A CRISIS OF INVESTOR CONFIDENCE: CORPORATE GOVERNANCE AND THE IMBALANCE OF POWER*

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ABSTRACT

Purpose - Recent corporate scandals such as WorldCom, Enron, and others suggest a failure of corporate governance, that is, of the allocation of power and its lawful use and accountability within the corporation.

Design/methodology/approach - This chapter presents a game theoretic model for analyzing the power dynamics among the three groups responsible for oversight in the Anglo-American corporate model - namely the Board of Directors through its audit committee, corporate management, and the external auditors.

Findings - The chapter shows, among other findings, that the current governance structure results in an extreme imbalance of power among the three groups that not only permits but even induces management to conceal necessary financial data and often to ignore the long-term interests of the firm.

Implications and value - The chapter also derives changes in principles of governance that can right such imbalances and prevent defalcations from taking place through institutionalizing effective ex-ante checks and balances of power in addition to the ex post measures that come into play only after a wrong has been committed and which are the case with recent exchange rules and Congressional enactments.

Research limitations - None.

Originality/value - No prior analysis along these lines.

Keywords: Corporate governance; balance of power; Sarbanes-Oxley; director liability; audit committees

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OVERVIEW

Ted Seabrooke, Phillips Exeter Academy's venerable wrestling coach during the 1960s when I was a student there, taught me an invaluable lesson that I have found applicable to a myriad of situations beyond the grappling mat. In describing how to bring a man down when, for example, the wrestlers begin the second period and one finds himself on the top with the opponent beneath him, Seabrook admonished us that "a man is a table. To bring him down, therefore, all you need do is create insecurity in one of the legs of the table. Then, you apply force in line with that insecurity." It was this image that came to mind as I began to collect my thoughts about what appeared to be the sudden, widespread failures of corporate accountability as demonstrated by the demises of WorldCom, Enron, Tyco, Global Crossing, and the like: this was the result of unrestrained forces acting upon insecurities inherent in the system. The suddenness and widespread nature of the problem seemed to stagger investors' faith in financial markets. Investors globally began to ask, "[H]ow much confidence should… [they] place on companies' financial statements?"[1] Indeed, in the case of WorldCom, Karen Nelson, a professor of accounting at Stanford Graduate School of Business, was quoted as saying, "Enron was all about complex partnerships and accounting for special purpose entities. But what WorldCom did wrong is something that's taught in the first few weeks of a core financial reporting class. That is why people are asking, given its basic nature and its magnitude, how could it have been missed."[2]

How indeed? Prior to those reporting embarrassments, United States' Generally Accepted Accounting Principles (GAAP) was viewed as the gold standard to which multinational corporations must conform in order to take the greatest advantage of the efficiencies of international financial markets. As a director of the Vorstung of Germany's Deutsche Bank pointed out to this author, after raising the bank's accounting standards from German-mandated GAAP to International accounting standards, the bank's senior management determined it was worth spending around an additional $200,000,000 in order to comply with U.S. GAAP so that the bank could be listed on the New York Stock Exchange. The managers realized that such a listing would unlikely have any marked effect on the liquidity of the bank's stock. Indeed they expected it to be thinly traded on the New York Stock Exchange. However, it was their view that the bank's stock would always trade at a discount if it could not demonstrate that it had complied with the (perceptually) more accurate U.S. GAAP. Now in light of Enron, WorldCom, and other similar embarrassments, the effectiveness of U.S. GAAP, our corporate accountability system, and U.S. business ethics in general are all being questioned, with the consequent adverse effects on the prices of issues on public exchanges, and even the dollar's loss of parity with the euro (although, admittedly, that may be attributable to other factors as well). Moreover, much like the return of a lesson unlearned from the bank runs of the early Great Depression, a new paradigm of insolvency seems to be facing corporations:

bankruptcy not caused by traditional financial problems, but rather by the loss of investor confidence.

Yet for a long time even before these events, there seemed to have been a sense that maybe the system was not quite right; that it needed improvement. In 1998, the New York Stock Exchange and the NASDAQ convened a Blue Ribbon Committee (the BRC) to undertake a study of corporate governance, with particular emphasis on improving the effectiveness of corporate audit committees. Yet the convening of this panel was less of an affirmative response by the two exchanges to their own perceived need to tighten accounting procedures and investor accountability, than it was a response to a September 28, 1998 speech by SEC Chairman Arthur Levitt who excoriated the entire audit process as a game of nods and winks involving the analysts, the auditors, and those in charge of the corporation's affairs. Lamenting that "integrity" may be losing out to illusion, he commented on various "hocus-pocus"' categories that were flagrant distortions of the financial reporting processes. Levitt then introduced a nine-point plan, two of the most important of which focused on the requirement that corporate audit committees take responsibility for their companies and "function as the ultimate guardian of investor interests and corporate accountability." The BRC released its extensive report in February 1999. More recently, following a number of dramatic failures, including Enron, and apparently responding to various Congressional initiatives that will have the effect of impinging upon the independence that public companies have traditionally enjoyed, the New York Stock Exchange adopted, following its original proposal on June 6, 2002, detailed, stricter standards for its listing members. These standards adopted the recommendations of the BRC and expanded on them in certain important respects.

Clearly, the efforts of the BRC and the recent rule amendments of the New York Stock Exchange are moves in the right direction. What neither change analyzes in methodological detail, however, are the causes of these dramatic business failures. Absent such analysis, it is naturally impossible to predict whether the problem has been properly addressed. Indeed, for example, if GAAP accounting is too antiquated for the current stresses and functionalities of modern business, putting more responsibility on audit committees and tightening rules of corporate governance will do little to address that fundamental problem. Similarly, because CEOs in huge companies cannot possibly be aware of all their firm's financial transactions, it is not realistic to endeavor to solve the problems simply by requiring the CEOs to certify that the financials are, in fact, accurate.

My approach in this thesis is a modest, but decidedly different, one than what has been taken thus far. Rather than proposing axiomatic remedies to address specific problems that seem to have appeared in the recent cases, I suggest that the problems have arisen as a consequence of the forces arising from the imbalance of power in our corporate governance system being unleashed upon the two fundamental weaknesses (or "insecurities" to return to the wrestling analogy at the beginning of this chapter) intrinsic to the Anglo-American corporate governance structure: namely (a) the unitary board of directors having conflicting obligations of oversight and management, and (b) the incomplete contract that exists between shareholders and management in defining the parameters of management's authority and obligations, as stockholders' proxies to run the corporate entity. While these weaknesses have existed since the joint stock company came into being with the original English East India Company model, the increasing extent and magnitude of the differential in power dynamics among the three groups, which are ultimately responsible for guarding investor interest and providing for corporate accountability, specifically management, the external auditors, and the Board of Directors represented by its audit committee, has reached the point where it is now overwhelming in favor of management, even after acceptance of the BRC's recommendations and the new rules of the New York Stock Exchange. Because of this, I submit that it is only by making adjustments in some of the fundamental relations to this "three-legged stool" of corporate accountability, as the BRC called it, that a more stable equilibrium in the balance of power among these groups may be achieved and thereby proper accountability restored within the system.

To put this problem another way, both the BRC and the New York Stock Exchange rules, for example, do delegate new responsibilities to the Board of Directors through its audit committee and seek to require the Board to adopt a series of new and constructive protocols to buttress the meaningfulness of the company's financial statements. However, unless such delegation of responsibilities is accompanied by assignments of power, the rights sought to be assured to shareholders will likely prove as elusory as those in that famous "piece of paper" held by Chamberlain after his negotiations with Hitler at Munich guaranteeing "peace in our time."

What this thesis offers is a methodological analysis and approach to this growing problem of major international consequence. It focuses primarily on the narrow issue of power dynamics and its relationship to mandated disclosure. A fundamental premise, not examined however, is that disclosure and daylight will ultimately have salutary effects upon corporate governance. Also not examined is whether there may be fundamental problems in GAAP accounting, generally, which need to be addressed systemically. Further, I have not examined whether fundamental, statutory changes in corporate law might aid as well. Thus, I accept as given, for purposes of this chapter, the systemic weaknesses of the basic unitary board concept, although I argue that an analysis of it is essential to understand the fragility of the disclosure process and, thereby, its susceptibility to the relative strengths of the three principal players.

I begin with an analysis of the weaknesses of Anglo-American corporate governance stemming from the stockholder's incomplete contract with management, and from the nature of the unitary board, and how these problems can have a paralyzing effect on accountability. I then look at the power attributes and weaknesses of the three principal players in the disclosure process: management, the external auditors, and the Board of Directors through its audit committee. After demonstrating the gross imbalance of power in favor of management, I analyze the exogenous vectors to which management is subject, which impede disclosure and impel concealment.

Following the analysis section, I look at some examples of corporate audit committee charters and reports as examples of the results of the cur- rent process, and the likely inconclusive results that will follow from the current state of affairs, without adjustment to the imbalances of power.

The fourth section discusses briefly other approaches used in Europe, and in particular Germany and the United Kingdom, and why their approaches may or may not be applicable to U.S. governance.

I next undertake an analysis of the BRC's and the New York Stock Exchange's changes, and, in the final section of this chapter, make my own suggestions that address the imbalance of power dynamics still present even after such recommendations are adopted. I close with some overall observations and a final question.

ANALYSIS: DEVELOPMENT OF A MODEL

Systemic Weaknesses

Boards of Directors under the Anglo-American model of corporate governance have two primary functions, which from any initial analysis appear to be at odds with each other. First, the Board of Directors is the ultimate head of all executive decisions of a corporation. It is the final arbiter and deliberative body that sets corporate policy, determines and executes strata- gems on behalf of shareholders, and is ultimately responsible for compliance with applicable laws. Second, the Board has ultimate responsibility for supervising proper governance of the corporation and assuring the accountability of the executive officers whom the Board has appointed to manage the day-to-day operations of the entity's affairs.

In spite of such inherent conflict, this structure works fine when a corporation is owner-operated and even when there is a small group of investors, venture capitalists, and the like who closely monitor and are a part of the day-to-day decisions of the entity. Once there is a separation of ownership from control, however, two results ensue. First, executives no longer have the same financial incentive as would an operator who is also an owner to increase the future value of the firm. The executive's incentives are defined only by his contract. While this will be discussed in greater detail later in this chapter, even so-called "incentive contracts" are tied to isolated factors that are intended to be indicia of what the shareholders would prefer, but such factors, obviously, cannot be precise reflections of shareholder interest in all circumstances. Moreover, executives are normally chosen for their creativity and entrepreneurial attributes which are necessary in order to maximize opportunities presented by the market from time-to-time. Thus, a broad spectrum of freedom of action is normally ceded to such executives. The practical problem, then, is to find a way to promote managerial freedom without jeopardizing their accountability to stockholders. This gap has been referred to as the "costs of agency" and the result of (necessarily) incomplete contracts.[3] As discussed in "Wearing Two Hats: The Conflicting Control and Management Roles of Non-Executive Directors,"[4] an incomplete contract exists whenever the contracting parties are unable, ex-ante to specify fully the actions to be taken in every possible future "state of nature." Thus, results that are economically efficient are best achieved where the organizational structure of a firm is such that those who ultimately have the final claims to an entity also have the ability to determine the actions of that entity. This is simply for the reason that the downside of any action taken that does not seek to maximize value will ultimately have to be borne by them. The degree by which separation of ownership from control effects of loss of control over such factors is another way to characterize this "agency cost," and the agency cost, in turn, is a consequence of the need to leave management contracts largely incomplete.

Historically, this problem, as well as the inconsistency of the two obligations of the Board of Directors, has been addressed through requiring detailed disclosure by management to shareholders. The disclosure requirement, it is thought, will act as automatic checks on the Board vis-a-vis the shareholders, and on the chief executive officer, vis-a-vis the Board; the theory being that if actions with which the shareholders or the Board may disagree are known, they may be overruled, or the offending party removed from office. This system of accountability through disclosure, in turn, has two essential parts to it. The first is the system of legally mandated shareholder rights that gives shareholders the ability to obtain information not otherwise readily available. The second is the automatic disclosure required to be provided by the executives and by the Board itself.

The basic flaws in this system are obvious. First, there is little incentive for the average shareholder to effectively monitor the activities of any large public corporation. Not only is it extremely expensive for shareholders to launch initiatives (as shown by the exorbitant costs of hostile takeover bids and the like) but the economic benefits inuring to such a shareholder from such monitoring function can, because of such shareholder's relatively small percentage ownership of the overall corporation, only marginally benefit that shareholder. On the other hand, the disincentive to engage in any monitoring activities by such a shareholder is increased by the fact that all other shareholders who have not incurred such costs obtain exactly the same proportional increase in the value of their stock- holdings through that shareholder's efforts, while having a "free ride" with respect to the cost of the monitoring activity. "Hence, each shareholder has an incentive to free ride and it becomes irrational for an individual shareholder to devote resources to becoming better informed and to voting intelligently."[5] Additionally, this analysis may begin to give one the sense that the accountability of the executive to the Board is different in kind and scope than the accountability obligations of the Board to the shareholders.

These protections become further diluted by a recognition that stock- holders are not the only ultimate residual claimants to a corporation's assets; hence the theoretical unitary goal of "maximizing return to share- holders" cannot be the sole objective function either of the executives or of the Board. Because of that, each may often act in ways contrary to the "interest of the shareholders." By way of example, various studies have shown that numerous non-shareholder constituencies influence corporate decisions. These include customers, labor, senior debt holders, and the like.[6]

Further, the general law of fiduciary duty as well as various state statutes throughout the United States provides that when a corporation is "insolvent," officers and directors are required to act in the best interest of creditors, rather than of shareholders. For this very reason, there is no requirement under Delaware law (or the law of any other jurisdiction of which this writer is aware) that the filing of a bankruptcy petition requires a shareholder vote. Indeed, under Section 1107 of the Bankruptcy Code, a corporation whose management continues in control of the company's assets operating its affairs after filing a bankruptcy petition is required, with only one exception, to represent the interests of creditors. The only exception is with respect to a plan of reorganization that the company files. And, with respect to the plan of reorganization, it is at that point that in addition to representing the interests of creditors, management may also represent the interest of the "company." Obviously, the "company" is thus something other than its shareholders although it may include the shareholders in the concept. One may attempt to argue that such a change in director and management loyalty is only fair in these cases because it occurs under an extreme situation, namely when the company is "insolvent." The problem, however, is that there are at least three definitions of insolvency; thus, one is never certain when "insolvency" commences or occurs.[7]

Finally, the goal of "shareholder" welfare is not by itself equivalent to the concept of share price maximization. Markets systematically undervalue certain long-term expenditures, particularly expenditures that may fall into the categories of capital investment or research and development spending. This excessive short-term focus yields a form of market myopia that may encourage, therefore, management to view its obligations to increase the share price rather than deal with a more elusory concept of "shareholder value." This tendency, of course, is enhanced when management's own contracts provide bonuses based upon increases in the per share price.[8]

To summarize the foregoing analysis, the incomplete contract that exists between the shareholders and the executive managers of a firm afford the managers a broad range of discretion. The necessary incompleteness of such a contract, as well as the natural conflict between the self-interest of the managers and the differing interests of the shareholders, provides the opportunity for executives to act in a manner not necessarily in the best interests of shareholders. Further, there is often the opportunity and, in certain circumstances, the obligation, for management to act in the interests of other parties. Thus the obligations of management to shareholders become weakened and unclear as well as diverted, in certain respects and instances, by obligations to other parties. Further, it is impracticable for individual shareholders themselves to undertake meaningful monitoring activities of management. While this obligation is delegated to the Board, the

Board itself is riddled with the same conflicting obligations as has management. Further, the Board, as the commander in chief of operations, is not clearly objective in its supervision of its own policies.

Against this backdrop of these weaknesses inherent in the corporate governance structure, let us now turn to analyze the dynamics of power within the accountability system itself. I propose to do this in two parts. First, I shall analyze the attributes and vulnerabilities of the three primary players in the disclosure process in order to evaluate their relationship to each other and their ability to control reporting outcomes. Second, I shall focus on the forces impelling management toward concealment as well as those forces impelling management toward disclosure, since it is management, as will be shown, who have the decided advantage in determining the context of the disclosure process.

The Dynamics of Power - The Three Groups

Dramatis Personae: A few words must be said about the choice of players analyzed in this chapter from the perspective of the audit process. I have identified them as falling into one of three categories: management - and particularly the CEO and Chairman of the Board; the external auditors; and the audit committee of the Board of Directors. Clearly, there are other significant actors involved. The Board itself, the chief operating officer, senior financial management, the internal auditor, and the like, all have important roles to play in the process. However, since the focus of this chapter is on power dynamics, I have viewed the traditional chains of command and authority as establishing separate, distinct groups that, for the most part, resolve dis- agreements with respect to courses of action within themselves. While this obviously results in some oversimplification, I believe it is useful in view of the scope of the analysis undertaken and the fact that deviations from lines of authority, such as in the case of whistle-blowers, are relatively rare and, in all events, the existence of such deviations from traditional lines of authority would not materially change the fundamental analysis discussed in this chapter. Further, the growing trend in the literature has tended to characterize these three groups as the ones that are the primary players in the audit process.[9]

A second point that must be made relates to the position of the chairman of the Board. From my own professional experience, a review of numerous current articles on the subject, a cursory review of the management structure of some of the largest companies in the United States and from speaking with numerous members of Boards and audit committees, the chairman's views are almost invariably aligned with that of the CEO, except in cases where the chairman is a figurehead or his power is waning, such that he is disregarded or likely to be replaced in the near future. Indeed, in these latter two cases, there is normally a vice-chairman or other party who serves a similar function and who eventually takes over the chair's role. In most instances this alignment is obvious: the chair and the CEO is the same person. This is probably the most common. In a second type of situation, the chair was the CEO but, for various reasons such as age, desire to focus on other issues, or the like, the chair decides to resign from his or her position as CEO, picks a successor to that position as his or her proxy, and assumes the chair position so as to be relieved of the burdens of day-to-day management. In the third type of situation, the relationship between the CEO and the chair may have been arrived at independently, but the CEO recognizes that by virtue of the chair's position of great power, he or she will have to work closely with the chair in order to have programs which the CEO pro- poses be adopted by the full Board. If the chair were to oppose any position of the CEO, the CEO would not likely take it before the Board unless it were a matter of great concern, and then the CEO would likely do so only after having "counted noses" among the other members of the Board. Where the CEO is successful in such a situation, it is often an indication of a waning of power on the part of the chair.

The Model: The relevance of a power dynamics approach is, of course, central to this chapter. While I have come across many articles dealing with organizational power, power between various management groups, and the like, I found no analysis dealing precisely with this subject. Equally surprisingly, in the various recommendations of third parties that will be discussed later in this chapter, no mention is made about effecting a balance of power within the three groups responsible for the audit process. The original Cadbury Committee Report, discussed below, the report of the BRC, and more recent amendments to the rules of the New York Stock Exchange for its listing members seek to assign added responsibilities to the audit committee but, with limited exceptions, do not fundamentally alter either the legal responsibilities of nonexecutives or the basic structure of the Board or the system of effecting accountability through disclosure (see, e.g., Ezzamel & Watson, p. 56). Additionally, again with only minor exceptions contained in the newer rules of the New York Stock Exchange, no discussion whatsoever is given of a need to balance power. I found this odd, not only in light of my own experience, but also as a student of the U.S. Constitution where the concerns and intense focus of the founding fathers were to institute an effective set of checks and balances among our three branches of government. Specifically, the framers of the Constitution did not focus so much on delegations of authority to one branch or to another. Rather, the primary focus within the Constitution was in assignments of power to the various branches that would balance out and temper the power granted other branches of government.

Viewed from this prospective, I suggest a model for looking at the relative strengths and weaknesses of each of the actors forming the "three- legged stool" that are a part of the audit process. While my enumeration of the factors set forth below is somewhat subjective, it is the result of a thorough analysis of the customary roles of each of the actors and as confirmed by fulsome discussions with various directors and audit committee chairmen. Further, my purported quantification of each of those factors is also, admittedly, subjective. For that reason I do not suggest that the actual qualitative assignments given to each of the 3 groups in the 18 categories which follow should be viewed as anything other than a mere statement of the relative dominance of one group over another, and the relative weak- ness of another group to the others. One may rightfully differ with the absolute numbers assigned as well as whether or not other categories should have been included, but, again, the main purpose is to give an over- all view of the relative strengths and weaknesses among the three groups.

What comes through, I submit, is the overwhelming dominance of management, represented by the CEO, compared to that of the audit commit- tee, contrasted with the high vulnerability of the audit committee compared to the other groups. If these factors were to be subject to multiplier effects arising from additional stresses (discussed immediately thereafter), the overall impression with which one is left is that if this model has any validity, important changes must be effected in order to prevent further embarrassments to the integrity of the financial markets as exhibited by the WorldCom and Enron cases.

What sparked this thought process was Exhibit 1-2 to the Report of the National Commission on Fraudulent Financial Reporting delivered in October 1987, a copy of which Exhibit is set forth as Fig. 1, below.

Fig. 1.

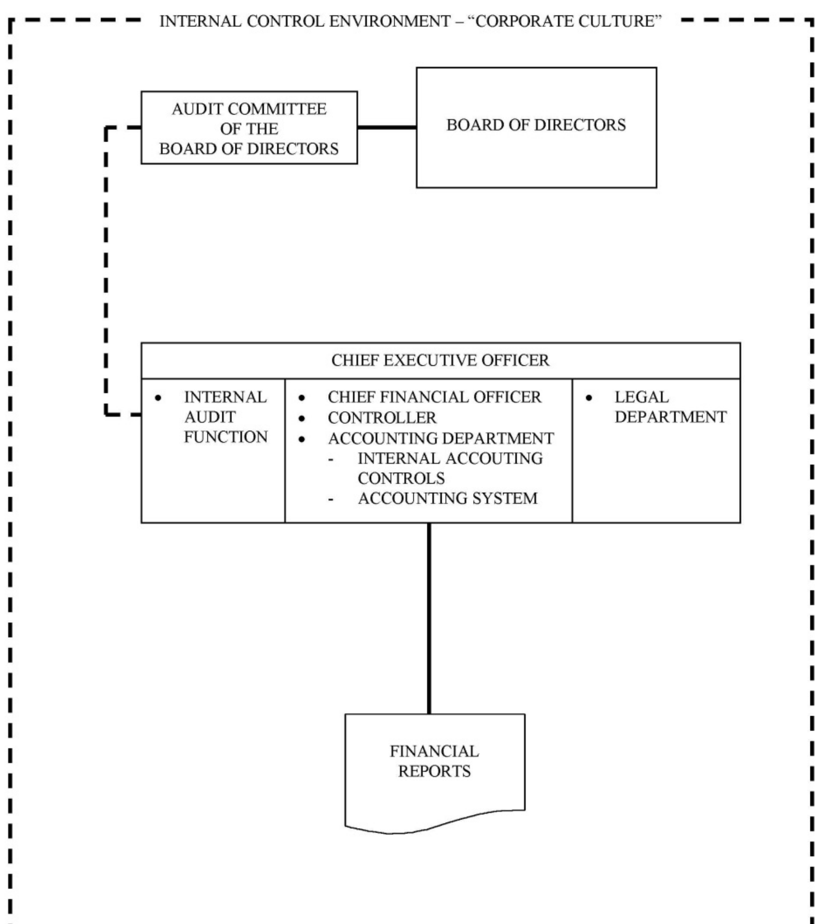

Exhibit 1-2 The Public Company

While this figure shows only the internal control environment of corporate culture, and thereby excludes the outside auditor, what is apparent is the overriding and, some would say, dictatorial power of the chief executive officer over the issuance of financial reports. The dotted line indicating the role of the audit committee is, interestingly, far more ephemeral than the solid line emanating from management to the financial reports. Further, this drawing does not show the tie between the chief executive officer and the chairman of the board who exerts substantial control over the Board of Directors itself and, therefore, over the audit committee as well.[10]

This model is divided into two parts. The first part quantifies nine attri- butes of power within the domain of management, through its CEO, the audit committee, and the external auditors. The second table does the same thing for nine vulnerability attributes or weaknesses of each of these three actors. Within each category, I have ascribed a number between 0 and 3 to each actor, depending upon whether the characteristic was nonexistent (denominated by the letter N and assigned the numerical value 0), slightly existent (denominated by the letter S and given the numerical value 1), moderately existent (denominated by the letter M and assigned the numeri- cal value 2), or highly existent (denominated by the letter H and assigned the numerical value 3). It is of course legitimate to argue that the "H" valuation should more appropriately be valued at 4, 5, or even 10 in certain instances and that other valuations similarly should have some numbers in between the ones that are assigned. However, that would give this table the misleading appearance of a degree of certainty to which it does not aspire. Again, these numbers are more relativistic than anything else. The two tables show Power Attributes (Table 1) and Vulnerability Attributes (Table 2) and are set forth below:

Table 1.

POWER ATTRIBUTES	**CEO/ MANAGEMENT**	**AUDIT COMMITTEE**	**OUTSIDE AUDITORS**
	H M S N (3) (2) (1) (0)	H M S N (3) (2) (1) (0)	H M S N (3) (2) (1) (0)
Operational Control	3	0	0
Board Influence	3	1	1
Information Access	3	1	2
Information Restriction	3	0	2
Employee Patronage	3	0	1
Executive Patronage	3	0	0
Hiring of Auditors	3	1	0
Auditor Review	3	2	1
CEO Review/Compensation	2	0	1
Totals	26	5	8

Table 2.

VULNERABILITY ATTRIBUTES	CEO/ MANAGEMENT	AUDIT COMMITTEE	OUTSIDE AUDITORS
	H M S N (3) (2) (1) (0)	H M S N (3) (2) (1) (0)	H M S N (3) (2) (1) (0)
Accountability to Board	3	2	1
Accountability to Investors	3	2	2
Accountability to Regulators	3	2	2
Susceptibility to Whistleblowers	3	1	1
Plan Target Failures	3	0	0
Lack of Upside	0	3	2
Subject to Patronage	0	3	2
Lack of Information	0	3	1
Lack of Audit Control	0	3	1
Totals	15	19	12

At this point it would be appropriate for me to say a few words about each of the attributes listed in the left margin, make certain comments regarding some of the numbers assigned to each of the actors, and describe the theoretical source of this model.

"Operational Control" seems rather obvious. It is a major power source for management, particularly with respect to subordinates, and, that aspect of control, portions of which may be picked up by other categories, reflects the realities of a military-like chain of command in favor of management that typifies the modern multinational corporation. "Board Influence" is high for the CEO and management, due to not only their natural alignment as discussed previously, but also because of the added power which comes when the CEO and the chair is effectively the same person.

"Information Access" is of course greatest in the CEO, slightly lower when it comes to the case of the auditors, but least of all readily available on a first-hand basis to the audit committee. The obverse side to the issue of being able to have access to information, is, of course, the power to impose "Information Restrictions," and that power is almost exclusively within the domain of management itself, should it desire to do so. The concepts of "Employee Patronage" and "Executive Patronage" relate to the power of the CEO to hire, fire, and reward both low-level employees and executive-level employees. This is an extremely powerful tool, and becomes even more powerful when this executive is also a member of the Board of Directors.

I listed the power to "Hire Auditors" and the right to "Review Auditors" as separate items. A consultant must always endeavor to please, subject to professional constraints, the person who is responsible for their receiving a paycheck. This person also is likely to be their champion when they come under attack. Because the review of the auditors is an independent process and specifically delegated to the audit committee, this is one area where the audit committee should have some additional strength. On the other hand, the failure of outside auditors to accommodate requests of management on a particular issue may result in their not remaining auditors to the company in the future, or their not receiving lucrative consulting assignments down the road. Thus management has an even stronger hand in this category. Finally, there is the issue of "CEO Review and Compensation." The outside auditors have some influence in this area inasmuch as they do report the financial results of the company. It is the CEO, however, that has the most power to exert in this area, particularly through the alignment with the chair that provides control over executive compensation plans and bonuses, except in cases where it is abundantly clear that he or she is not living up to expectations.

In his article "Power, Politics, and Influence" (*op cit*), Robert Vecchio dealt with classical analyses of the bases of power within an organization. The power analysis proposed in that article at pages 73 through 75 divided organizational powers into five categories: reward powers, coercive power, legitimate power, expert power, and referent power. Each of the power attributes listed in the model fall into one of these categories, except for referent power which, by definition, deals with special personal qualities or areas of attractiveness of an individual's personality that cause others to identify with them. A good example of this would be someone like Hitler. Since the instances of that power are specific to individual personalities, I have not included it in this analysis, although it is common that CEO's are dynamic, attractive personalities. However, the first two categories of operational control and board influence constitute elements of legitimate power; namely reflections of others' willingness to accept an individual's direction by virtue of his possessing some aspect of legitimate authority.

The ability to access or restrict information clothes the holder with expert power; that is, a regard for the person having the power as being knowledgeable in a given area, particularly with respect to the personal knowledge base of the other party. The balance of the categories falls into examples of coercive power and reward power.

On the vulnerability side, the first three categories deal with accountability or subservient liability to others. These are consequences of an actor's susceptibility to coercive and legitimate power of others. Clearly, because of the dominant position of the CEO in formulating business planning and being responsible for overall guidance of the corporate ship, failures in accountability are ultimately laid at the CEO's doorstep. The culpability and exposure of the audit committee and the outside auditors is also high, albeit to a lesser extent. When it comes to issues of the potential failure of the company to achieve targeted goals (the consequence of being subject to reward powers), neither the audit committee nor the auditors have any significant exposure and again, this appears to be management's susceptibility. Similarly, if there is something to fear from potential whistleblowers (which reflects one's vulnerability to coercive powers), it is primarily management that has exposure to that rather than the other two actors, although these latter two, of course, will have culpability for their own misdeeds. The fear of acting without proper information and the fear of having to be a part of the audit process without full control (the obverse side of expert power) is something which is high on the audit committee's list and a matter of some concern to the outside auditors. It is not generally a matter that effective management is concerned about at all. The next vulnerability of "Lack of Upside" (reflecting an absence of reward power) could easily be a multiplier of these attributes in itself and, in fact, is discussed separately in addition to it being listed here.

What is most troubling to me in looking at these tables is the lack of any upside for the audit committee with respect to the obligations that it currently has, and the additional ones that it may be asked to accept in the future. While management has significant risks and vulnerabilities as the second table indicates, success will result in its receipt of enormous benefits in the form of compensation and stock options. The audit committee sees none of this. Indeed, as will be discussed below, current recommendations are that the audit committees not receive any special bonus compensation, since to give it such would jeopardize its independence. The relevance of this factor is that one is more likely to redouble one's efforts to do his best job if he sees that there is a large gain if he should do so effectively. Indeed that is the precise theory behind management's incentive contracts. One's appetite for late hours, detailed work, and bucking the entrenched powers of the CEO and chair become substantially lessened if there is not much in it for such a person and, indeed, as reflected in the next category, "subject to patronage" (an example of susceptibility to reward power), in opposing the desires of the chair/CEO one may be alienating powerful individuals who gave the outside director his audit committee assignment to begin with.[11] Audit committee members have traditionally been assigned their role by the chair as a way of recognizing their status as a senior member of the Board. This "privilege" of an additional title also has some compensatory aspects as well as prestige and therefore may make the designee of this position both beholding to the chair as well as more subject to psychological pressure in the event of any difference between the committee and the chair. Further, and while this next point could have been listed as a separate category, there is a further power weakness that the chairman of the audit committee faces in confrontations with the chairman of the Board. Because the audit committee is still "a committee," its chair is susceptible to having his power undermined by the CEO/Board-chair through solicitations of the non-chair members of the audit committee not to support a particular position that the audit-chair knows to be correct.

Finally, the last two categories of lack of full information and lack of audit control (vulnerability to expert power) are weaknesses which will inhibit the audit committee from standing too strongly against the CEO or Board-chair, particularly in view of the latter two's much greater access to information and audit control which would allow them to speak more authoritatively on any given issue.

Again, to sum up what the above model illustrates is not a measurement of any absolute quantification of each group's aggregate power, but rather the extreme differences in the magnitude of powers between the CEO on the one hand and audit committee on the other hand contrasted with the relatively equal susceptibility to weaknesses on the vulnerability scale of the schedule.

So as not to give a mistaken impression of a level of precision of which this model is not capable, I rejected the temptation to weight the power attributes in the first table with reference to the potential upside of each of the groups. Looking at this issue for just a moment, however, another important qualitative factor reveals itself. Because the principal goal of management is to further the creation of shareholder wealth, attainment of that goal not only customarily results in high levels of compensation (both in terms of money, options, and stock for the executive), but to the extent stock is received in compensation, the attainment of that goal has a multiplier effect. Similarly, judging from the large fees that are paid to the (now) big four auditing firms from not only auditing services but consulting services provided to large, publicly traded companies, there is an extremely lucrative upside for the auditors as well in this process. Now look at the audit committee. Its goals are to exercise prudent business judgment in such a fashion that its members neither embarrass themselves before the public or the Board nor sustain liability for breach of their oversight responsibilities. Thus, putting these statements about the three actors a different way, management and the auditors have a substantial financial reward attendant to the exercise of their powers and prerogatives while the audit committee not only has no real upside, but their principal goal is avoid substantial downside. I believe that human nature is such that when one is given power, one is more likely to exercise it to achieve a positive benefit for oneself, rather than merely to stay out of trouble. Thus, I believe it appropriate to recognize that some multiplier of the power attribute totals would be appropriate for both the CEO/ management and the auditor groups in the above model, which would not be relevant to the audit committee. Of course to do so would widen even further the gap between power and exposure of the CEO verses the audit committee.

Forces Impelling Concealment and Disclosure

It being apparent from the previous model that there is a great disparity between the relative power to vulnerability ratios of CEO/management compared to the other two groups, it is useful, as a final part of this analysis, to examine the various exogenous forces acting upon the CEO to apply that power either to effect concealment of financial data that is adverse to his performance, or to disclose it. This analysis, while not in model form, is again from discussions with various directors and also, in this case, from helpful literature itself. In both cases, there are four forces either impelling concealment or disclosure. I will discuss them each in turn.

Forces Impelling Concealment: One of the first places to look for incentives impelling concealment is in the nature of the contract with the executive himself. There has been a great deal written about the basic form of incentive contracts and, undoubtedly, the common type of executive contract for large, publicly traded companies is one which provides quite significant rewards to the executive for his reaching certain levels of earnings or stock price growth. The obvious purpose of such a contract is to endeavor to align the interest of the managers more closely with that of shareholders. The problem, however, is, as stated in part earlier, that the benchmarks used to identify such alignment are only rough approximations of what is desired. Additionally, they divert the focus from a flexible alignment with shareholders' interests to a unitary, economic measure that may at times be adverse to shareholder interest. Thus, for example, if the incentive is realizable on profit reaching a designated level for a certain accounting period to which the contract relates, the executive will endeavor to increase the short-term accounting profits so as to hit his targets at perhaps the expense of long-range business opportunities. Indeed, because the contract represents an "obligation" of the executive, he may feel that he is in fact, obligated to affect such a result.

The basic problem here, of course, is that because "value" is a complex concept, it is usually defined in incentive contracts as revenue growth, earnings per share, or share price, and the calculation of any of these three factors generally fails to incorporate value that only is realized over time. In the case of share price, the most common of benchmarks, is commonly proportional to the price to earnings ratio of the corporation's shares as traded. Therefore, an increase in earnings will yield an increase in price, if but only if, the price to earnings ratio at the outset of the executive's contract is at least the same as at the end of the measurement period. Note however, that as earnings, and therefore prices, rise, there is often a ratcheting effect which results in the application of an even higher price to earnings ratio; thereby, similarly ratcheting the bonus to which the executive is likely to become entitled. Finally, the heavy use of stock options as incentives skews management's judgment criteria heavily toward risk-taking, inasmuch as options have no downside to failure, but an unlimited potential upside.

In sum, what may start out as an innocent skewing of revenue or operational results in order to realize income sooner or defer expenses later, nonetheless may result in an impetus to distort income.

Second, executive's contracts are invariably measured at least on an annual basis over the prior annual period, if not on a quarterly basis. The purpose of this is, of course, to keep the "pressure" on the executive to perform. As discussed earlier, because of general market myopia, long-term growth strategies, capital investment or R & D programs, are discounted by the market, not only because of the immediate present value of the expenditure compared to the distant future value of the expected return, but because the future value must be discounted further by risk factors, change in the economic environment, and other discoveries rendering the activity obsolete in the interim, and the like. Thus, if an executive truly believes that such an expenditure is necessary, there are four options with which he is faced: defer the expenditure, recharacterize the expenditure as a capital investment or suffer lower earnings or accelerate recognition of income.

Deferral is itself a misrepresentation. If indeed management does believe that a replacement, expansion, change, or development is necessary, a failure to do so, therefore, is a disservice to equity. Further, deferral constitutes a misrepresentation inasmuch as the shareholders do not have the knowledge that the executives do and may be thinking that all is well while matters may invisibly be deteriorating. On the other hand, the executive may undertake the expense but endeavor to effect recharacterizations of one sort or another in order to conceal it. This then may preserve his ability to receive the desired incentive bonus without revealing the truth of the concealment. From the executive's standpoint he has "done right" by the company, because he has both made a change which he knows needed to be instituted, while he has not punished himself for doing so. Recharacterization comes in various forms. One may stretch a reportable position on a capital item verses an expenditure as in the case of WorldCom, one may anticipate income or defer expenses as in the cases of Xerox, Tyco, and the like, or one may create off balance sheet entities, as in the case of Enron, so that one appears merely to be making an "investment" in a subsidiary that conducts the desired activity while hiding expenditures or debt for the corporation were it to do so directly. Another common approach criticized by Chairman Levitt was to take advantage of "cookie jar reserves" - that is drawing down on excessive write-offs in prior quarters that management had accumulated to offset current losses - or by taking "big bath" reserves in a current profitable quarter in order to cushion the adverse effects of future expenditures and so as to enhance near term future earnings.

Two additional principles need to be kept in mind when looking at the quarterly review factor, generally. The first is that deferral of a long-term project may also be rationalized as an appropriate activity by management because a large percentage of investors in publicly traded companies are not investors for the long term.[12] Management could characterize its deferral of a needed improvement as proper because short-term share- holders have interests that need to be protected too and his contract (being incomplete as discussed earlier) did not prohibit him from electing, from time to time, to favor one group of shareholders over another. Second, and more importantly, corporate culture is not long on giving second chances to managers who fall short of their targets. The very nature of looking to quarterly results is that each quarter may determine whether an executive's contract is renewed or not. Thus, if an executive believes that while he may fall short in one quarter he will more than make it up in subsequent ones, there will be strong incentive either to conceal or overstate the current quarter's results under the assumption that one is merely buying time and can make up for the concealment in subsequent quarters' profits.

The third factor impelling concealment is a general lack of respect for GAAP accounting, generally. As stated by Ezzamel and Watson (p. 55):

> Today, a multitude of "creative accounting" practices which exploit the inevitable ambiguities and many alternative methods of reporting the financial effects of transactions are both available and routinely used by Boards to mislead rather than inform shareholders. [Authorities omitted] A few informed commentators now believe that, despite the increased financial reporting regulations and/or the supposed "independence" of the auditors of the financial statements, the system is unable to prevent effectively a determined Board of executives from adopting reporting practices which greatly hinder accountability.

Indeed, when one requires the application of a system that does not work or whose methodologies do not bear any real resemblance to business requirements, one foments disrespect for the system in general. Such disrespect for GAAP has three basic roots. First, there is a cultural disrespect arising out of "accounting for tax purposes" as opposed to "accounting for shareholder reporting purposes." This divergence of reporting is not permitted in many other countries, such as in Germany, where it is the result shown on the tax returns that must be reported to shareholders and on which trading is based. Further, in the United States, tax reporting has acquired, as a part of its culture, the concept of being able to assert a "reportable position" which will not result in a fine, but, if one is not "caught," may result in the reporter "getting away with" a position that may be less than supportable if examined in detail. (Bear in mind also that the American Revolution began as a tax revolt, so this cultural tradition runs deep.) Further, proper tax treatment often turns on using the proper label or structure as opposed to turning on the substance of the transaction. When form prevails over substance, one loses grounding in the relevance of values; and this can prove fertile territory for deception. Indeed business schools routinely teach that such activities are not a negative. Tax minimization is a lawful and laudable goal and indicates the taking of initiative by executive management.[13] Further, tax minimization increases earnings per share, which in turn generally increases price per share and, thereby, executive compensation. Unfortunately, when the numbers cease to have meaning and the form is more important than the substance, this same approach may easily carry over to reporting for purposes of investor analysis as well.

A second root of disrespect is a philosophical one. The historical cost approach evidenced by GAAP accounting is really not relevant to cash flow issues or future value. By way of example, the historical cost of a plant acquired 100 years ago is irrelevant to its actual correct value. Alternative non-GAAP approaches such as value accounting are being promoted more actively in recent days, although nothing concrete has yet been agreed upon.

Finally, there is a practical aspect. Certain accounting rules that are completely lawful have the practical effect of ignoring the troubled realities of a situation and can only serve to hide more fundamental problems. By way of example, FASB 15, used to effect the restructuring of the debt of a troubled company, allows a lender to convert a nonperforming loan, which would be an expense item on the income statement, into a new loan, a portion of which is performing and therefore need not be expensed or may be taken into income if it has previously been expensed, while the balance is in an expensed into a "suspense account" which may be later recovered as additional income when, as and if it is realized. However such characterization tells neither the auditors nor the stockholders anything about the very troubled nature of the loan in which the lender is engaged to begin with and whether the reported portion of that loan may likely be in future jeopardy. Yet this rule, appropriate for accounting purposes, has no tether to the realities of business life, and therefore results in a lack of disclosure with respect to financial condition issues.

The final factor impelling concealment relates to the management's basic confidence in itself. The moral hazard attendant to concealment that one is merely "buying time" until management's plan holds or a new solution is found is all too common. Further, arguments are often heard that "technicalities" should not stop management from carrying out its vision or taking a risk that it knows the Board of Directors either would not, or could not, approve. Management views itself as the only one with all of the facts and, aware of the information asymmetries that exist between itself and the Board and the shareholders on the other hand, yields disrespect for their opinions or their short-term judgments. Further, the authoritarian, military- style chain of command structure that pervades the large corporate environment is one where obedience of subordinates to the CEO is not only expected, but also culturally engrained. The "tyrannical corporate leader is a well-established figure." Numerous studies have shown that subordinates are highly reticent to disobey commands of superiors, even if they believe that the conduct being ordered is morally or ethically wrong.[14]

Forces Impelling Disclosure: Here again there are four items, although the description is shorter and there are limitations to each of these.

The first relates to the fundamental goodness of mankind's nature. Philosophers have debated whether the basic nature of man is good or evil, but I believe it is a fundamental tenant of American life that fair play is an honorable thing. Thus, there is a basic reticence in all managers' character to engage in deception. Hence the need for justification.

The second positive reason is the notion of a respect for collective wisdom of the Board and its ability to provide fresh insights into operational problems. Yet while this is true as a theoretical matter, it does, nonetheless, have several practical limitations. First, such notion is antithetical to the basic principal that operational issues are management's responsibilities. Thus, if management needs the assistance of the Board, there is a sense that it has in some sense failed. Second, and related to the first, the fault- based nature of our legal system pervades the judgment process attendant to looking at quarterly results. Thus, there is a stigma that attaches to a failure to reach targeted results as opposed to a generalized view that no one manager can have all answers and that therefore the need for more views or more help is normal and acceptable. Third, American culture demands quick and immediate results. Again, this is reflective of the "quarterly report cards" to which management is subject. With so few second chances, there is often a need to buy time. Finally, if the manager should be overruled by the Board, this would obviously be a defeat and be considered shameful by management. Because of this, CEOs routinely lobby the Board before a meeting concerning their proposals and are unlikely to put forth proposals for which there does not appear to be adequate support. Of course this process substantially detracts from the nature of the strength of the Board.

In addition there are two negative reasons impelling disclosure. There is always a fear of getting caught. Yet this is limited by two important constraints. First, management must have a view that what it is doing is wrong to begin with. For the reasons stated earlier, this is often not the case (recall also Enron's original position). Second, there is often a general perception that this will never happen at all. WorldCom is an excellent example of this. Having gotten away with fraud in one quarter, management is emboldened to believe that the same result will follow in subsequent quarters. The second negative factor is the penalty of criminal sanctions in the event of major catastrophes. While the current situations are fresh in our mind and this appears to be a potent force, the truth is that criminal actions are relatively rare and the recent criminal investigations by the SEC and the Attorney General are not routine occurrences. In the past, the principal downside to discovery was being relieved of command and, even in that case, management often was able to find new employment with other corporations.

In summary then, the strong upper hand that management has to effect concealment, combined with its large upside for succeeding with this endeavor, are pushed along by the four cultural systemic and structural forces toward what may appear to be the benign concealment of crucial financial data. One thing is clear: the current corporate structure does not seem designed to provide meaningful impediments to such activity.

The remainder of this chapter examines lessons that may be learned from an examination of current cases. These are, first, what appears to be the meaninglessness of current systems, second, the recommendations of the BRC and the New York Stock Exchange to deal with this problem, and third the lessons that may be learned and that may not be learned from other countries. Finally, I will offer my own suggestions as to what may likely restore this balance of power and thereby halt the tendency to effect the deceptions with which financial markets are currently burdened.

LESSONS LEARNED FROM CURRENT CASES

A review of the audit committee charters of various public companies does not generally reveal marked differences from which one may draw conclusions that might explain why, for example, WorldCom and Enron ended up as they did whereas others have not. On the other hand, there is one conclusion that possibly may be drawn from such an analysis: most of the current charters are merely pieces of paper which do not ultimately alter the balance of power within the corporate governance system or man- date disclosure to investors. This author compared, as illustrative, the audit committee charters of General Electric, Gillette, Eastman Kodak, and ICANN as they existed as in 2001-

2002, as well as forms of sample charters, such as one recommended by Wachtell, Lipton, Rosen, and Katz as a "model form of audit committee charter for the post-Enron world," and a another model charter proposed by the American Institute of Certified Public Accountants, with those of 2002 WorldCom, Enron, Global Crossing, and Adelphia Communications Corporation. It is obvious that the charters of the last four companies failed to provide for any meaningful warning or disclosure to investors. The model charters purport to be just that: current "state of the art" recommended by two distinguished institutions. The first group of charters is of various companies of various sizes and in various industries that appear to be well run.

What one may take from reviewing these charters is that the length and the detail contained in them do not seem to affect the outcome. Indeed, Enron's charter appears to be most detailed and most distinguished of the group; one of Enron's advisors was Nobel laureate and New York Times editorial columnist Paul Krugman. General Electrics on the other hand is more vague and quite lean by comparison. The model charter proposed by Wachtell Lipton contains, at the end, strong exculpatory statements disclaiming culpability and responsibility by the audit committee.

One common thread is that there is a regular trend across these charters to review or listen to the information that is put before the committee by management and the auditors. Further, they are to inquire about disagreements between management and the auditors that are reported to them. There is no power or requirement to do any independent investigation nor is there any real authority to seek independent advice. If a problem does exist, some of the charters provide that the committee should meet with the corporation's in-house general counsel. In sum, therefore, it appears that the audit committee's role is, first, to look at matters to which its attention has been drawn by management or the auditors and, second, to guess if it seems appropriate. Nothing in these documents provides a real mechanism for obtaining alternative views or giving the committee a power base from which it could effectively be at odds with the CEO/Chairman. As discussed previously, absent a firm power base by a truly independent audit commit- tee, the asymmetries of power and of knowledge between any committee and the CEO is such that no meaningful challenge could realistically be mounted. In summary, therefore, it appears that to the extent that General Electric and Gillette, by way of example, have financial statements that more or less fairly reflect the financial condition of their companies, that result is attributable to managements' determination to do so rather than any independent activity, oversight or input of the audit committees. Each of the charters examined delegates responsibilities and assigns obligations for audit committees to go through certain steps to ask certain questions and look at certain documents. None of them, however, assigns any meaningful power to the committee.

As also discussed previously, the nature of corporate management follows a dictatorial, military structure. In view of the authoritarian nature of such a structure, the phrase "corporate governance" almost seems like a misnomer. Indeed, for the most part shareholders are a docile group with the only disturbances of note at annual meetings coming from special interest groups, such as environmentalists, that seek to inject political issues extraneous to traditional business operations before the Board. Occasionally there are also proxy fights, but these are far and few between. Thus, one must ask if this is what citizens of the United States truly refer to as governance?

> Imagine a system of government in which there are annual elections, that these are almost never contested. Whenever they are, the incumbent government wins by an overwhelming majority. All the information about the state of the nation which the voters receive is controlled and distributed by the government and is glossy and self- congratulatory in tone. Changes in the senior leadership do take place, normally through an orderly process of retirement in which the incumbent leaders select and groom their successors. Occasionally there is more violent change. Sometimes this takes the form of an internal coup d'état or it may occur as a result of the intervention of the hostile government of another state. This is not a description of Eastern Europe before perestroika and glasnost. It is a description of the system by which public companies [under the Anglo-American system] … are controlled and governed.[15]

In sum, the contents of the audit committee charters merely reflect the institutional dominance of the Chairman/CEO in the Anglo-American corporate system. The detailed areas of inquiry put forth in the Enron audit committee charter did not prevent management from engaging in a myriad of schemes to distort and hide the true financial condition of the company. Pieces of paper and assignments of obligations can never do that. Only the granting of power to truly independent entities can.

RECENT RECOMMENDATIONS

Outside of the Report of the National Commission on Fraudulent Financial Reporting (October 1987) referred to earlier and the Sarbanes- Oxley Act, there has been little official action to deal with this disclosure problem, generally. The two principal other initiatives have been report of the BRC, also previously referenced, the amendments to requirements for the New York Stock Exchange listed companies submitted by the Exchange's Corporate Accountability and Listing Standards Committee to the Securities and Exchange Commission.[16] In rendering their reports or in enacting the Sarbanes-Oxley Act, none of the BRC, the New York Stock Exchange Governors, or Congress appeared to undertake a conceptual or philosophical analysis of the fundamental problems of corporate governance so that they could explain how their recommended new oversight procedures would address those fundamental problems. One may assume that this was in part because they held a belief (albeit an untested one) in the fundamental soundness of the corporate structure and because they would have viewed it as beyond their authority to suggest changes in basic legal rules. Then again, sometimes change must be effected in increments, and recommendations of the direction in which change must proceed give society the opportunity to adjust to the realities that inevitably must take hold. On the other hand, these recommendations and new laws were not inspired by any independent determination that something fundamental was wrong with the system or that any self-analysis be undertaken in order to derive recommendations responsive to such a determination. The BRC was a response to a challenge and extreme criticism leveled by the then SEC Chairman. The new proposed recommendations of the New York Stock Exchange similarly fell hard on the heels of SEC criticism in the wake of the Enron disaster and the consequent clamor among various politicians for immediate change. Indeed, of the numerous bills that had been proposed in the Congress, some of which sought to impose govern- mental oversight over matters correctly within the private control of individual companies, the Sarbanes-Oxley Act was adopted in extreme haste in then only in response to President Bush's demands that "something" be done in view of the exorbitant losses sustained by millions of registered voters. In this light, these recommendations and changes may be viewed as an effort to take initiative voluntarily or to blunt the need for comprehensive, methodological Congressional action and intervention.

Whatever its purpose, the direction is clearly a correct one. The BRC and Sarbanes-Oxley Act focused most closely on what ought to be a commanding, separate role for the Board of Directors' audit committee and sought to strengthen its power by expanding greatly the requirements of independence and financial literacy. Further, they sought to mandate independent lines of communication between the auditors and lower level internal audit staff on the one hand, and the committee on the other hand. With respect to this latter point, there was, regrettably, no real power granted to the audit committee to affect the meaningfulness of that communication. Further, an analysis of the bibliography appended to the official report of the BRC is the lack of extensive research of a theoretical nature, as well as the total inattention to the voluminous work of the British (discussed below) in addressing the same problems in a similar system.

The recent New York Stock Exchange rule changes and Sarbanes-Oxley Act are even broader and go even further than the recommendations of the BRC. These recommendations apply to corporate governance issues generally, the compensation committee, the audit committee, ethics issues, ongoing education, and the like.

While both the New York Stock Exchange rule changes and the Sarbanes-Oxley Act do go even further than those of the BRC, they stop short of creating a full power base in the audit committee. On the positive side, independence is greatly strengthened with limitations on stock owner- ship, a five-year cooling off period from company relations for all former employees, consultants, business partners, and the like, as well as a limitation on bonus compensation to directors. For the first time, the audit committee is given the sole power to hire and fire auditors as well as to approve any non-audit work done by the auditors. Further, the audit committee is now involved directly with the 8-Ks (press releases) issued by the company as well as in the preparation of the normal portions of all 10-Qs (quarterly reports) and 10-Ks (annual reports) entitled "management discussion and analysis."

An interesting dichotomy is presented in the New York Stock Exchange recommendations that reflect the reticence of the Exchange fully to empower the audit committee. One of its recommendations is to require regularly scheduled private meetings among non-management directors (who are also required to be a majority of all Boards). On page 8 of these recommendations, the Corporate Accountability and Listing Standards Committee writes that "regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of such executive sessions. [Emphasis supplied]" The regularizing of these meetings is an essential and an empowering assignment of power. First, it is a tacit acknowledgment that the non-management directors may be influenced by the management directors and the CEO in their discussions and that it is necessary to free them from that overpowering influence by promoting separate meetings. Second, the exchange correctly recognized that there would be a great reluctance on the part of directors to call such executive sessions since, to do so would telegraph the message that they were concerned about something - that something was wrong - and thereby give the management directors the opportunity to lobby to quash that meeting.

This was an important change. However, note the lack of similarity with respect to the issue of access to independent counsel and consultants, such as auditing consultants. Rather than mandating that such consultants and advisors be on retainer and be required regularly to attend all audit committee meetings so as to be able to be consulted on all issues, the recommendations merely "permit" such consultants to be retained if the committee believes that it requires such assistance. While it is true that permission to initiate such retention was granted to the audit committee, similarly, there will be great pressure put on them to use general counsel or the "independent auditors" rather than hire "expensive outsiders" when a problem ensues, since outsiders threaten the CEO with loss of control over resolution of that problem. On the other hand, if availability to such expertise is part of the regularized process, then there will be no adverse inference from such advisors being at a meeting and, more importantly, no opportunity to interfere with truly independent advice and analysis. Further, and perhaps resulting in an even greater propensity for empowerment, would be the courage that would be imparted to an audit committee by virtue of such independent advice. Any individual member may be subject to political and emotional pressures exerted by the chair/CEO not to insist upon a particular disclosure or interpretation. As a practical matter, it would be hard to resist concerted efforts in this fashion. However, if one received clear advice from one's own counsel and auditors to the contrary, an audit committee member would have both a legitimate power base from which to refuse such a request from the chair ("I would like to go along with you but my lawyer tells me I cannot"), as well as the recognition that if the audit committee were to take a position against the advice of its counsel and independent accountants, then the existence of that advice would be conclusively damming if the matter warned against proved to be a problem in the future. It is my personal opinion that the different treatment for the audit commit- tee with respect to this issue is because it really would make the audit committee completely independent in a way that would not be palatable to most chairs or CEO's of modern corporations. Putting it another way, while such a step probably should be implemented, the exchange may be concerned about whether it may be forcing too much change on its listing members at a time when they may not be ready for such change.

Other alternatives have also been suggested. GAAP itself has come under criticism and accountancy professionals are generally addressing in what ways GAAP itself should be changed. Congress has now required CEOs to certify the accuracy of financial data. Peter Knutson, Emeritus Professor of Accounting at Wharton, is of the view that it is impossible for CEO's of large companies to meaningfully make such a certification. "How is a CEO to certify that the financials are accurate? Think of General Electric, for instance, and [former CEO] Jack Welch. Could Welch know whether the firm's numbers were accurate? He had to rely on the controller, the chief accounting officer. He relied on the officer in the controller's department whose job it is to prepare the annual report. They have to have people they can rely on." In another approach, the Massachusetts Legislature had a bill pending before it imposing strict liability upon accountants simply for a failure to detect fraud by the company they audited. No finding of negligence by the auditors would be at issue. As reported in the Boston Globe on June 30, 2002, Massachusetts Senate President Thomas Birmingham's deleting this absolute liability requirement was highly criticized and an effort was made to connect his actions to his receipt of modest campaign contributions from the accounting industry. While it seems illogical to mandate that auditors be liable for fraud absent negligence on their part (particularly since certified audits regularly state clearly that they are not fraud audits and that it is beyond their scope to detect fraud) it is still indicative of the national mood and the need for a definitive solution to this problem.

Other solutions that have been adopted include mandatory rotation of auditors, elimination of consulting engagements for outside auditors, and SEC oversight review of financial reporting by public companies.

All of these proposals do have one thing in common; they seek to create a separate power base that is independent of and has a separate line of authority to which corporate management must conform. Therefore, if indeed public corporations are to avoid governmental intervention in their internal auditing processes to an even greater extent, one must ask if there is not a way further to buttress the recent proposals of the New York Stock Exchange in a way that accomplishes this result without mandating an entirely new system of corporate governance. Perhaps something might be learned by looking at how other countries have addressed this issue.

LESSONS LEARNED FROM THE UNITED KINGDOM AND GERMANY

In Geert Hofstede's article "Cultural Constraints in Management Theories"[17] an analysis is made of various corporate governance structures throughout the world, particularly with their relevance to the American system of corporate governance. Hofstede, however, both begins and ends his article with the acknowledgement that despite efforts to arrive at "culture free theories of management," nonetheless, all such available concepts "for this purpose are themselves alive with culture, having been developed within a particular cultural context. They have a tendency to guide our thinking toward our desired conclusion." Nonetheless, certain observations of foreign debate on the issue may prove enlightening to the issues discussed in this chapter.

The issue of supervision of management became a controversial issue in the negotiations over the formation of the European Union. The debate over this issue focused on the development of the European Economic Community's proposed "Fifth Directive."[18]

As originally proposed, the Fifth Directive contemplated a two-tier structure of governance for all corporations as is more typical in France and particularly in Germany. As finally adopted in 1983, the Fifth Directive allowed countries to elect a choice between the original two-tier structure and a unitary board as is customary in the United Kingdom. However - and this is important - the compromise for the inclusion of the one-tier structure was a requirement that the majority of the members of the unitary board be nonexecutives. With respect to the two-tier structure, executives would be excluded from the upper-tiered supervisory counsel.

This two-tier form is typical in the German system where publicly held companies established that managers be supervised fully by non-managers through two Boards of Directors. The lower Board, the "Vorstung," is a board made up of manager-directors who supervise and direct the day-to- day operations of the company. In effect, the powers of this board are much akin to the powers that are vested in one CEO in the United States. As a practical matter, these directors delegate specific areas of authority to each other, but each is responsible overall for the performance of the company to the upper board. The upper board, the "Aufstichsrat," is made up exclusively of non-managers. Indeed, members of the Vorstung are not permitted to be on the Aufstichsrat. As a practical matter, the chairman of the upper board has enormous amount of power.

This system works effectively in Germany due to the heavy participation of the banks in the process, normally as important members of the Board. Because most stock certificates in Germany are in bearer form and the certificates are held by banks, corporations have no way of knowing who the ultimate holders of the stocks are and rely on the banks to take a leadership role in communicating with shareholders and, in the case of shareholders' meetings, to obtain requisite proxies. However, the banks in obtaining such proxies, do not do so on behalf of the management committee. Rather, they solicit proxies that they are authorized to exercise themselves. As a consequence, and because banks cast most of the ballots, they normally elect shareholders, bank representatives, and various official experts as members of the upper board. Further, while it is not expressly clear under German law, German jurists are of the opinion that it is implicitly forbidden for management to participate in the solicitation of proxies. Banks in the United States, however, cannot, as a practical matter and likely may not as a legal matter as well, take the active role that German banks do in electing directors.

Obviously this sort of authoritative supervision is not a concept that comports well with U.S. culture, let alone U.S. law. Nonetheless, the concept that management and supervision should be divided between two separate bodies seems better calculated to provide a separate and effective balancing of power. Of greater interest to the U.S. System is the compromise in the Fifth Directive of permitting a unitary board provided a majority of the directors are "independent." This then raises the issue of how the British responded to this impetus.

While not recognized by the background research of the BRC, there has been extensive public comment and numerous separate official reports issued in Britain with respect to this very issue. After Britain had suffered a recession after 1990, there were a number of bankruptcies and firm failures that led to scandals, and the exposure of corruption and abusive power by corporate executives. The business failures hurt many individual investors. In response to this, and in an effort again to restore the confidence that seemed to have eroded, the Stock Exchange and Financial Reporting Council established a committee of inquiry (the "Cadbury Committee") to conduct an investigation and to issue a report relative to corporate governance. The final report was released in 1992 and includes a code of best practices and various voluntary recommendations. These were followed by the Greenbury Report in July of 1995, the Hempel Report in January of 1998, and the Turnbull Report in September of 1999.These reports analyze the problems and come to many of the same conclusions and recommendations as has the New York Stock Exchange, although the analysis is greater in depth. Like the BRC Report and the more recent New York Stock Exchange rules, these reports do not question the fundamental concept of the unitary board. However, beginning with the Cadbury Report, and stated in greater detail in the Hempel Report, is an analysis that begins with the acknowledgment that there are, in fact, two key tasks that must be undertaken at the very top level of management: "the running of the board and the executive responsibility for running the company's business" (Hempel Report, p. 16). With respect to this issue, the Hempel Report, at §3.17 (p. 28), states as follows:

> Cadbury recommended that the roles of chairman and chief executive officer should in principal be separate; if they were combined in one person, that represented a considerable concentration of power. We agree with Cadbury's recommendation and reasoning …. Our view is that, other things being equal, the roles of chairman and chief executive officer are better kept separate, in reality, as well as in name. Where the roles are combined, the onus should be on the Board to explain and justify the fact. [Emphasis supplied]

None of these British Reports have the authority of law, such that compliance with their proposals requires voluntary observance. Some commentators on these reports have argued that the Cadbury Report and its progeny resulted in a missed opportunity significantly to enhance monitoring roles. They say this because their analysis "restricted its proposals to what could be achieved without fundamentally altering the legal responsibilities of nonexecutives, the basic structure of the unitary board, or the United Kingdom's 'accountability through disclosure' sys- tem [emphasis supplied]." As this comment points out, it appears to be a necessity that empowerment of independent directors be effected through ceding them legal rights so that ultimately the system may rebalance itself.

Both the Fifth Directive and the various U.K. Reports and comments focus on the same issue that has been central to this chapter: namely, reallocations of power dynamics to counteract the dictatorial imperative of the Chairman/CEO in U.S. public companies. Some commentators have expressed despair as to whether this is in all events possible. For example, in the Conrad article cited earlier (at p. 1480), the author states that "whether effective supervision of management is possible in the United States for very large, very widely held corporations is debatable. It will not be brought about merely by electing a majority of directors who are 'independent' … Effective supervision will not take place unless it is accompanied by additional measures to activate it."

Indeed, it is my very thesis that such "activation" requires an assignment of power.

CONCLUSIONS AND RECOMMENDATIONS

Public companies in the United States have risen truly to be multinational entities that rival the economic size of most countries. As of 2012, the gross revenues of the United States' largest company exceeded the gross domestic product of the 27th largest country in the world, while the 100th largest company had gross revenues in excess of the gross domestic product of the 92nd largest country in the world. Viewed from this context, one might rightfully question whether the enormous economic power controlled by such companies should be vested primarily in one man, absent the existence of checks and balances that realistically and effectively prohibit the abuses of power such as those of the type that we have so recently seen. The issue becomes even clearer when one recognizes that these companies are both entrusted with savings of a wide variety of private individuals, and also are relied upon as key components of the financial markets, generally. While it is not the purpose of this chapter to analyze or suggest mechanisms of public intervention, it is its purpose to examine whether in light of the fact that such multinational companies have grown to the point where they have the ability to exercise power having a magnitude, from an economic standpoint, of large countries, it is not unreasonable at this point to require that they observe meaningful protocols of corporate governance and be required to show respect for differing views of "loyal opposition" within the company. U.S. citizens have fared well under the deliberative democracy that was established through James Madison's influence on the drafts of the U.S. Constitution. One might question, when as has apparently become the case, companies grow to the size of governments, whether they would benefit from the constructive and encouraged exchange of ideas to which our own government is subject. Whether that is the case, at some point when power grows so great, there must be an effective balance to it lest it be consumed with its own unbridled power. Referring back to the model developed earlier, this may be accomplished by mechanisms that would lessen each of the four power bases that may be exerted by the CEO in this process and by supplementing each of such power bases on the part of the audit committee. This leads me to make seven recommendations, and leave unanswered one crucial question that I have not been able properly to address.

First, the chairman of the board and the CEO should be two independent and unrelated individuals. I would even go so far as to insist that the chairman of the board also be an independent director. This must be accomplished in fact rather than having the chair a mere figurehead, with some other executive director holding the real power on the board. Such a rule would lessen the CEOs legitimate, coercive, and reward powers. Directors of European companies with whom I spoke have taken the view that no one from management should even be on the board whatsoever and that their presence there, if at all, should only be in an ex officio capacity - without power to vote. It is my instinct that it is essential to have those in management who work day-to-day with the company's operational issues, people, customers, and vendors provide their guidance and knowledge to those who are independent, as an integral part of the board.

Second, directors' compensation, and particularly the compensation of audit committee directors must be addressed to be meaningful and related to their level of responsibility and required effort, while not exorbitant. Further, it should minimize the number of shareholdings that they have compared to their net worth so that their judgment will not be affected by their own financial stake in the enterprise. This would likely mean severely limiting or eliminating stock options for directors. In so doing, the director's susceptibility to reward and coercive powers would be lessened.

Third, a truly "independent board" requires that management-members be limited to perhaps the CEO and CFO. In, for example, a seven-member board with three management directors and four independent directors, management will always vote as a block, whereas each of the independents is, realistically, a loner. This means that management needs to ally itself with or obtain the affirmative vote of only one independent director to see that is choices carry, whereas an opposition group must secure unanimity among independents to oppose management.

My final four recommendations relate to the audit committee. I accept the judgment of the BRC that this committee ought, indeed, to be the "first among equals." I accept further former SEC Chairman Levitt's view that audit committees are to "function as the ultimate guardian of investor interests and corporate accountability." In order for these goals to be achieved, the audit committee must function with separate mandates, separate power, and, effectively, a type of separate second board of directors of within the unitary board structure. It should be, in effect, be a type of Aufstichsrat but only with respect to financial disclosure and oversight. To accomplish this, in addition to the current recommendations of the New York Stock Exchange, I recommend the following:

First, as discussed above, the audit committee should have on retainer its own independent counsel and auditing consultant, neither of whom has or recently has had any significant relationship with the subject company. Such representatives are to meet regularly with the audit committee and to be available for consultation with them, and particularly with the chair, on an as needed basis. This recommendation would raise both the legitimate power and the expert power of the committee.

Second, audit committee meetings must not be attended by any other management-director or management representative, absent an invitation for that to occur. Further, the meeting should not be held at the same time as the board meetings. The presence of the audit committee at board meetings should only be for purposes of rendering a report previously prepared or for answering questions regarding that report or additional concerns of the board. This requirement lessens the susceptibility of the audit committee to the coercive and reward powers of the CEO/Chair. The purpose of this requirement is to insulate the audit committee from the influence of the Chair and to permit it freedom of deliberation without pressure of having to come to a conclusion and resolve issues to meet deadlines of others. Too often, audit committee meetings are scheduled for an hour or so before the official board meeting. In such instances, if problems arise there may be too much pressure to let the matter slip because it cannot be dealt with in the abundance of time that a full deliberation of the matter requires.

Third, any changes in the composition of the audit committee should be treated exactly in the same fashion as a change in the outside auditor. The matter must be publicly reported and reported to the SEC and a detailed explanation of the reason for the change must be given. Again, this will both enhance the committee's status of legitimate power and insulate it from coercive power.

Finally, it is possible for difficult audit committee members to be voted off after only a year. Further, there is a great deal of work that needs to be done in order to bring audit committee members up to speed and have them familiar with the processes. For that reason, audit committee members should have three-year terms, which may be staggered so as to provide continuity and the opportunity for each member to oversee a three-year span of financial statements. This enhances both expert and legitimate power while providing additional protection from coercive power.

I believe the foregoing recommendations, in addition to those proposed by the New York Stock Exchange, will more adequately establish a separate focus of power which will allow the audit committee to be immune from manipulation by management while providing mechanisms for reasonable oversight without interfering with management prerogatives. Again, such a highly independent audit committee is one that would be independent solely for the purpose of financial oversight and audit statement review. Particularly since management's compensation often turns on the accuracy of those financial statements, it seems most appropriate that someone who is fully independent be appointed to "count the change" that management is handing back to them. If management is indeed comprised of men and women of principle, then they will recognize that these recommendations will in no way interfere with their executive authority in terms of managing the day-to-day business of the company and, in view of their honesty, they should welcome the opportunity to have a certification as to the propriety of their conduct. On the other hand, if management is not so scrupulous, then so much more is the reason that such change is needed.

The one question that I must leave open at the end of this chapter, regrettably, is the question of why anyone would want to serve on such an audit committee. Clearly, there ought to be a reward of some sort for undertaking such a valuable service to the investing public. Most authorities seem to feel that stock options are not the way to go. Further, this is not like public service where the low wages paid to congressmen, and even to our own president, are ameliorated by the prestige attendant to holding such office as well as the basic notion that one should fulfill a public duty that is a part, I assume, of most politicians' decision to seek such a job. Clearly, there ought to be some benefit for all the risks so undertaken; otherwise, how many qualified individuals would be attracted to the position in the first place. Perhaps an answer may lie in recognizing such public service through a separate pool of stock options of all companies, administered in a blind fashion and available to those who serve on audit committees. Perhaps it would lie in providing committee members immunity from suit by any private individuals (i.e., nongovernmental plaintiffs) for alleged defalcations of their duty of care in exchange for an agreed waiver of any attorney-client privilege between the members and their official committee counsel. These, of course, would have to be governmental initiatives.

However an analysis of that question will have to wait for another day.

ENDNOTES

1. "What went wrong with WorldCom?" See http://knowledge.wharton.upenn. edu/article.cfm?articleid = 587. Accessed on July 3, 2002.

2. *Ibid.*

3. Hart, O. (1995). "Corporate governance: Some theory and implications." *Economic Journal*, 105, 678-689.

4. Ezzamel, M., & Watson, R. (herein, "Ezzamel and Watson"). (1997). Chapter 3. In R. P. Vecchio (Ed.), *Leadership*. Notre Dame, IN: University of Notre Dame Press.

5. *Id.*

6. Garvy, G., & Swan, P. (1994). "The economics of corporate governance: Beyond the Marshallian firm." *The Journal of Corporate Finance*, 1, 139-174.

7. Insolvency can be defined as "balance sheet insolvency," that is, liabilities in excess of assets; an inability to pay debts when due in the ordinary course; or the existence of inadequate capitalization.

8. Keasey, T., & Wright. (1997). "Introduction: The corporate governance problem – Competing diagnoses and solutions." In K. Keasey, S. Thompson, & M. Wright (Eds.), *Corporate governance: Economic and financial issues* (p. 5). New York, NY: Oxford University Press.

9. See, for example, Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (p. 7): "A proper and well-functioning system exists, therefore, when the three main groups responsible for financial reporting - the full Board including the audit committee, financial management including the internal auditors, and the outside auditors - form a 'three-legged stool' that supports responsible financial disclosure and active participatory oversight. However, in the view of the Committee, the audit committee must be 'first among equals' in this process, since the audit committee is an extension of the full Board and hence the ultimate monitor of the process."

10. See, for example, "Power, politics and influence" by Robert Vecchio in *Leadership*, *op. cit.*, pp. 73 *et seq*.

11. See "Designed by Committee", *The Economist*, 15 June 2002, pp. 69-71.

12. Much of the bases of this and the subsequent points are taken from The Corporate Paradox by Wouter H. F. M. Cortenraad, Kluwer Academic Publishers, 2000, pp. 165-169.

13. A partner at one of the then, big five accounting firms that had bid on the Enron account that was eventually won by Arthur Anderson advised the author that Enron wrote them saying that they had been passed over because they had failed to exhibit sufficient "creativity."

14. In the early 1960s, Stanley Milgram of Yale University conducted tests testing when Americans might kill if instructed to do so by an authoritative figure. The results were frightening (see Robert P. Vecchio's "Power, Politics and Influence," *supra*, at pp. 93-94, for a full description).

15. Davis, E., & Kay, J. (1993). "Corporate governance, takeovers, and the role of the Non-Executive Director." In M. Bishop & J. Kay (Eds.), *European mergers and merger policy* (Ch. 5, p. 200). New York, NY: Oxford University Press.

16. In addition to the foregoing, on April 11, 2002, Hardwick Simmons, the Chairman and Chief Executive Officer of the NASDAQ, filed a five-and-a-half-page letter with SEC Chairman Harvey Pitt suggesting "a number of tentative conclusions," as well as areas for further study, that had been deemed appropriate by NASDAQ. In light of the more detailed reports of the BRC and the New York Stock Exchange, the thinness of this response does not reflect well on the NASDAQ. By way of example, this letter boasts that the NASDAQ now "requires that each member of the audit committee be 'able to read and understand funda- mental financial statements, including a company's balance sheet, income statement, and cash flow statement.'" The NASDAQ's lack of seriousness in addressing this matter is itself a commentary on the inadequacy of corporate oversight processes.

17. *Leadership*, Robert Vecchio (Ed.) op. cit., pp. 465-483.

18. This item kept its name of the Fifth Directive even though it eventually became the Tenth in order of approval. 58, J.O. COMM. EUR.(No.C 131) 49 (Oct. 13, 1972) [herein after cited as "Fifth Directive"].

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