

CHAPTER 28

Corporate Governance and Accountability

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INTRODUCTION

Corporate governance consists of a set of internal procedures, laws, and informal guidelines that govern how corporate officials make decisions and who bears responsibility for harms, losses, or injuries that flow from such decisions (Iksander and Chamlou 2000; Monks and Minow 2004; Thomsen 2008). The objective of the system is to ensure that corporate decisions are made with the best interests of the corporation and its stakeholders in mind and that corporate officials speak truthfully when communicating with investors and the public (Sale 2004).

The principal challenge for corporate governance is to create a system that holds decision makers accountable while according proper respect to their authority over the corporation. The standard accountability mechanisms are the market, shareholder voting, and civil and criminal liability. In theory, these mechanisms work together to create incentives for responsible decision making and to deter self-dealing or other forms of misconduct. In reality, however, each of these accountability mechanisms contains flaws that allow corporate officials to sometimes exercise an unreasonable degree of discretion when making decisions that affect the fortunes of so many. When governance systems fail, the impact can be devastating for investors, employees, and the economy. Recent corporate scandals and the near-collapse of the global financial system all demonstrate the importance of maintaining an effective corporate governance regime.

This chapter begins with a description of the principal sources of corporate governance standards. It then provides a detailed examination of federal oversight of financial reporting, and identifies significant problems within the oversight system. Next, it describes prospective corporate governance reforms proposed in response to the 2008 financial crisis. The final section offers summaries and conclusions.

SOURCES OF CORPORATE GOVERNANCE STANDARDS

In the United States, corporate governance standards arise from an amalgam of state law, federal law, and stock exchange standards, as well as guidelines and

principles devised by private organizations. Together these laws, listing standards, and informal guidelines create a structure designed to provide accountability for corporate decision makers.

State Law

The base layer of corporate law rules are set at the state level through statutes and case-by-case decision making in the common law tradition. Under the internal affairs doctrine, the law of the state of incorporation governs disputes that arise between corporate officials, shareholders, or creditors. By choosing a state of incorporation, corporate managers select the law that governs the substance of their relationship with creditors, shareholders, and the state. Delaware has long been the leading choice for state of incorporation for large publicly traded corporations, leading many to argue that Delaware has led a race to the bottom in corporate law (Cary 1974; Nader, Green, and Seligman 1976). Others maintain such competition has instead created a race to the top for optimal legal standards in corporate law (Winter 1977; Romano 1993).

Under state law, a corporation's directors are charged with managing the business and affairs of the corporation (Delaware General Corporation Law 2002, § 141). Directors delegate this authority to executives who manage the day-to-day affairs of the firm. Ostensibly, shareholders elect directors at the annual meeting. As Bebchuk (2007) and others indicate, however, the board of directors tends to be a self-perpetuating body and shareholders have little practical ability to displace directors when dissatisfied with their performance.

State corporate statutes provide little guidance regarding a director's duties. Instead, the contours of these duties have developed through common law decision making in courts. Through common law doctrine, courts have established that directors and officers owe fiduciary duties to their corporations. These obligations include duties of care, loyalty, candor, and good faith, which require directors to manage the corporation with diligence and to advance the interests of the corporation rather than their own (*Guth v. Loft* 1939).

The shareholder lawsuit is the principal mechanism for enforcing fiduciary duties. In a derivative lawsuit, shareholders may sue directors or officers on the corporation's behalf for breach of fiduciary duty. Shareholders can also sue directly when they suffer direct harm as a result of directors' decisions (Clark 1986). But shareholders' ability to enforce fiduciary duties is hampered by several formidable doctrinal and procedural hurdles.

First, under the business judgment rule, courts defer to directors' judgment on most substantive corporate decisions. Courts focus instead on assessing the process by which a decision was reached. In *Smith v. Van Gorkom* (1985), for example, the directors' failure to adequately inform themselves before approving a merger led the court to set aside the business judgment rule and require that the challenged transaction be assessed for its fairness to the stockholders.

The business judgment rule is also set aside when a conflict of interest exists between a corporation and its officers or directors, such as when a director stands on both sides of a transaction. When such a conflict exists, courts will scrutinize the challenged transaction for fairness. However, statutory and doctrinal rules restore the business judgment rule when a conflict transaction is approved by disinterested directors or shareholders (*Oberly v. Kirby* 1991).

Recent decisions in Delaware such as *In re Walt Disney Co. Derivative Litigation* (2006), *Stone v. Ritter* (2006), and *Lyondell Chemical Co. v. Ryan* (2009) have elevated the doctrinal significance of the duty of good faith. After the Delaware Supreme Court revived a lawsuit against Disney's directors in 2003, Sale (2004) and Griffith (2005) speculated that "good faith" might become a tool that judges use to discipline errant directors, especially during times of scandal. Subsequent Delaware Supreme Court decisions in *Disney*, *Stone*, and *Lyondell* have undermined the disciplinary threat that the newly revived "good faith" standard had implied. These more recent rulings firmly ensconce good faith within the duty of loyalty rubric, making clear that only sustained dereliction of duty or an act intended to harm the corporation will lead to personal liability for independent directors (*Stone v. Ritter* 2006).

Special procedural burdens associated with derivative litigation such as the demand requirement and special litigation committees further ensure that directors can avoid liability for errors in judgment or neglect of their duties (Jones 2006). Finally, exculpation, insurance, and indemnification provide additional protection to corporate officials by covering litigation costs and most judgments and settlements. The cumulative result of these doctrinal and procedural protections is that outside directors almost never pay personally for the breach of their duties to shareholders (Black, Cheffins, and Klausner 2006). The absence of an effective enforcement mechanism for fiduciary duties has led many to conclude that state corporate law may be best understood as providing merely aspirational guidelines for how directors should manage a corporation's affairs (Rock 1997; Stout 2003).

Federal Securities Law

The federal securities laws provide an important supplement to state corporate governance standards. These laws require corporations to disclose financial and other business information to investors and the public on an ongoing basis. Under the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act), a corporation must provide investors with detailed information whenever it proposes to sell securities to the public or if its securities trade in a public market.

Although disclosure rules are the dominant feature of the federal securities laws, Seligman (2003) and others have pointed out that some of the 1934 Act's most significant provisions govern corporate conduct. For example, the conduct of the shareholder meetings is dictated largely by the requirements of the Exchange Act and stock exchange listing standards with state law requirements playing a supporting role. More importantly, many disclosure requirements addressing compensation, conflicts of interest, and the like are simply regulators' attempts to indirectly influence corporate conduct.

Unlike state-based duties that are notoriously difficult to enforce, corporations and their officials face significant liability for making false or misleading statements to investors or failing to disclose material facts when a duty to disclose exists. Securities law liability extends to the corporation, its officers and directors, accountants, underwriters, promoters, and even its attorneys and bankers (Securities Act of 1933, §§11, 12(a)(2); Securities Exchange Act of 1934, Section §10(b), Rule 10b-5). All of these officials face the prospect of draconian liability for violating securities laws.

Enforcing the Securities Laws

The securities laws are subject to multiple enforcement mechanisms including private lawsuits, SEC enforcement actions, and criminal prosecutions by the U.S. Department of Justice. In recent years, state authorities have become more active in enforcing state securities statutes, introducing another layer of oversight into the system.

The private class action lawsuit presents the most significant liability threat. The aggregate value of settlements for securities class action lawsuits reach into the billions of dollars each year (Ryan and Simmons 2008). The largest settlements involving Enron, WorldCom, and Cendant were \$7.1 billion, \$6.1 billion, and \$3.5 billion, respectively. In addition to the prospect of astronomical settlements, securities litigation is costly and complex and can consume a disproportionate amount of management resources and time. These costs and aggravations have led to concerns about the efficiency and fairness of the shareholder liability regime.

Alexander (1991), Grundfest (1994), and Pritchard (2008) have all targeted the open-market securities fraud class action under Exchange Act Rule 10b-5 as an unjustified aspect of the securities regime. In a fraud action under Rule 10b-5, plaintiffs can recover damages whenever a corporation's stock price drops due to false or misleading disclosures by the issuer or its executives (*Basic Inc. v. Levinson* 1988). Critics charge that the astronomical amount of potential damages creates skewed incentives for plaintiff attorneys who file speculative suits on a contingent basis in the hope of securing a quick and lucrative settlement (U.S. House of Representatives 1995).

According to these critics, private attorneys function as public policemen but they are free from effective discipline or oversight mechanisms to prevent them from advancing their own interests at the expense of the plaintiff class. In response to concerns about the plaintiff bar's extortionary power, Congress adopted the Private Securities Litigation Reform Act of 1995 (PSLRA). Among other reforms, the PSLRA created heightened pleading standards for Rule 10b-5 claims, stayed discovery pending a defendant's motion to dismiss, and replaced a system of joint and several liability with a proportionate liability regime for most unknowing violations of the securities laws.

The PSLRA increased the costs of shareholder suits while reducing the chances that such claims would survive a preliminary motion. Coffee (2002) and Cunningham (2003) suggest that by discouraging securities lawsuits and reducing litigation risks, the PSLRA may have contributed to a business environment in which fraud could thrive unchecked. Scholars have attempted to assess the impact of the PSLRA on securities filing and settlement trends. Choi's (2007) study concludes that the statute not only has deterred frivolous claims (as intended), but also has discouraged lawyers from filing meritorious claims. Johnson, Pritchard, and Nelson (2006) reach a similar conclusion.

SEC Enforcement

Some critics of the shareholder litigation regime assert that limiting private lawsuits is justified in light of the SEC's ability to enforce the securities laws. They assert that the SEC's public mission and its political accountability make it a more trustworthy advocate for shareholder interests than the private plaintiffs' bar. SEC

enforcement efforts can deter fraud through monetary penalties, disgorgement, and other sanctions. The SEC also has power to compensate investors through Sarbanes-Oxley's "FAIR funds" provision, which allows the SEC to return penalties collected from defendants to shareholders harmed by their fraud (Sarbanes-Oxley 2002, § 108).

Although some view the SEC as the most appropriate agent for vindicating shareholder interests, the effectiveness of SEC enforcement has been seriously questioned (Poser 2009; Fisch 2009). Macey (1994) and Pritchard (2005), among others, have long charged that the SEC is subject to industry capture, such that it affords powerful business interests with high-priced legal representation advantages that are not available to ordinary citizens. There is some evidence to support this capture perspective. For example, Cox and Thomas (2003 and 2009) find that the SEC concentrates its enforcement efforts on smaller companies and typically allows larger firms to settle claims by paying small fines and agreeing to minor sanctions.

A recent report by the SEC's Inspector General (SEC 2008a) lends further support to the capture paradigm. The Inspector General found that lawyers at a large New York law firm enjoyed special access to senior SEC enforcement staff and awareness of such access may have impeded the progress of an ongoing investigation against a senior Wall Street official. Moreover, Jones (2004) and Macey (2004) note that the SEC lagged behind state regulators in high-profile investigations involving investment analyst conflicts, mutual fund market timing, and, more recently, abuses in marketing auction rate securities to investors.

Despite these shortcomings in the agency's enforcement program, many scholars including Seligman (2003), Langevoort (2006), and Prentice (2006) reject the capture narrative. Instead, these scholars view the SEC as an institution that balances competing interests of investors, issuers, and financial intermediaries rather than serving a monolithic corporate interest. Although the capture scenario is likely too simplistic, recent history suggests that the SEC is a less than perfect enforcer of the securities laws.

Another difficulty with relying exclusively on public enforcement of the securities laws is the concern that the SEC has not been sufficiently aggressive in pursuing corporate fraud. In the post-Enron era, the SEC became more aggressive in its enforcement practices, but retreated dramatically under Chairman Christopher Cox's leadership. In a recent report, the U.S. Government Accountability Office (GAO) (2009) noted that the aggregate amount of SEC penalties fell from \$1.59 billion in 2005 (the beginning of Chairman Cox's term) to \$256 million in 2008.

Many suspect that new SEC policies contributed to this decline. In 2006, the Commission adopted a policy that seemed to question the appropriateness of corporate-level penalties. Then in 2007, the SEC initiated a "Pilot Program" requiring enforcement staff to consult with the Commission before engaging in settlement discussions with corporate counsel (Nagy, Painter, and Sachs 2008). The GAO concluded that these policies and practices caused the enforcement staff to retreat in its pursuit of corporate penalties due to the Commission's unwillingness to accept staff recommendations on sanctions. SEC chair Mary Schapiro announced the end of the Pilot Program in 2009, and pledged to work to address enforcement staff concerns about their autonomy and authority (Schapiro 2009a and 2009b).

Criminal Enforcement

In addition to civil enforcement by private citizens and the SEC, the U.S. Justice Department pursues criminal violations of the securities laws. High-profile frauds at Enron and WorldCom led to criminal convictions of Kenneth Lay, Jeff Skilling, and Bernard Ebbers. All of these men received long prison sentences for their roles in their corporations' frauds.

Other Sources of Corporate Governance

Other important sources of corporate governance standards are the U.S. stock exchanges and nonbinding pronouncements developed by private entities. Stock exchange listing standards cover such governance issues as director independence, audit committee composition, shareholder voting in mergers, executive compensation, brokers' discretion to vote for their clients, and many other key areas of corporate governance. These rules are subject to SEC approval and the agency can amend exchange rules as it deems necessary and appropriate in furtherance of the purposes of the Exchange Act (Securities Exchange Act of 1934, § 19(c)).

Among the most influential privately generated governance standards are the American Law Institute's (ALI) *Principles of Corporate Governance* (1994). The ALI Principles offer directors and officers guidance in the conduct of corporate affairs beyond what is provided by corporate law doctrine. Other important purveyors of governance standards (sometimes called *best practices*) include the National Association of Corporate Directors and the Business Roundtable.

FEDERAL OVERSIGHT OF FINANCIAL REPORTING

The federal securities laws provide significant discipline for corporate officers and directors. The financial reporting system forms the backbone of this accountability system. Under the 1934 Act, public corporations must file periodic reports of financial results with the SEC. These reports include the annual report on Form 10-K, quarterly reports on Form 10-Q, and interim reports on Form 8-K which must be filed upon the occurrence of specified material events.

Investors rely on the information in these reports to evaluate a company's business prospects and make investment decisions. Although investors value the historical information included in SEC filings, they are much more interested in estimates of future performance from a firm's management or professional analysts. These forecasts and earnings estimates have a large impact on stock price, and missed estimates (reporting actual earnings below analysts' consensus estimate) often lead to a sharp decline in stock price.

In addition to the required SEC filings, companies communicate with investors on a more informal basis through press releases, speeches, and conference calls. One purpose of these informal communications is to manage investors' expectations with respect to future performance. Managers are keenly aware of the close connection between earnings projections and stock price and seek to ensure that financial analysts' published estimates are reasonable in light of management's own internal projections. Achieving such harmony requires managers to communicate regularly with the financial analyst community.

During the 1990s, SEC chair Arthur Levitt expressed concerns about the common practice in which financial officers would “whisper” earnings estimates to analysts to ensure that published estimates were in line with reality (Levitt 2002). To curtail this practice, the SEC adopted Regulation F-D, which prohibits selective disclosures to investment professionals. Under Regulation F-D, whenever a company discloses material information to analysts or investors, it must simultaneously disclose the information to the public at large (SEC 2000).

Financial Reporting Standards

The securities laws grant the SEC authority to develop standards for financial reporting. Since its inception, the agency has looked to private standards setters to generate generally accepted accounting principles (GAAP). Through its professional organization, the American Institute of Certified Public Accountants (AICPA), the accounting profession played a leading role in establishing the GAAP framework (Bratton 2007). Concerns with the potential distortions associated with allowing the accounting profession to set accounting standards led the AICPA to cede direct authority over GAAP to an independent body.

In 1973, acting with SEC support, the profession created the Financial Accounting Standards Board (FASB) to oversee GAAP. Until 2002, the FASB was funded through the sales of publications and voluntary contributions from public accounting firms. This funding arrangement proved problematic as the board found it awkward to adopt accounting standards opposed by audit firms and their clients while depending on those same firms for its operating funds (Nagy 2005). With the Sarbanes-Oxley Act of 2002 (SOX), Congress quashed this arrangement by requiring any standard setter designated by the SEC to be funded by fees collected by the federal government from filing companies (Sarbanes-Oxley § 109).

Concerns with the FASB’s independence were more than theoretical. As Herwitz and Barrett (2006) explain, the FASB proposed a number of controversial accounting pronouncements during the 1990s that reporting companies resisted because they prohibited the accounting treatments they preferred. The FASB’s efforts to adopt new reporting standards for employee stock options are emblematic of this tension.

In 1993, the FASB proposed rules to require companies to treat stock options as a compensation expense rather than a charge to capital on the balance sheet. The major audit firms and the high tech industry led private-sector opposition to this standard. Critics argued the rule would unreasonably burden start-up firms that relied on options to attract and retain management talent and appealed to the SEC and Congress for support. At the behest of these advocates, several congressmen, including Senator Joseph Lieberman, introduced bills to prevent the FASB from adopting the standard (Levitt 2002). In response to this pressure, the FASB relented and adopted FAS 123 which encouraged, but did not require, companies to expense options. Similar controversies surrounded FASB pronouncements on treatment of derivatives and off-balance-sheet financing (Herwitz and Barrett 2001; Mark 2007). As with option expensing, industry groups and auditors were vocal in their opposition to these measures and sought to use their influence in Congress to defeat them. In all of these areas, the FASB ultimately adopted its proposed accounting

treatments but only after prolonged conflict and delays (Herwitz and Barrett 2006; Mark 2007).

The Globalization of Financial Reporting Standards

Although GAAP has long been the standard for financial reporting for U.S. companies, its continued standing is open to question due to the widely perceived need to achieve convergence among competing accounting standards around the globe. Convergence proponents assert that uniformity in international financial accounting standards would broaden access to capital across borders and facilitate investors' ability to compare corporations from different countries, expanding their array of investment opportunities (Takor 2005).

Convergence efforts have focused primarily on encouraging countries to adopt International Financial Reporting Standards (IFRS), established by the International Accounting Standard Board (IASB), as the standard for financial reporting. Efforts to promote IFRS have been fairly successful and IFRS now governs in more than 100 nations and in the European Union. A second objective of convergence advocates is to reduce or eliminate differences between IFRS and U.S. GAAP. The FASB and the SEC have engaged with their foreign counterparts in these efforts. Under the Norwalk Agreement reached in 2002, the FASB and the IASB agreed to work to achieve compatibility among their respective accounting standards (Hanson 2006).

In 2007, the SEC embraced the convergence objective and moved to recognize IFRS for foreign issuers filing financial statements with the SEC, without reconciliation to U.S. GAAP (SEC 2007). The SEC took this step to reduce impediments to foreign issuers listing their securities on U.S. stock exchanges. In August 2008, the SEC went further and released a "road map" that proposed shifting the financial reporting standard for U.S. companies from GAAP to IFRS (SEC 2008b). The road map envisioned optional IFRS reporting for large issuers beginning in December 2009, with a transition to mandatory IFRS reporting for all issuers by 2014 (an earlier proposal had considered allowing optional IFRS reporting without an eventual mandate).

The proposed shift from GAAP to IFRS reflects a broader campaign to jettison a reporting system with rigorous, complex rules in favor of a principles-based system that would be more palatable to those who prepare financial statements. In the standard critique, GAAP's rules-based regime is maligned for being formulaic, complex, difficult to interpret, and easy to evade (formal compliance while evading the purpose of the rule). In contrast, IFRS's principles-based regime is deemed to be more flexible, substantively meaningful, and easier to apply (Cunningham 2008a).

Cunningham (2008a), Cox (2009), and Bratton and Cunningham (2009) have expressed skepticism regarding the SEC's haste to embrace IFRS. They point to gaps in expertise, conversion costs, and substantial treatment differences between GAAP and IFRS as reasons to tread cautiously on the march toward globalization. With the change in the presidential administration, the U.S. shift to IFRS is again in doubt. SEC chair Mary Schapiro is reevaluating the proposal. Schapiro has acknowledged critics' concerns with the road map's timetable and conversion costs. In the meantime, the FASB and the IASB continue to focus on convergence, seeking greater compatibility pending consensus on global accounting standards.

The Problem of Accounting Fraud

The SEC's financial reporting system and the accompanying liability threat form an important component of the corporate governance accountability system. The financial reporting regime creates at least two sources of discipline for managers. For companies that regularly access capital markets, reported financial results directly affect their ability to raise capital as well as the cost of capital. Therefore, managers are motivated to run their companies effectively so as to assure continued access to low-cost capital. In addition, many companies use equity to finance acquisitions. A higher stock price means that equity will go further in support of a company's acquisition strategy.

The financial reporting regime remains an important disciplinary device for companies that do not rely on capital market financing. For most corporations, executive compensation is linked closely with reported financial results, which means that managers of companies that report higher earnings can expect to earn more. These compensation schemes are designed to encourage managers to lead their companies in a manner that achieves earnings growth over the long term.

Management's Role

The effectiveness of financial reporting as a disciplinary tool depends on the accuracy and reliability of management's financial reports. Management prepares a company's financial reports subject to the oversight of the directors and an audit by a public accounting firm. Management's control over financial reporting creates a basic conundrum for our corporate governance system.

Managers face strong incentives to manipulate financial reports in order to present as rosy a picture as possible of a company's financial condition. In general, managers aim to present an impression of steady and predictable earnings growth over a sustained time period. However, the reality of a firm's financial performance rarely jibes with the smooth and steady growth profile most managers hope to achieve. This divergence between ideal financial results and the inevitable ups and downs of business performance can lead managers to smooth reported earnings (Levitt 1998).

Scholars describe income smoothing, or *earnings management*, as the practice of using discretionary accounting judgments to shape the level of reported earnings to meet management objectives or analyst expectations (Erickson, Hanlon, and Maydew 2006; Lev 2003). Managers can also manage earnings through manipulation of discretionary expenditures or purchases such as research and development or capital improvements (Cunningham 2008b). This form of earnings management, often termed *real earnings management*, may be objectionable, but it is legal.

Incentives to manage earnings intensify when the compensation of high-level executives is directly linked to a company's stock price. Stock option grants are the most common method that corporations use to align executive and shareholder interests. Stock options give executives the right to purchase company stock at the current price at some point in the future. As a company's stock price increases, options become more valuable. Thus, option grants create incentives to manage the company so that earnings and stock prices rise in a reliable fashion.

While stock options likely provide incentives for hard work and effective management, they also create incentives to manipulate reported earnings. Numerous

studies have sought to establish a link between equity-based incentive pay and accounting fraud. Bergstresser and Philippon (2006), Elayan, Li, and Meyer (2008), and Zhang, Bartol, Smith, Pfarrer, and Khanin (2008) all find a positive correlation between earnings management and high levels of equity compensation. A study by Baker, Collins, and Reitenga (2003) suggests that managers are more likely to engage in earnings management when their total compensation depends heavily on financial performance, as through stock options. Johnson, Ryan, and Tian (2008) report that these effects are most pronounced when compensation consists of vested options or unrestricted stock, when managers would feel the effect of a drop in stock price most acutely.

In contrast, studies by Erickson et al. (2006) and Armstrong, Jagolinzer, and Larcker (2009) fail to demonstrate a conclusive link between compensation practices and accounting fraud. Laux and Laux (2009) theorize that one explanation for the lack of clarity on this issue is that although lucrative equity compensation increases incentives to manipulate earnings, it may also increase the audit committee's scrutiny of financial reporting, thereby reducing opportunities for fraud. A study by Cornett, McNutt, and Tehranian (2009) on governance and earnings management at bank holding companies lends support to this contention.

The Auditor's Role

A corporation's directors and its auditors form the front line for protecting investors and the public from management fraud in financial reporting. Although directors have oversight over a company's financial reports, they rely chiefly on auditors to assure that these reports are prepared in accordance with GAAP and fairly reflect the company's financial condition.

The securities laws require an independent audit of annual financial statements filed with the SEC. The purpose of the audit is to provide some assurance to those who use financial statements that management's assertions have a reasonable basis in fact. The audit firm seeks to verify enough of the information contained in the financial reports so that it can reasonably conclude that the company prepared these reports in accordance with GAAP.

During the 1990s, evidence began to mount that auditors were insufficiently rigorous in their review of corporate financial statements. Between 1997 and 2002, 10 percent of all listed companies restated their financial reports, indicating widespread audit failures (Klein and Coffee 2004). The number of SEC fraud enforcement actions also rose dramatically in this period (Beasley, Carcello, and Hermanson 1999). After a series of major audit failures, including at Enron and WorldCom, public officials grew wary of the auditing profession's ability to maintain proper auditing standards and oversee its members' compliance with such standards.

With SOX, Congress set out to overhaul the financial reporting process and reallocate responsibilities for establishing audit procedures and for the oversight of auditors. The centerpiece of the legislation was the creation of the Public Company Accounting Oversight Board (PCAOB), a new private nonprofit entity to oversee the accounting industry (Nagy 2005). SOX gave the PCAOB authority to establish generally accepted auditing standards (GAAS), stripping the AICPA of its traditional role. Congress also charged the PCAOB with maintaining standards for auditor independence and conducting inspections of audit firms on a regular basis.

The PCAOB first recognized extant GAAS on an interim basis. It also acted quickly to adopt standards for the audit of internal control procedures prescribed by SOX Section 404. Section 404 requires managers to annually assess and report on the quality and effectiveness of their firms' internal controls and requires the independent auditor to attest to management's report. Perhaps the most controversial provision of SOX, Section 404 imposed new costs on public companies. Critics maintain this provision has encouraged public companies to go private and has discouraged foreign listings on U.S. stock exchanges (Committee on Capital Markets Regulation 2006).

Assessing the costs and benefits of Section 404 is a challenging task. In a review of the empirical literature on Section 404's impact, Prentice (2007) concludes that the provision's costs have been exaggerated and that its benefits, while real, are hard to quantify. According to Prentice, estimates of the average Section 404 compliance costs in the initial implementation year were about \$4 million per issuer. However, a major portion of these costs are properly attributed to improvements in internal controls that firms needed but had deferred. The initial costs also included significant nonrecurring ramp-up costs. After initial implementation, Section 404 compliance costs declined 40 percent for large companies and 30 percent for smaller firms.

Prentice (2007) concludes that the empirical literature supports the view that Section 404 has proffered concrete benefits by restoring investor confidence, contributing to better-quality financial reporting, and likely decreasing the incidence of fraud. First, SOX helped fuel a market recovery by restoring investor confidence in management's financial reports (Benoit 2006). Further, studies by Bedard (2006), Doyle, Ge, and McVay (2007), and Li, Rupley, and Johnstone (2009) suggest that Section 404 has improved the quality of financial reporting, reducing the incidence of abnormal accruals and restatements.

Finally, studies by DeFranco, Guan, and Lu (2005) and Doyle et al. (2007) show that companies reporting internal control deficiencies under Section 404 saw declines in their stock price. Ashbaugh-Skaife, Collins, Kinney, and LaFond (2009) show that after companies corrected reported deficiencies, their costs of capital declined. These studies suggest that the internal control audit conveys useful information to investors and improves the allocational efficiency of markets.

Still, many critics complain that the costs of Section 404 exceed its benefits, especially for small companies that lack economies of scale. Some argue for a Section 404 exemption for smaller firms (Butler and Ribstein 2006; Committee on Capital Markets Regulation 2006). A special SEC Advisory Committee (SEC 2006) recommended that the agency exempt smaller companies from Section 404 compliance. Thus far, the SEC has deferred the Section 404 compliance date for smaller companies multiple times, but has declined to provide a complete exemption from its requirements. In the absence of further delays, all companies must be fully compliant with Section 404 in their reports for the fiscal year ending on or after June 15, 2010 (SEC 2009).

The Audit Committee's Role

In addition to strengthening oversight of auditors, SOX sought to encourage greater director involvement in the financial reporting process. Congress looked to the audit committee of the board of directors to help insure the integrity of management financial reports. Section 301 of SOX instructed the SEC to require stock exchanges

to adopt rules mandating that all members of the audit committee of listed companies be independent of management. Congress also called for increased accounting expertise on the audit committee. Section 407 requires issuers to disclose if the audit committee has at least one member who is a “financial expert.” If no member of the audit committee is a financial expert, the issuer must disclose that fact and explain why not. Finally, Congress sought to enhance the resources and authority of the audit committee. SOX specifies that the audit committee (not management) has the authority to hire and fire the auditors and that auditors must report directly to the committee. SOX also makes clear that the audit committee can hire its own experts with the corporation bearing any costs related to such consultations.

Congress apparently believed that increasing the audit committee’s independence and assuring expertise would encourage directors to take a more active role in the review of financial reports and oversight of the audit. Empirical research suggests that enhanced director independence and expertise does have a positive impact on the quality of financial reporting (Cunningham 2008b). Carcello and Neal (2000), Klein (2002), and Anderson, Mansi, and Reeb (2004) all report that the presence of independent directors and financial experts on audit committees appears to improve the quality of a firm’s financial reporting.

Further research has shown a greater benefit from accounting expertise than from either independence or general financial expertise (Abbott, Parker, and Peters 2004; Dhaliwal, Naiker, and Navissi 2006). Thus, directors with experience preparing or auditing financial statements seem to contribute most significantly to constraining earnings management and other forms of financial fraud (Cunningham 2008b).

PROSPECTIVE REFORMS

The SOX provisions reviewed in this chapter are a stark example of Congress’s direct regulation of corporate conduct, which disrupted the traditional understanding of the federal role in corporate governance (Bainbridge 2006). With Section 404, new audit committee rules, and other governance provisions, Congress delved deeply into the details of how management and the board conduct their affairs. SOX has also laid the groundwork for more intensive federal engagement in corporate governance.

The 2008 financial collapse and subsequent government bailouts have created an even more direct federal role in the oversight of major corporations. Massive federal funding of private corporations sets new precedents and raises important questions about government’s role in business. Importantly, the bailouts shift the terms of the governance debate, as corporate law can no longer be viewed purely as a matter of balancing private interests.

Against the backdrop of the federal government as a partner in private enterprise, a new wave of regulatory reform looms on the horizon. President Barack Obama’s financial reform proposals include enhanced federal oversight of systemically significant financial firms and a new financial regulator to focus on consumer protection. The President has also proposed legislation to provide for the regulation of hedge funds and derivatives, as well as measures to enhance shareholder power over executive compensation and the selection of directors.

Amidst calls for regulatory overhaul, the continued viability and authority of the SEC hangs in the balance. The SEC’s reputation has suffered severely in

the wake of the 2008–2009 financial crisis (Coffee and Sale 2009; Fisch 2009; Poser 2009). The agency's passivity during the collapse of Bear Stearns, its failure to detect Bernard Madoff's massive fraud, and the failure of the Consolidated Supervised Entity program for financial conglomerates have led to serious questions about the agency's competence and relevance.

Despite these recent missteps, sober analysis suggests that the SEC needs to be strengthened rather than weakened in response to recent crises. The SEC's rule-making authority and political independence equip it to respond more deftly to emerging problems than either Congress or the courts. The SEC's recent failures can be attributed in part to the erosion of its independence and authority at the hands of Congress and the courts (Jones 2009). Budgetary threats and adverse federal court decisions delayed or thwarted SEC initiatives to increase oversight of financial firms, hedge funds, mutual funds, and auditors. Perhaps more importantly, the SEC was led most recently by a chairman who appeared less than committed to the agency's mission (Scannell and Craig 2008). The regulatory dormancy engendered by his approach allowed problems in the financial markets to fester and worsen, eventually requiring urgent intervention by the Treasury and the Federal Reserve. If the agency can be reconstituted under competent leadership and its proper authority restored, the SEC can be expected to reprise its role as the bastion of investor protection that it has been during most of the past 75 years.

SUMMARY AND CONCLUSIONS

The structure of the U.S. corporate governance system has remained fairly stable since the time of the New Deal. The SEC has overseen a regulatory system that relies heavily on financial disclosure requirements to motivate responsible conduct by corporate officials. These rules are backed by a severe liability threat that encourages full and fair disclosure to shareholders and the public.

Congress has generally ceded specific conduct standards to the states, which developed common law fiduciary duties to govern the conduct of corporate officials. Over time the rigor of state regulation dissipated and the erosion of the fiduciary duty doctrine compelled Congress and the SEC to engage more directly in corporate governance issues, leading to SOX and likely more substantive governance reforms in the future.

Overall, the U.S. corporate governance system is sound in design but problems with enforcement, at both the state and federal level, mean that the performance of corporate executives and directors does not reflect the lofty standards embodied within state and federal law. The best hope for responsible management seems to be the broad inculcation of proper moral standards in the individuals who run our corporations. How the law can play a role in that endeavor is a question that has confounded corporate law and criminal law theorists for decades.

DISCUSSION QUESTIONS

1. Why do state courts generally defer to management's business judgment? What might be some dangers of imposing liability for breach of fiduciary duty more frequently?
2. If the SEC recognizes IFRS for U.S. issuers, the IASB, a foreign nongovernmental organization, would have authority over U.S. accounting standards. Is such

an arrangement consistent with SOX's requirement for a government-funded accounting standards setter? (See Sarbanes-Oxley § 109.) Does ceding power over U.S. accounting standards to a foreign body create accountability problems? How might such issues be resolved?

3. Numerous studies cited in the chapter support the view that incentive compensation contributes to financial fraud. Assuming this connection is well founded, how should compensation practices at public corporations be reformed?
4. The topics reviewed in the chapter suggest that each of the accountability mechanisms relied on for corporate governance is flawed in some way. What appear to be the most pressing problems in corporate governance? What are possible reforms to increase the accountability of corporate managers?

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