

Financial reporting is self-regulated. Managements prepare reports, interpreting how to report results. Reports are seldom immediately reviewed by regulators and may never be reviewed. Managements’ greater fear is that analysts, strike lawyers, competitors, or reporters will find errors in the financial statements. Self-regulation will not change, and there is no need to change it.

Notwithstanding this conclusion, we have learned, or have at least been reminded from recent experiences, that certain aspects of the financial reporting system need to be fixed.

Standards for Financial Reporting
We need to fix Generally Accepted Accounting Principles (GAAP), the benchmarks for financial reporting. Accountants are overwhelmed with the standards setting process.

Financial statement readers want reports on assets and liabilities in a world that is trading elements of assets and liabilities. It is difficult to reduce business complexity to simple, transparent financial statements. Assets and liabilities today are carved into elements, dividing shared responsibility and ownership. For example, engineered transactions like special purpose entities have never been dealt with effectively by those who decide GAAP. Today, two years after Enron, a debate continues over variable interest entities, as companies try to understand a proposed standard that is getting old before it is even implemented.

The standards setting process is emotional and political. Debate is less about accounting theory than the impact on financial position and capital allocation.

To address the GAAP problem, a new law, Sarbanes-Oxley, directed the Securities and Exchange Commission (SEC) to do two things: decide who is in charge of GAAP and whether GAAP should be principles-based or rules-based.

So far, the SEC’s answers are weak, perhaps demonstrating the depth of the problem. A year after the passage of Sarbanes-Oxley, the SEC has concluded that the Financial Accounting Standards Board (FASB) is in charge, but the SEC directed the FASB to further develop the conceptual framework of accounting, eliminate bright line tests, manage the convergence of U.S. standards with the rest of the world, and complete other difficult tasks.

The SEC answered the question of principles-based versus rules-based by concluding that standards should really be objectives-based. Companies and auditors continue the journey without a good map.

Internal Controls
Sarbanes-Oxley addressed a second problem: internal controls over financial reports. Internal controls are activities that assure companies achieve business objectives, not the least of which is good financial reporting. Some companies do not have good internal controls. But even if they do, bad managers can ignore the controls and initiate improper transactions in financial statements.

Internal controls have never been well documented. They develop more from instinct, similar to the way a person dons a coat when it is cold. Documenting instinct seems to add little value. But many risks
need for controls are not as obvious as temperature changes. Formal development and documentation can help.

Sarbanes-Oxley requires new reporting to investors on the effectiveness of internal controls. These new requirements exposed the truth about controls. Documentation does not support evaluations by management and auditors. As a result, documentation of controls is now done on a crash basis by smart people lacking business school background on what constitutes good internal controls. Required reporting has been delayed one year.

The requirement is controversial because compliance is expensive. Audit fees have increased dramatically and companies are investing heavily in compliance. Many managers wonder if we are preparing for the possible or the improbable.

Auditors
Auditors are a separate, complex problem. Auditors assure investors about the reliability of financial reports, but auditors know there is an "expectation gap." Auditors cannot accomplish everything expected. Auditors work from a risk model that weights costs of finding problems. The model accepts undiscovered reporting problems when the cost to find them is too high. When the expectation gap becomes a problem, the argument is about auditor negligence, so difficult to defend in hindsight. Accounting firms manage this risk through contracting, legal defense, settlements, stop loss organizational structures, and insurance. If these fail, partners melt into other firms, leaving the damage behind.

Confidence in auditors has suffered. Auditors proudly proclaim their own self-regulation, administered through the American Institute of Certified Public Accountants. Firms use self-inspections and peer reviews. But many suspect they easily pass each other’s work, failing to identify serious deficiencies and independence issues.

The past haunts the accounting profession. Investors are troubled by self-regulation and audit quality. Large firms face huge litigation claims and their nonaudit practices are viewed with suspicion. Smaller firms do not want to assume the responsibility. Sarbanes-Oxley established the Public Company Accounting Oversight Board to qualify and register firms before they can audit public companies and to inspect the practices of firms. But with four firms auditing 99 percent of all public company sales, there is doubt about meaningful regulation. Regulation is premised on fear that failure by any of the four will result in restructuring the profession and may require change in our assurance model.

Conclusion
The problems are difficult, but not addressing them leaves open doors to those who will take advantage of any opening. The overwhelming majority of honest managers and competent professionals are embarrassed and maddened by the actions of those who caused the dramatic changes now being implemented. How can so few cause so much damage for all? Most business people can, and do, make decisions every day against temptation, greed, arrogance, and self-interest.

Knowing the great damage caused by a small minority, the majority must balance that harm with humble, generous service, recognizing that each decision leaves a trail showing a willingness to be open and honest.

Table 1
Housing and Interest Rate Forecast

<table>
<thead>
<tr>
<th>Housing (in thousands)</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Starts</td>
<td>1,573</td>
<td>1,601</td>
<td>1,711</td>
<td>1,786</td>
<td>1,700</td>
<td>1,658</td>
</tr>
<tr>
<td>Single Family</td>
<td>1,232</td>
<td>1,272</td>
<td>1,364</td>
<td>1,445</td>
<td>1,381</td>
<td>1,358</td>
</tr>
<tr>
<td>Multi-Family</td>
<td>341</td>
<td>330</td>
<td>347</td>
<td>341</td>
<td>319</td>
<td>300</td>
</tr>
<tr>
<td>New Single Family Home Sales</td>
<td>880</td>
<td>907</td>
<td>977</td>
<td>1,065</td>
<td>994</td>
<td>985</td>
</tr>
<tr>
<td>Existing Home Sales</td>
<td>5,158</td>
<td>5,282</td>
<td>5,595</td>
<td>5,986</td>
<td>5,712</td>
<td>5,653</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Interest Rates</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Rate</td>
<td>8.1%</td>
<td>7.0%</td>
<td>6.6%</td>
<td>5.9%</td>
<td>6.3%</td>
<td>6.8%</td>
</tr>
<tr>
<td>ARMs</td>
<td>7.0%</td>
<td>5.8%</td>
<td>4.6%</td>
<td>3.8%</td>
<td>4.2%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Prime Rate</td>
<td>9.2%</td>
<td>6.9%</td>
<td>4.7%</td>
<td>4.1%</td>
<td>4.1%</td>
<td>5.6%</td>
</tr>
</tbody>
</table>

Source: National Association of Homebuilders