

Financial Markets, Investor Confidence, and Corporate Governance

INTRODUCTION

The U.S. financial markets are characterized by a widespread ownership structure where about 100 million Americans, directly or indirectly, through retirement plans, mutual funds, or active trading, participate in the capital markets. This type of ownership structure can be influenced by a typical agency problem of separation of the decision control assigned to management and the ownership control retained by a wide range of shareholders.¹ The integrity and efficiency of financial markets depend on the quality and reliability of financial information disseminated to the markets by public companies as well as investor confidence in such information. Congressman William Lacy Clay (D-MO) states:

*Over a hundred million Americans have investments in our markets. The confidence of these investors is paramount to the continued viability of the markets. This confidence is buoyed by the accuracy, reliability, and transparency of our financial reporting.*²

The primary role of all corporate governance participants as defined in this book centers around the fundamental theme of protecting investors, creating long-term shareholder value, restoring investor confidence, and supporting strong and efficient capital markets. Corporate governance measures (e.g., independent directors, competent and ethical executives, effective internal controls, credible external audits) can play an important role in minimizing the agency problem and ensuring that management's interests are aligned with those of shareholders. The pervasiveness of financial scandals and the related loss of billions of dollars of shareholder value have received extensive media coverage and attention from regulators and standard setters. This chapter discusses the importance of financial markets and the free market system, investor confidence, public trust, and effective corporate governance.

SIGNIFICANCE OF FINANCIAL MARKETS

About half of all households in the United States are now participating in the securities markets through private investing in public company shares, mutual funds, and public and private pension funds. Regarding the U.S. capital markets, the U.S. Treasury secretary, Henry M. Paulson, states that as the lifeblood of the nation's economy, the capital markets function as a conduit connecting

*those who need capital with those who invest or lend capital. They play a vital role in helping entrepreneurs implement new ideas and businesses expand operations, create jobs. They give our citizens the confidence to invest, earn higher return on their savings, and reduce the costs of borrowing for student loans, mortgages, and consumer credit. Our capital markets are the deepest, most efficient, and most transparent in the world ... competitive capital markets will pave the way for continued economic growth that benefits all Americans.*³

The U.S. financial markets are an important sector of the nation's economy. Consider these facts:

1. The U.S. financial services industry's gross domestic product (GDP) in 2006 exceeded \$1 trillion, accounting for 8.1 percent of the U.S. GDP.
2. The securities industry accounted for more than \$175 billion, about 17 percent of the total for financial markets.
3. The financial services sector employed about 6 million workers in the United States in 2005, accounting for 5 percent of the total private sector employment.⁴

As employers continue to shift the responsibility for funding retirement to individual workers, the national trend of increasing inflows into mutual funds is only expected to grow and employees will need to become more knowledgeable about investing.

The financial markets play an important role in society by:

- Efficiently allocating a scarce resource of capital.
- Enabling public companies to raise capital for establishing or expanding their businesses.
- Providing a financial marketplace for individual investors to invest money in an attempt to fund their retirement goals or try to save enough for their children's education.⁵

The free enterprise system in the United States is developed and promoted to create jobs and wealth, enable growth, foster innovation, reward initiatives and risks, and effectively use resources. It has been transformed from

a system in which our businesses were generally owned and controlled by small groups of people—and often managed by those same people—to

*a system in which our businesses are owned by public investors, each of whom share a stake in the prosperity of new business opportunities and innovations. The U.S. has achieved this widespread participation by maintaining high quality disclosure standards and enforcement policies that protect the interests of public investors.*⁶

The liquidity, integrity, safety, efficiency, transparency, and dynamics of capital markets are vital to the nation's economic welfare, since the markets act as signaling mechanisms for capital allocation. The capital markets have been vibrant because investors have confidence in them and are able to obtain, analyze, and price securities based on the information provided about public companies and the economy. Information is the lifeblood of the capital markets. Without information, stocks would be mispriced, capital markets would be inefficient, scarce resources (capital) would be inefficiently used and allocated, and economic growth would not be possible.

Capital markets provide public companies the opportunities to raise capital to establish or expand their businesses as well as finance their investments and other public projects while enabling investors to put their capital to work.⁷ Their efficiency, liquidity, and integrity depend on their "ability to obtain, digest, and price securities derived from information about companies and the economy."⁸ Lynn Turner, a former chief accountant at the Securities and Exchange Commission (SEC), in testifying before the Senate Banking Committee, states, "[T]he ability of the U.S. capital markets to attract capital depends on investors having confidence in the integrity and transparency of the markets. Confidence is earned over time through honest and fair markets that provide investors with the material information they need to make informed decisions."⁹ However, as three former chief accountants of the SEC have said: "In our capital markets a single catastrophic reporting failure is a disaster in which losses to investors and the public can be, and often are, overwhelming, wiping out decades of hard work, planning, and saving."¹⁰

PUBLIC TRUST AND INVESTOR CONFIDENCE

Public trust and investor confidence in the nation's economy and its capital markets are the key drivers of economic growth, prosperity, and financial stability. Investors are confident when stock prices are high, the news about future stock performance is optimistic, and financial information is perceived to be reliable. The wave of financial scandals in the late 1990s and the early 2000s coupled with the economic downturn had a substantial negative impact on investor confidence. Corporate and accounting scandals are still a major concern among investors. In May 2006, more than 71 percent of investors felt that accounting issues negatively affected the capital markets (down from 91 percent in 2002).¹¹ Corporate governance reforms, including the Sarbanes-Oxley Act of 2002 (SOX), SEC-related rules, listing standards of national stock exchanges, and best practices, have been established to rebuild public trust and investor confidence in corporate America. Investors would like to see changes in the corporate governance structure that not only require compliance

with these reforms but also address managerial incentives and pressures, vigilance and independence of boards of directors, quality and independence of auditors, objectivity of financial analysts, and shareholder democracy in director elections. Public trust and investor confidence in public financial information is a complex issue that “cannot be legislated . . . the investment community is requiring individual companies, one by one, to earn back market trust.”¹²

High-quality financial information contributes to investor willingness to invest in the capital markets, facilitates investment activities of public companies at a justifiable cost of capital, enables efficient capital markets and proper allocation of capital, contributes to business growth and expansion, and eventually supports economic growth and stability for the nation. Four factors can contribute to efficient, fair, and full disclosures and to the flow of high-quality information to the capital markets.

1. Public companies have strong incentives to disseminate high-quality financial information about their financial position and results of operations to enable them to raise capital at the lowest possible cost.
2. Federal securities laws, including the Securities Act of 1933 and the Securities Exchange Act of 1934, require fair and full disclosures of financial information, and they enforce an efficient flow of information to the capital markets by penalizing companies for furnishing misleading information.
3. Legislators have intervened through SOX to ensure public trust and investor confidence in financial information and the capital markets.
4. The capital markets have utilized mechanisms and technological advances to enable market participants to efficiently receive and use information in their investment activities and trading decisions.

The efficient functioning of the capital markets is based on the premise that all market participants comply with a set of laws, rules, regulations, standards, and best practices known as corporate governance. Investors must have confidence that corporate governance measures are effectively enforced and that public financial information disclosed by corporations is reliable. One factor that has contributed to the gradual decline of public confidence in corporate America is the public’s heightened awareness of the importance of corporate accountability and responsibility as it relates to financial reporting. This can be explained in several ways. First, many institutional investors have relied less on companies to provide them with transparent, reliable, and useful information in making sound investment and voting decisions and are now relying more on themselves to make their own decisions. Corporations should focus on this trend and become trustworthy and valuable by providing high-quality financial information.

Second, investors are more inclined to look to individuals, such as directors and officers, and trust them rather than “faceless” corporations. A survey reveals that “Americans are consistently more favorable towards people than towards the institutions they represent.”¹³ For example, Americans place more confidence in members of the military (soldiers) than the military, a police officer than the police, the president than the presidency, and executives in major corporations than

major corporations themselves. This fact suggests that a company's directors and officers, rather than the company itself, are more instrumental in influencing investor confidence and public trust. This trust can be badly damaged when executives of high-profile companies (e.g., Enron, WorldCom, Global Crossing, and Tyco among others) are convicted of crimes that harm investors.

Third, "Americans express the most confidence in people and institutions which are sworn to protect the public."¹⁴ This finding suggests that professionals—public accountants, doctors, attorneys, financial stock brokers, and executives—are expected to be more trustworthy than laypeople. Unfortunately, the recent wave of corporate and accounting scandals, indictments, and convictions of executives has adversely affected corporate culture and the attitude of future corporate leaders. A survey shows that: (1) only 2 percent of surveyed investors reported that they believe highly in the trustworthiness of the chief executive of large companies; (2) only 9 percent said they had full trust in financial services in 2005 compared with 14 percent in 2004; and (3) over 90 percent believed that big companies have too much influence on the government.¹⁵ Despite the low confidence that investors, both sophisticated and average, had in the ethics and corporate governance of U.S. companies, this confidence is even lower for non-U.S. companies.¹⁶

In its recommendations to improve corporate governance and public trust in corporate America, the Committee for Economic Development (CED) states:

We are unwavering advocates for the free market system, but we are just as firm in our belief that businesses and their leaders must earn the public's trust. Perceptions that firms flout rules, behave unethically, and use deceptive business processes weaken confidence in, and support for, the free enterprise system. . . . We acknowledge at the outset that no laws or policies will ever be sufficient to end all corporate misbehavior (or, for that matter, misbehavior in any segment of public life). We are confident, however, that truly independent and inquisitive boards of directors will provide the best safeguard against corporate wrongdoing.¹⁷

The heads of the six largest global audit networks—PricewaterhouseCoopers, KPMG, Ernst & Young, Deloitte & Touche, Grant Thornton, and BDO—believe that six important attributes make the capital market stable, efficient, and prosperous:

1. Investor need for information is well defined and met.
2. The roles of the various stakeholders in the capital markets (preparers, investors, regulators, standard setters) are aligned and supported by effective forums for continuous dialogue.
3. The auditing profession is vibrant and sustainable in adding value to the efficiency and growth of the capital markets.
4. A new business reporting model reflecting both financial and nonfinancial performance measures is developed to provide relevant and reliable information in a timely manner.

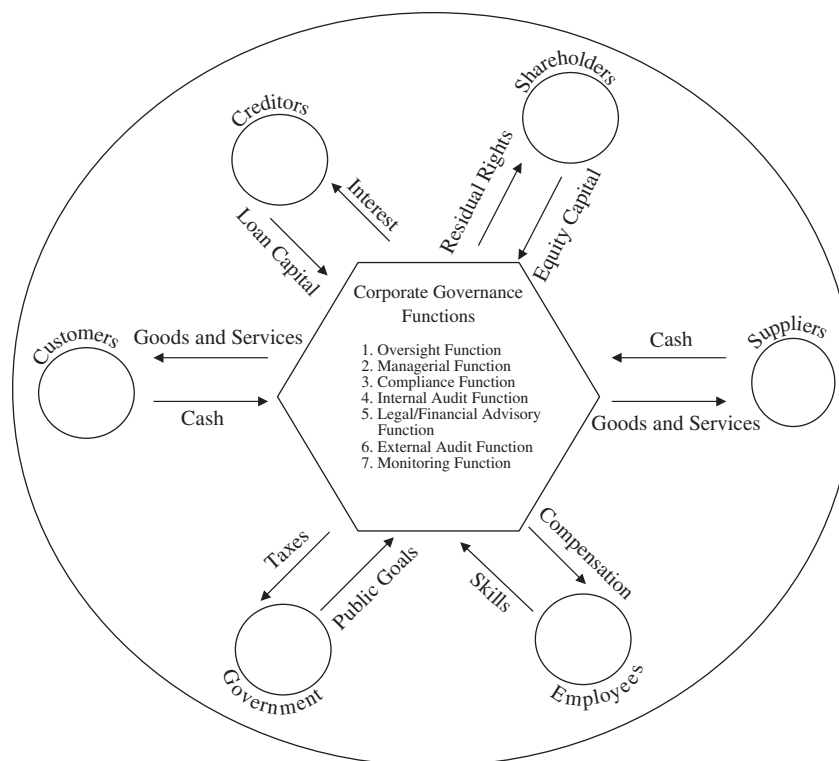
5. Large, collusive frauds, particularly financial statement frauds, are increasingly rare.
6. Financial information is reported and audited pursuant to globally consistent standards.¹⁸

The two key contributing factors to the efficient functioning of the financial markets are entrepreneurs and reliable financial information, both of which are provided by public companies. The next section presents the important role that corporations play in the financial markets.

CORPORATIONS' ROLE IN SOCIETY

Corporations with entrepreneurial spirit are the main engines that drive the nation's economy and its capital markets to long-term sustainable prosperity. Corporations have contributed to the creation of millions of jobs, which have helped to maintain unemployment at below 5 percent for many years in the United States. Corporations and their financial information contribute to the safety, integrity, and efficiency of capital markets. The financial markets provide a means of ensuring retirement funds for senior citizens, college tuition funds for the younger generation, and income for the workforce. Thus, the safety, integrity, and efficiency of the capital markets can benefit everyone. As depicted in Exhibit 1.1, corporations in the United States are viewed as creators of sustainable economic value. Public companies have a set of contractual relationships with a broad range of participants, including shareholders, creditors, vendors, customers, employees, governmental agencies, auditors, and global communities and societies.¹⁹ Corporations are viewed as a nexus of contracts with their stakeholders.²⁰ Contracting participants pursue their own goals and continue their relationships with the company only so long as there is a mutual interest and the company creates value for them. Society in general and the government in particular create an environment in which corporations are able to fulfill their social responsibility and tax obligations.

Public companies are vital to the nation's economic growth and prosperity. Sustainable performance of public companies depends on the willingness of investors to invest in them. Such willingness has been undermined by a loss of confidence in corporations and their directors and officers to look after the interests of investors. Public companies rely on public sources of funding through issuing stocks as opposed to private funding through banks or selected groups of investors. For this open financial system to function effectively there should be an appropriate system of checks and balances, namely an effective corporate governance structure. The separation of ownership and control in the open financial system can result in the agency problem between management and shareholders, where management's interests may not be aligned with those of shareholders, or where management withholds important information from shareholders (information asymmetry). Under the open system, shareholders invest in a corporation and elect the board of directors, which then hires management to run the corporation.

**EXHIBIT 1.1** Corporations' Role in Society

Source: Extracted from Z. Rezaee, *Financial Statement Fraud: Prevention and Detection* (Hoboken, NJ: John Wiley & Sons, 2002)

Exhibit 1.2 shows the distribution of 9,428 public companies by market capitalization as of June 2005. The exhibit indicates that about 77.1 percent of total public companies and about 5.5 percent of the total U.S. equity market capitalization are made up of public companies with less than \$700 million market capitalization whereas 22.9 percent of the total U.S. public companies and about 94.5 percent of the total U.S. equity market capitalization have greater than \$700 million market capitalization. The majority of new jobs in the public sector are created by smaller companies, which constitute about 80 percent of all public companies. As smaller companies grow, the integrity and quality of their financial reporting become more important to investors who provide capital for them.

Corporations are separate legal entities. Shareholders are not involved in day-to-day corporate decision making and thus cannot know enough about the company's condition to evaluate management's performance. The agency theory implies that the board of directors is elected to manage the potential conflict

EXHIBIT 1.2 Distribution of Companies, by Market Capitalization (March/June 2005)

Market Capitalization	Number of Companies	Average Market Capitalization (in millions)	Median Market Capitalization (in millions)	Percent of Companies (%)	Cumulative Percent of Number of Companies (%)	Percent of Market Capitalization (%)	Cumulative Percent of Market Capitalization (%)
\$ 0 to \$ 25m	2,641	\$8.2	\$6.3	28.0	28.0	0.1	0.1
\$ 25m to \$ 50m	965	36.1	35.0	10.2	38.2	0.2	0.3
\$ 50m to \$ 75m	565	62.0	62.0	6.0	44.2	0.2	0.5
\$ 75m to \$100m	418	86.9	86.5	4.4	48.7	0.2	0.8
\$100m to \$200m	1,020	143.3	140.9	10.8	59.5	0.9	1.6
\$200m to \$500m	1,270	325.0	314.6	13.5	73.0	2.4	4.1
\$500m to \$700m	393	597.8	601.8	4.2	77.1	1.4	5.5
\$700 to \$ 1b	408	839.1	831.8	4.3	81.5	2.0	7.5
\$1b to \$ 5b	1,195	2,173.6	1,839.3	12.7	94.1	15.4	22.9
\$5b to \$ 10b	234	7,099.6	6,851.2	2.5	96.6	9.8	32.7
\$10b or more	319	35,637.8	18,803.5	3.4	100.0	67.3	100.0

Source: Adapted from Securities and Exchange Commission, Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission, April 23, 2006. Available at: www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

of interests between management and shareholders. It further assumes that this internal mechanism is designed to align the interests of management with those of the shareholders without the need for external mechanisms (e.g., regulations and rules). The first wave of financial scandals at the turn of the twenty-first century and the second rash of option backdating scandals in 2006 prove that internal mechanisms alone may not be adequate. There should be a set of laws, rules, regulations, standards, and best practices that lead management to act ethically and responsively, in the best interest of shareholders, and to provide market participants with accurate, complete, timely, and useful information. It is unrealistic to expect all corporate directors and officers to provide accurate and complete financial information all the time. Indeed, the reported financial scandals and highly publicized financial restatements prove that directors and officers can be motivated to provide misleading and fraudulent financial reports when the opportunities exist. Thus, corporate governance measures are designed to create a culture of ethical conduct and compliance and to ensure that investors receive accurate, complete, and timely information to make investment and voting decisions.

Investors are responsible for providing needed capital to facilitate the effective operation of the company and have a right to elect their representatives, the company's board of directors. The board of directors is authorized to make decisions on behalf of its constituents (investors) and is directly responsible for selecting and continuously monitoring management's decisions and actions without micromanaging. Management is authorized to run the company and is responsible and accountable for decisions made and actions taken with the primary purpose of creating and enhancing sustainable shareholder value. Corporate governance provides the opportunity for shareholders to monitor the company's board of directors and enables the board to oversee management and facilitate management's decision-making process, which creates shareholder value. Corporate governance should create an appropriate balance of power-sharing that:

- Provides shareholder democracy in freely electing directors (e.g., the majority voting system).
- Enables the board of directors to make strategic decisions and oversee and consult with management without micromanaging.
- Empowers management to run the company.

The separation of ownership and control in the modern corporate structure, the diffuse nature of ownership, and the focus on protecting the interests of a wide range of stakeholders (investors, creditors, employees, management, customers, suppliers, government, and others) necessitate the need for an effective corporate governance structure that addresses, manages, and minimizes potential conflicts of interest among corporate governance participants. These conflicts of interest are commonly referred to as an agency problem resulting from differences in incentives and goals of corporate governance participants and information asymmetry among those participants. The primary goal of corporate governance is not simply to reduce agency costs, but to create an equitable balance of power and access to relevant information among all corporate governance participants, particularly shareholders,

directors, and management. Recent financial scandals have raised serious concerns about how this balance is being managed and who is watching over the companies to ensure that shareholders' interests are being protected.

SOURCES OF INFORMATION TO THE CAPITAL MARKETS

Technological advances, including the Internet, enable investors to have real-time online access to a large volume of information about public companies—their governance, operations, and investment choices—and capital markets. The Internet facilitates the flow of fair and transparent information to all investors, individuals, and institutions, small or large. Investors have online access to companies' financial disclosures filings and auditor and analyst reports, and they rely on information public companies disseminate to the capital markets in making investment and voting decisions. Information from public companies flows into the marketplace from three fundamental sources: regulated disclosures, voluntary disclosures, and research analyst reports.²¹

Regulated Disclosures

The United States Congress established the capital markets as a disclosure-based system rather than a merit-based system. That is, the SEC regulates the capital markets by establishing rules and regulations that require public companies to disclose material information that may impact investors' investment decisions. The SEC does not regulate by determining the merits of whether it is appropriate for a company to be public and sell its stock to the public. Accordingly, in the late 1990s, the SEC permitted dot-com companies to make initial public offerings (IPOs) despite questionable business plans, recurring losses, and little or no revenue streams, provided they made the required disclosures.

Regulated disclosures include filings with the SEC of annual audited financial statements on Form 10-K, quarterly reviewed financial reports on Form 10-Q, extraordinary transactions on a current basis on Form 8-K (e.g., auditor changes, resignation or death of a director or an officer, bankruptcy), and internal control reports for large public companies (Sections 302 and 404). These filings are discussed in detail in Chapter 6. Financial statements and internal control reports should be prepared from the perspective of shareholders who have residual claims on a company's assets. These regulated financial disclosures are a vital source of information to investors. These disclosures create a way for public companies to communicate with their shareholders about financial and corporate governance issues that affect their financial condition and results of operations. SEC-mandated filings have been criticized for encouraging public companies to focus on the short-term performance of meeting earnings forecasts and creating a check-box compliance mentality in order to ensure minimum compliance with SEC rules rather than focusing on improving earnings quality and quantity.²²

Donald T. Nicolaisen, the former chief accountant of the SEC, stated regarding the importance of high-quality financial information that "financial reporting can be

a matter of life and death . . . If this [the wave of accounting scandals and corporate fraud] happened in the medical profession, we wouldn't stand for it. It's time for the accounting profession and the business community to catch up."²³ Financial disclosures under SEC regulations are a step forward in providing investors with reliable financial information. William McDonough, the former chairman of the Public Company Accounting Oversight Board (PCAOB), stated, "[C]onfidence in the accuracy of accounting statements is the bedrock of investors being willing to invest, in lenders to lend and for employees knowing that their firms' obligations to them can be trusted."²⁴ The SEC, through its EDGAR online filing and disclosure system, has the potential to facilitate electronic access and the ability to compare financial reports of public companies. The SEC is also promoting the use of tagged financial reporting data by utilizing the eXtensible Business Reporting Language (XBRL) to enable investors and other market participants to access and analyze financial data from different software platforms. The move toward the use of the XBRL format should provide investors with online real-time access to a large volume of standardized tagged financial information. On September 25, 2006, the SEC announced that it awarded three separate contracts totaling \$54 million to transform its filing disclosure system from a form-based electronic filing cabinet to a dynamic real-time system with interactive capabilities.²⁵ The three contracts are intended to: (1) modernize and maintain the EDGAR database to use interactive data using the XBRL language; (2) complete XBRL code writing for U.S. GAAP (generally accepted accounting principles) financial statements by preparing XBRL taxonomies that can be used by all companies in all industries; and (3) develop interactive data tools for investors on the SEC's Web site to enable investors to view and analyze companies' financial data that are filed in XBRL.

The value of investors' investment and quality of their voting decisions depend on the accuracy of information they used in the decision-making process. It is expected that in the post-SOX era, investors will have more access to better-quality financial information for four reasons:

1. New corporate governance reforms (SOX, SEC rules, listing standards), which promote more shareholder democracy (e.g., majority voting, declassified boards)
2. More vigilant oversight responsibility by boards of directors, particularly the audit committee
3. Executive certifications of internal controls and financial statements
4. Improved audit objectivity and independence (the PCAOB, SEC rules)

The SEC's self-filing financial disclosures have worked well in requiring public companies to file their quarterly reviews and annual audited financial statements and in punishing companies for filing misleading financial reports or violating securities laws. The SEC, by moving toward convergence and principles-based global accounting standards, can facilitate the flow of capital across national borders and enable investors to gain access to more easily available, less complex, and more comparable global financial information. The SEC's success in achieving its mission of protecting investors from receiving misleading financial and regulated disclosures and maintaining efficient, transparent, and competitive capital markets can only be

measured in terms of investor confidence in the markets. Establishing appropriate securities laws and maintaining effective enforcement of the laws is essential in sustaining investor confidence. Securities laws that are not cost-effective, efficient, and scalable and are not effectively enforced can erode investor confidence.

Voluntary Disclosures

Public companies often voluntarily release earnings guidance regarding projected performance and other financial and nonfinancial information in addition to their mandated disclosures. Public companies have traditionally provided investors and analysts with earnings guidance. This practice was initiated during the 1970s, when many companies began privately communicating their earnings forecasts to large investors; it became a common practice during the stock market boom of the 1990s, particularly when Congress protected companies from liability for their earnings forecasts.²⁶ Earnings announcements, even though not required, provide valuable information to market participants and motivate companies to meet their earnings expectations. Voluntarily released earnings guidance is expected to result in higher valuations, lower volatility, and improved liquidity.²⁷ However, a study reveals that while corporate earnings guidance may increase trading volumes in the short term, it does not increase valuations and has no lasting effect on stock price volatility or liquidity.²⁸ The 2006 survey of 213 finance executives who prepare financial reports including earnings guidance indicates that: (1) the majority (53 percent) issuing earnings guidance, about 37 percent, do not issue such guidance and more than 10 percent while still issuing earnings guidance are considering issuing it less frequently; and (2) the majority (59 percent) do not think that eliminating quarterly reports (10-Qs) and keeping just annual reports (10-Ks) would serve shareholder interests of focusing companies on long-term performance.²⁹

Several prominent public companies (e.g., Coca-Cola, Intel, Ford, General Motors, Google, and Citigroup) have discontinued the practice of issuing earnings guidance and instead issue more detailed performance measures.³⁰ These companies have decided to focus on sustainable goals and long-term performance instead of short-term earnings achievements. They are attempting to avoid both the costs associated with releasing earnings guidance and the possible negative impacts on stock price if earnings guidance targets are not met. However, the majority of surveyed companies (83 percent) that are already issuing earnings guidance plan to continue to do so. About 75 percent of the surveyed companies believe that earnings guidance helps to satisfy requests from investors and analysts, and over half report that the guidance facilitates management's focus on financial goals.³¹

Surveyed executives do not agree on the costs and benefits of releasing earnings guidance. The perceived benefits of issuing earnings guidance include:

- Satisfying requests from investors and analysts.
- Maintaining a channel of communication with investors.
- Intensifying management's focus on achieving financial targets.
- Moderating the volatility of the company's share price.³²

Ironically, potential benefits did not include achieving higher valuations, building a wider shareholder base, or increasing liquidity.³³ The executives surveyed mentioned costs associated with issuing earnings releases, including the cost of management time, the shortcomings of focus on short-term earnings, and the cost of employee time.³⁴ The survey also reveals that sell-side analysts demand earnings guidance more insistently than mutual/pension funds and hedge funds and that discontinuing earnings guidance releases may decrease the company's visibility and cause analysts to reduce coverage.³⁵

Merrill Lynch believes it would be in investors' best interests if companies dropped quarterly earnings guidance. It claims that market participants need to see earnings guidance for what it is—a rough assessment of one indicator of a company's well-being. Earnings guidance dictates an outcome and discourages debate.³⁶ It is not accurate and is constructed in such a way that companies have “either [met] or ‘beat[en]’ their guidance in 56 of the last 59 quarters.”³⁷

Large public companies, their analysts, and fund managers are in favor of discontinuation of quarterly earnings guidance. This discontinuation is expected to change the relationship between company's executives and financial analysts, as well as the way fund managers are evaluated and rewarded. Quarterly earnings guidance has been provided because it: (1) assists management to focus on short-term results; (2) makes forecasting by analysts easier; and (3) enables hedge funds to profit from discrepancies between actual earnings and forecasted earnings. However, earnings guidance, by focusing on the company's short-term performance at the expense of its long-term health, is detrimental to sustainable shareholder value creation and enhancement.

The CFA Institute Center for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics issued a report that calls on corporate leaders (CEOs, CFOs), asset managers, investors, and others to: (1) break the short-term obsession that is detrimental to corporate governance effectiveness and sustainable shareholder interest; (2) reform practices involving earnings guidance, compensation, and communications to investors; and (3) adopt practices to promote sustainable and enduring shareholder value creation and enhancement.³⁸ The report outlines a broad set of recommendations, suggesting that companies, their leaders, institutional investors, analysts, and asset managers deemphasize short-term performance. The nine specific recommendations are to:

1. Reform earnings guidance practice by reconsidering the benefits and consequences of providing earnings guidance and making adjustments to earnings guidance that best reflect shareholders' sustainable interests.
2. Develop long-term incentives across the board by linking compensation for corporate executives and asset managers to the achievement of long-term strategic and value-creation goals.
3. Demonstrate corporate leadership by focusing on sustainable shareholder value creation and enhancement.
4. Improve communications and transparency by providing more meaningful and frequent information regarding the company's strategy and long-term value

drivers that could effectively lessen the financial community's dependence on earnings guidance.

5. Promote broad education for all market participants about the benefits of long-term thinking and the costs of short-term thinking.
6. End the practice of providing quarterly earnings guidance.
7. Align corporate executive compensation with long-term shareholder interests.
8. Improve disclosure of asset managers' incentive metrics, fee structures, and personal ownership of funds they manage.
9. Endorse the use of corporate long-term investment statements to shareholders that adequately reflect the company's operating model.³⁹

The report states: "The obsession with short-term results leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns and impeding efforts to strengthen corporate governance."⁴⁰ William Donaldson, former SEC chairman, while supporting recent efforts to convince public companies to stop issuing quarterly earnings, warned that any movement in this direction should be balanced by increasing disclosure about the company's key performance indicators, including long-term strategic goals.⁴¹ Christopher Cox, the chairman of the SEC, says that "recent calls for public companies to stop issuing quarterly earnings guidance are healthy recommendations."⁴² However, any efforts in reforming earnings estimates should not make public companies less transparent or their disclosures less frequent to investors. Relevant, timely, and forward-looking information is vital to the financial market and is instrumental in reducing financial risk and uncertainty over corporate prospects.

Technological advances enable corporations to utilize a variety of means to communicate with their shareholders and other users of their financial and nonfinancial information. An increasing number of high-profile companies publish corporate blogs and online diaries to disseminate relevant information. SEC disclosure rules including Regulation Fair Disclosure (Reg. FD) allow public companies to provide information by any broad and nonexclusionary methods including blogs, Web sites, webcasts, news releases, and regulatory filings that reach a broad audience. Indeed, in the first official communication posted to a blog by Christopher Cox, the chairman of the SEC encourages companies to disclose significant financial information through blogs as a way to expand investors' access to relevant information.⁴³ As of November 2006, more than 30 Fortune 500 companies, including Amazon.com, Cisco Systems, Oracle, Boeing, and General Motors, were utilizing blogs to disseminate relevant, broad, nonexclusionary, timely, and robust information to the investing public.⁴⁴

Research Analyst Reports

Financial analysts who follow and project companies' future earnings and evaluate their short-term quarterly performance are an important source of information and are essential to transparent and efficient capital markets. Analysts forecast for both long-term and short-term earnings quality and quantity. The mere focus on short-term analyst forecasts and quarterly earnings guidance when such earnings numbers can be easily managed through either acceleration of revenue recognition or deferral of investments (e.g., technology, research, and development) can create

an illusion of value relevance of earnings releases. Management has traditionally manipulated earnings disclosures by establishing or promoting a low threshold for earnings forecasts and then attempting to beat the forecasts through actual lower-than-optimum performance or earnings management. This process can lead to the misallocation of investor capital when reported earnings are higher than management-forecasted earnings.

Academic research documents that sell-side analysts' earnings estimates and forecast revisions provide an important source of information to the marketplace, with a stronger market reaction to upward rather than downward forecast revisions.⁴⁵ During the economic and market boom of the 1990s, the objective and skeptical mental attitude of analysts became almost irrelevant. The perception was that the analysts' research was not influenced by investment banking concerns. However, reported financial scandals of the early 2000s raised three concerns regarding analysts' conflicts of interest:

1. While the Nasdaq Composite Index was dropping by more than 60 percent, less than 1 percent of analysts' recommendations in 2000 were to sell.
2. About 99 percent of all recommendations by sell-side analysts were to hold, buy, or strong buy.
3. Public companies often withheld business from firms whose analysts issued unfavorable reports.⁴⁶

SOX and SEC-related rules on Regulation Analyst Certification (Reg. AC) address the objectivity of analysts' forecasts and forecast revisions; the topic is discussed in detail in Chapter 8. Reg. AC requires that research reports distributed by brokers and dealers certify that the views expressed in the reports accurately reflect authors' personal views of the securities or issuers and state whether the authors' compensation was, is, or will be directly or indirectly related to the expressed recommendations or views.⁴⁷ The National Association of Securities Dealers (NASD) in 2006 issued its guide to understanding securities analyst recommendations, which suggests that analysts' ratings do not have clear and standardized meanings (e.g., "underperform" means different things to different analysts) and a potential conflict of interest may influence an analyst's recommendations.⁴⁸ Thus, investors should be aware of both the nature (potential conflicts) and content (meanings) of analyst recommendations.

The current system of financial disclosures—which consists of mandated disclosures of quarterly, annual, and other filings with the SEC; voluntary disclosures of earnings guidance above and beyond the required disclosures by the SEC; and analyst reports—has served the capital markets, investors, public companies, and regulators well. Nonetheless, this model captures only financial information regarding financial conditions and results of operations. A corporate reporting model that captures both financial and nonfinancial key performance indicators is needed. Nonfinancial information disseminated to the capital markets by public companies includes:

- Market information, such as market growth, market share, and regulatory environment.
- Corporate governance information, such as board of directors' composition, structure, and committees.

- Strategic information, such as goals and objectives.
- Information about management, such as track record, compensation plans, and incentive plans.
- Value-creating information, such as customers, employees, suppliers, innovative brands, and supply chain.
- Corporate responsibility information, such as environmental, ethical, and social information.
- Forecasts, projections, and other technical and quantitative market information.

Investors demand forward-looking financial and nonfinancial information, and companies have strived to provide such information. PricewaterhouseCoopers has recently published a practical guide based on best practices of providing a view of the future that investors need.⁴⁹ PwC's guide is based on the seven pillars of effective communication by public companies to their stakeholders, including shareholders:

1. Resources available to the company and how they are managed.
2. Key risk and uncertainties that may affect the company's sustainable performance in creating long-term value for its shareholders.
3. The significant relationships with principal stakeholders (e.g., shareholders, customers, suppliers, employees, governments, and society) that are likely to affect the company's sustainable performance.
4. Quantified data pertaining to trends and factors that are likely to influence the company's future prospects.
5. Any uncertainties underpinning forward-looking information.
6. Targets relating to key performance indicators (both financial and nonfinancial) used to manage the company's business.
7. How the report reflects the company's long-term objectives and the strategies to achieve those objectives.⁵⁰

The ever-growing complexity of business transactions (e.g., derivatives fair-value measurements), recent regulatory reforms, and litigious environment have contributed to the complexity of accounting standards. Overly complex accounting standards may not provide the necessary guidance for the preparers and auditors to produce high-quality financial information and can create a significant cost burden with little value to investors. Regulators (SEC), standard setters, and the business community should work together to address the complexity. While regulators should review the accuracy and completeness of financial reports as well as proper disclosures of business transactions, they should avoid second guessing management's judgments. When issuing accounting and auditing standards to assist in the preparation of high-quality financial information, standard setters should make their standards cost-effective, efficient, and scalable. Corporations should regard the preparation and dissemination of high-quality financial reports as their ultimate goal and fiduciary duty to the investing public. Any improvements in this system—such as more timely and ready access to relevant information by using the XBRL format, greater focus on a principles-based approach to financial reporting, or less complexity in and convergence toward globally accepted accounting standards—enable public companies to provide better-quality financial information to investors.

The capital markets in the United States, the strongest in the world, cannot survive without public trust and investor confidence in the reliability of the financial information disseminated to them. The reported financial scandals and financial restatements have underscored how vital these qualities are. The reliability, relevance, usefulness, and transparency of information disseminated to the marketplace depend on personal integrity, competence, and professional accountability of those involved in the financial reporting process. These participants are management, boards of directors (including the audit committee), independent auditors, and financial and legal advisors. Management is primarily responsible for the reliability and completeness of financial and nonfinancial reports; the other participants are corporate gatekeepers, as discussed in the next section. These gatekeepers play an important role in influencing the quality of information corporations disseminate to the marketplace.

CORPORATE GATEKEEPERS

True corporate governance reforms and best practices require the establishment of four key gatekeepers that ensure proper checks and balances and accountability for financial reporting. These gatekeepers are:

1. An independent and competent board to oversee management's strategy and financial reporting performance.
2. An independent and competent external auditor to provide a high level of assurance as to the reliability, quality, and transparency of the financial reports of public companies.
3. Competent legal counsel to provide ethical legal advice and to ensure that there is more than mere technical compliance with applicable laws, regulations, rules, and standards.
4. Competent and ethical financial advisors and investment bankers to advise companies in conducting their business affairs.

These gatekeepers play a key role in the effective and efficient functioning of the capital markets. Investors look to and often rely on the gatekeepers to protect their interests; regulators hold them accountable for guarding against corporate malfeasance and misleading financial information. It should be noted that legal counsel and financial advisors are generally viewed as advocates for those they represent as opposed to being investors' representatives. The other two gatekeepers—the board of directors and the independent auditor—are legally and conceptually regarded as representing investors with the purpose of protecting investor interests.

A look at the recent high-profile financial scandals shows that the failures of these gatekeepers were significant contributory factors. The question often heard during the reported financial scandals at the turn of the twenty-first century, “where were gatekeepers,” is being asked again as more than 200 companies are being investigated by federal authorities for their practice of backdating employee stock option grants. Backdating practices enable the company's executives and key personnel to profit by retroactively locking in a low purchase price for stock.

To fulfill their responsibilities effectively, gatekeepers should:

- Be objective and fully independent from the company.
- Exercise professional skepticism when dealing with the company's management or relying on management representations.
- Effectively discharge their professional responsibility to the company and its investors.
- Withdraw from any engagement when the integrity of their work is compromised due to conflicts of interest or if they become aware that misleading representations have explicitly or implicitly been made to investors due to factors beyond their control.

The value-adding activities, roles, and responsibilities of gatekeepers and other corporate governance participants are examined in more detail in Chapters 3 through 10. No corporate governance would be necessary if management acted in the best interests of shareholders and if corporate gatekeepers (board of directors, lawyers, and accountants) effectively discharged their fiduciary duties and professional responsibilities. Corporate governance is needed to avoid concentration of power in the hands of management and to create an effective system of checks and balances to balance power-sharing authority among shareholders, boards of directors, and management. Due to corporate governance reforms, all gatekeepers have increased responsibility and accountability to work toward the achievement of sustainable shareholder value creation and enhancement. The effectiveness of these reforms depends on the quality of the value-adding professional judgment of all gatekeepers.

Corporate governance is conceived broadly in this book in terms of institutional arrangements and mechanisms that affect and are affected by the role of corporate governance participants, particularly all corporate gatekeepers. Public companies have recently undergone a series of reforms intended to improve the effectiveness and objectivity of corporate gatekeepers. Corporate governance has been a central issue within those companies, and it is becoming a process through which shareholders induce management to act in the best interests of the company and its shareholders. A study of more than 300 global institutional investors reveals that corporate governance concerns are still very much on the rise even in the post-SOX era.⁵¹ The study also indicates that “corporate governance means different things to different people,” which is the topic that will be discussed in the remainder of this chapter.⁵²

CORPORATE GOVERNANCE

Philosophy

The corporate governance philosophy adopted herein does not advocate a “one-size-fits-all” approach to governance and management of the company. Instead, it focuses on a conceptual and integrated approach to creating an appropriate balance between the two complementary, and yet often conflicting, forces of the decision control

vested in the company's board of directors and management and its ownership control exercised by shareholders. Shareholders elect directors to govern the company; then directors hire top management and other key professionals, such as financial advisors, legal counsel, and auditors, among others, to operate the company for the benefits of the shareholders. Thus, shareholders place trust in management to act in their best interests, and they rely on corporate governance mechanisms to reinforce this trust, although it may be adversely affected by conflicts of interest and information asymmetries between management and shareholders. The principal-agent relationship can be aligned and strengthened through a proper system of checks and balances and accountability provided by corporate governance.

The effectiveness of corporate governance depends in part on compliance with appropriate state and federal statutes as well as listing standards and best practices suggested by investor activists and professional organizations. Failure to comply with such standards could result in fines, delisting penalties, and bad press, causing a substantial devaluation of the share price and ultimately bankruptcy. While compliance is required, it does not guarantee effective corporate governance. Effective corporate governance can be achieved only when all participants:

- Add value to the company's sustainable long-term performance.
- Effectively carry out their fiduciary duty and professional responsibilities.
- Are held accountable and personally responsible for their performance.
- Develop a practice of compliance combined with a commitment to the highest ethical standards with a goal of avoiding potential conflicts of interest and acting in the best interests of the company and its shareholders.

The 2006 Global Study by the Institutional Shareholder Services (ISS) finds that corporate governance has transformed from a compliance obligation to a business imperative, and it is now regarded as being a part of the ownership responsibility.⁵³ This business imperative philosophy is advocated and discussed throughout this book. As one would expect, well-governed companies outperform weak-governed companies over the long term. A study by Governance Metrics International reveals that companies with less effective corporate governance, measured in terms of less board oversight, were more likely to restate their earnings and financial statements and were less compliant with corporate governance reforms than well-governed companies.⁵⁴ Academic research suggests that good (poor) corporate governance is associated with higher (lower) profits, less (more) risk, less (more) stock price volatility, higher (lower) values, and larger (smaller) cash payouts; and that firms with stronger corporate governance experienced higher stock returns (an average abnormal return of 8.5 percent per year) than those with weaker corporate governance during the 1990s.⁵⁵

Definition

The business literature has defined corporate governance in different ways and from different perspectives. Some authors define corporate governance from a regulatory perspective as "the system of laws, rules, and factors that control operations at a

company.”⁵⁶ Others define it from the point of view of corporate governance participants and the related constraints of dealing “with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”⁵⁷ Yet others view corporate governance as more than merely the relationship between the company and its capital providers, by focusing on the broader aspects of stakeholders. In the areas of law and economics, corporate governance investigates how to secure and motivate efficient management of corporations by the use of incentive mechanisms, such as contracts, organizational design, and legislation.⁵⁸ Corporate governance can also be defined in the context of the agency theory, as a process designed to align interests of management (agent) with those of shareholders (principals), and to hold management accountable to the company’s equity owners.

In essence, corporate governance is a legal concept used to describe corporate oversight accountability and the balance of power that exists among shareholders, management, and directors. The legal definition of corporate governance focuses on the enforcement of shareholders’ rights, stating that “the field of corporate governance is concerned with the rules and principles that regulate the power relationship among owners [shareholders], directors, and managers.”⁵⁹ Thus, corporate governance defines shareholders’ rights and their enforcement and the fiduciary duties of the company’s directors and officers to its shareholders. State laws have traditionally provided the definition and enforcement of shareholders’ rights. Nonetheless, federal laws and regulations (SOX, SEC rules), through proxy rules and public filings, have significantly influenced the enforcement of shareholders’ rights.⁶⁰ Institutional investors have used the federal proxy rules in an effort to shape and improve corporate governance practices at individual companies. Thus, from a legal point of view, corporate governance is influenced by state and federal laws as well as regulations and the listing standards of national stock exchanges.

In practice, effective corporate governance can be described as a vigorous set of checks and balances that establish responsibilities, require accountability, and enforce consequences. In this context, the term “corporate governance” refers to the company’s decision-making and control processes as determined by its board of directors. Thus, it can be more narrowly defined as the extent of a company’s compliance with applicable laws, rules, regulations, standards, and best practices, or it can be more widely defined as a company’s relationship with a wide range of corporate governance participants, including the board of directors, management, auditors, legal counsel, financial advisors, regulators, standard setters, shareholders, and other stakeholders. Corporate governance is a process effected by legal, regulatory, contractual, and market-based mechanisms and best practices to create substantial shareholder value while protecting the interests of other shareholders. This definition is adopted in this book and implies that there is a dispersed ownership structure and thus the role of corporate governance is to limit opportunistic behavior of management. In a capital structure where there is concentrated ownership and a small group of shareholders can exercise ownership control, corporate governance should ensure alignment of interests of controlling shareholders with those of minority or individual shareholders.

Corporate Governance Drivers

The corporate governance structure in the United States is a hybrid system of laws, regulations, and best practices. The primary drivers of corporate governance are state corporate laws, federal and state securities law, judicial process, stock exchange listing standards, best practices, and market correction mechanisms. These drivers are synthesized next and discussed more thoroughly in Chapter 6.

State Corporate Laws Corporations are incorporated in a particular state. Each state establishes its own corporate laws, and its court system interprets that law. State corporate laws establish a minimum standard of conduct for corporations and their directors, officers, and shareholders; they also specify the fiduciary duties, authorities, and responsibilities of each. State corporate laws influence corporate governance by creating a balanced power-sharing situation among company shareholders, directors, and management. Corporate law specifically affects corporate governance issues relating to company formation, rights of shareholders, fiduciary duties of directors and officers, financial reporting and disclosures, proxy rights at annual shareholder meetings, voting procedures, rights of foreign creditors and shareholders, and rights of minority shareholders. For example, according to Delaware general corporate law requirements:

- The board of directors must have at least one member.
- The board has the authority to run the business and affairs of the corporation.
- The board has the authority to designate new members if a current member is disqualified or resigns.
- Any committee can create a subcommittee, given that there is at least one committee member on the subcommittee.
- Directors are protected while performing their duties as long as they accept documents from officers, employees, and others in good faith and exercise due care.
- The company can loan money or provide other assistance to any director or employee.
- Nonindependent directors and directors with interests in other corporations are allowed as long as the relationship is disclosed and is not detrimental to the company.⁶¹

Federal Securities Laws During the early 1900s and prior to the establishment of the SEC in 1934, financial markets in the United States were primarily unregulated. Prior to the market crash of 1929, there was not much interest in federal regulation of the securities markets.⁶² Investors did not have much of an appetite for the regulations requiring financial disclosure or the federal oversight of the securities market. The Securities Act of 1933 was passed by Congress with the primary purpose of requiring that investors receive adequate financial and other information regarding securities offered for public sale, prohibiting misinterpretations, deceit, and other fraud in the sale of securities. The Securities Exchange Act of 1934 provided protection for investors who trade securities by creating the SEC to oversee

the securities industry. SOX was passed by Congress in July 2002 to further hold public companies accountable for their financial reports.

Federal securities laws are passed by Congress and are intended to protect investors and improve investor confidence. Lawmakers can influence corporate governance in two ways: (1) through their legislation, such as the passage of securities laws; and (2) through their efforts, often motivated by lobbyists, to influence the SEC's rule-making process. Legislation has been very effective and beneficial in protecting investors from corporate malfeasance and in creating an environment in which corporations conduct their legitimate business of creating shareholder value. Efforts by lawmakers to influence the SEC have been controversial and contra-effective, as stated by former SEC chairman Arthur Levitt:

*Every day, the SEC would receive letters from lawmakers opposing some proposed regulatory change—[auditing reforms, expensing of stock options]—letters that eerily mimicked the rhetoric of one industry trade group or another . . . Many of the reforms that were thwarted in this way could have saved investors some of the pain from the scandals of the past five years.*⁶³

The two fundamental federal securities laws pertaining to public companies are the Securities Act of 1933 and Securities Exchange Act of 1934. These Acts are primarily disclosure-based statutes that require public companies to file periodic reports with the SEC and to disclose certain information to shareholders. Since its inception in 1934, the SEC has influenced corporate governance beyond its mandatory disclosure requirements through establishing rules to regulate the disclosures and processes for proxy statements. The federal securities laws, while providing a regulatory environment within which public companies operate, do not generally “address rules of corporate conduct affecting the market place, except as to matters such as disclosure and fraud.”⁶⁴

Judicial Process Court cases brought under both state and federal laws have had some positive impacts on public companies' governance. For example, as part of the settlement negotiated by public pension funds (the California Public Employees' Retirement System, the New York State Common Retirement Fund, and the New York City Pension Funds) in *In re Cendant*, in addition to a \$3.2 billion cash settlement, Cendant agreed to several corporate governance reforms to prevent further occurrence of financial fraud.⁶⁵ The measures adopted at Cendant required:

- The majority of directors to be independent directors.
- The establishment of audit, compensation, and nominating committees composed solely of independent directors.
- The elimination of the staggered board.
- Shareholder approval regarding the repricing of underwater options.⁶⁶

Another example of the influence of courts on the development of corporate governance is the recent decision by the Second Circuit Court of Appeals, on

September 5, 2006.⁶⁷ The court decision overturned the SEC's staff interpretations that allow public companies to exclude shareholder proposals on nomination of directors from proxies. Indeed, the court ruled that under the existing SEC rules, shareholders may access the proxy for purposes of submitting proposals regarding the nomination of their choice of a candidate for director. The SEC, in October 2003, released a proposed rule that would require public companies to include in their proxy material shareholder nominees for election as director in order to enhance shareholders' ability to participate in the proxy process for the nomination and election of directors.⁶⁸ As of April 2007, no further actions had been taken by the SEC to finalize its proposal. It is expected that the court's decision will encourage the SEC to improve disclosure regarding nominees of long-term shareholders.

Listing Standards Listing standards adopted by national stock exchanges establish corporate governance standards for companies in order to promote high standards of corporate democracy, corporate responsibility, and accountability to shareholders, and to monitor the operation of the securities markets. Corporate governance listing standards address a variety of issues, from uniform voting rights to the mandatory audit committee formation and shareholder approvals of broad-based option plans. These listing standards are regarded as "rules" under the 1934 Exchange Act, and as such they must be approved by the SEC before they become effective.

Listing standards of national stock exchanges (NYSE, Nasdaq, and AMEX) go beyond provisions of SOX in establishing corporate governance rules for listed companies.⁶⁹ The seven key provisions of these listing standards follow.

1. Listed companies must have a majority of independent directors (e.g., two-thirds independent directors). However, investor advocates argue that the definition of "independent directors" adopted by national stock exchanges should be further strengthened.
2. An independent director is one who has no material relationships (e.g., financial, affiliation) with the company.
3. Independent directors must meet regularly (e.g., at least four times a year) without the presence of management.
4. Listed companies must have at least three mandatory board committees, including audit, compensation, and nominating/governance.
5. The three mandatory board committees must:
 - a. Be composed solely of independent directors.
 - b. Have a written charter addressing their purpose, goals, roles, authority, responsibilities, and resources.
 - c. Conduct the entire board and the committees' annual performance evaluation.
6. Listed companies must adopt and disclose their corporate governance guidelines.
7. Listed companies must adopt and disclose a code of ethics and business conduct for their directors, officers, and employees, and must promptly disclose any noncompliance with the code by their directors or officers.

Enforcement of listing standards has been criticized primarily because there has rarely been a delisting resulting from noncompliance with standards. These and other aspects of self-regulatory organizations are further discussed in Chapter 6.

Best Practices Corporate governance best practices suggested by professional organizations (Conference Board, the National Association of Corporate Directors, Business Roundtable) and investor organizations (Council of Institutional Investors, International Corporate Governance Network) are nonbinding guidelines intended to improve corporate governance policies and practices of public companies above and beyond the state and federal statutes and listing standards. Corporate governance best practices should not substitute for state or federal statutes or listing standards; rather they should be viewed as supplemental to those statutes and standards. However, the use of best practices should be encouraged, and corporate governance rating agencies do systematically grade public companies for their compliance with best practices. Furthermore, these best practices have assisted public companies in enhancing their long-term financial performance.

Market Correction Mechanisms It has been suggested that corporate governance does not need reform, since markets are efficient and ultimately they will adopt the best corporate governance practices. Essentially, there is no need for reforms beyond state statutes because market competition provides incentives for public companies to adopt the most efficient and effective corporate governance structure. Companies that do not adopt effective corporate governance are presumably less efficient in the long term and ultimately are replaced. This proposition may not be true for three reasons.

1. The numerous financial scandals in the late 1990s and the early 2000s prove that market-based mechanisms alone are not sufficient to solve corporate governance problems.
2. By the time the markets are able to make such a correction for ineffective corporate governance, investor confidence has been lost along with perhaps trillions of dollars of market capitalization, often caused by bankruptcy. This is exactly what occurred when capital markets hit rock bottom in the early 2000s.
3. A large percentage of pension fund assets are usually passively managed through indexed funds and therefore cannot sell poorly governed or poorly performing companies.

The primary causes of reported scandals were market correction mechanisms, lax regulations and oversight, and poorly developed disclosure standards that failed to protect investors. Market correction mechanisms are often initiated and enforced after the occurrence of substantial management abuse and after shareholders either lose millions of dollars as a result of accounting and other frauds or sell some of their actively managed shares. Selling shares has associated transaction costs and does not directly remove the assets from management's control, since sales simply pass shares to other investors who ultimately suffer the same management malfeasance. Accordingly, market correction mechanisms may affect corporate governance only after significant wealth is transferred or destroyed as a result of management

misconduct and corporate malfeasance. In addition, there are often considerable transaction costs for other stakeholders, including employees, in the form of layoffs, lost wages, and the permanent loss of retirement funds by individuals and large pension funds, and society in the form of lost taxes and large-scale bankruptcies.

Market mechanisms failed to prevent the corporate debacles of Enron, World-Com, and Global Crossing, which were devastating to shareholders, employees, pensioners, and society. A report by Glass Lewis & Co. shows that investors have suffered significant losses caused by fraudulent financial statements in the past decade.⁷⁰ As indicated in Exhibit 1.3, the lost market capitalization of 30 high-profile financial scandals caused by fraud during the period 1977 to 2004 is more than \$900 billion and resulted in a negative impact on stock returns for 77 percent of the fraud-prone companies.⁷¹ Thus, corporate governance reforms should create an environment that promotes strong marketplace integrity and efficiency and restores and promotes investor confidence and public trust.

CORPORATE GOVERNANCE REFORMS

The erosion in investor confidence in the early 2000s has been caused by many factors, among them the collapse of the dot-com market, an economic downturn, reported financial scandals, and numerous earnings restatements of high-profile companies. Several new corporate governance reforms in the United States have been established: SOX, SEC-related implementation rules, revised listing standards of national stock exchanges, guiding principles of professional organizations, and best practices. These reforms are intended to restore investor confidence by improving the vigilance and effectiveness of corporate governance and the reliability, integrity, transparency, and quality of financial reports.

Regulatory Bodies

Corporate governance reforms are fully discussed in Chapter 6. Exhibits 1.4 to 1.6 provide a list of regulatory agencies, standard setters, and organizations that either develop or promote these reforms. Investors often consider investment in companies a high risk when the information about the company is not favorable (e.g., financial restatement, internal control deficiencies). Thus, companies could benefit from corporate governance reforms that improve investor confidence in their financial reporting and help them achieve a wider and more diverse investor base. Corporate governance reforms should provide a “right balance” between effectiveness in protecting investors and efficiency in providing such protection.

The pre-SOX financial environment can be characterized as the era of ample incentives and opportunities for engaging in conflicts of interest that caused financial manipulations and fraud. A list of problems follows.

- There was a lack of vigilant boards of directors to oversee managerial functions, particularly financial reporting.
- Excessive management compensation, linked to reported earnings, provided incentives for management to manipulate earnings.

EXHIBIT 1.3 Fraud-Prone Companies and Their Market Capitalization Loss

Company Name	Ticker	Stock Price Peak Date	Price of Stock at Peak	Stock Price Bottom Date	Price of Stock at Bottom	Lost Market Cap (\$ in million)	Cumulative Return (%)
WordCom	WCOM	6/30/99	\$61.93	7/21/02	\$0.00	(\$119,874)	-100
Bristol-Myers Squibb	BMJ	12/29/00	\$73.94	7/24/02	\$20.55	(\$104,615)	-72
Tyco	TYC	1/30/01	\$62.80	7/25/02	\$8.25	(\$ 93,312)	-85
Nortel	NT	7/26/00	\$83.88	10/10/02	\$0.44	(\$ 67,157)	-99
Enron	ENE	8/23/00	\$90.00	12/2/01	\$0.00	(\$ 66,501)	-100
AIG	AIG	6/7/04	\$74.80	4/29/05	\$50.85	(\$ 62,653)	-32
Qwest	Q	7/5/00	\$58.00	8/13/02	\$1.11	(\$ 48,942)	-96
Xerox	XRXX	5/3/99	\$63.69	12/7/00	\$4.44	(\$ 39,068)	-93
EI Paso	EP	2/21/01	\$74.50	2/13/03	\$3.45	(\$ 35,172)	-94
Cendant	CD	3/24/98	\$41.00	10/8/98	\$7.50	(\$ 27,717)	-81
Fannie Mae	FNM	2/19/04	\$79.88	4/4/05	\$51.46	(\$ 27,675)	-36
Waste Management	WMI	5/4/99	\$59.00	3/28/00	\$13.06	(\$ 27,661)	-77
Global Crossing	GX	5/19/99	\$58.25	1/28/02	\$0.00	(\$ 25,356)	-100
MicroStrategy	MSTR	3/14/00	\$2,920.00	7/26/02	\$4.50	(\$ 22,803)	-100
Elan	ELN	6/20/01	\$62.87	10/9/02	\$1.17	(\$ 20,187)	-98
Dynegy	DYN	5/1/01	\$57.95	7/25/02	\$0.51	(\$ 18,700)	-99

Purchase Pro	PROEQ. PK	12/28/99	\$395.94	9/13/02	\$0.00	(\$12,353)	- 100
Rite Aid	RAD	1/8/99	\$50.94	10/31/02	\$1.79	(\$12,258)	- 93
Homestore	HOMS	1/25/00	\$122.25	2/11/02	\$0.69	(\$8,500)	- 99
Peregrine Systems	PRGN	3/27/00	\$79.50	9/22/02	\$0.00	(\$8,350)	- 100
Network Associates	MFE	12/24/98	\$66.00	12/28/00	\$4.13	(\$8,301)	- 94
Adelphia	ADELQ	1/4/01	\$50.31	6/25/02	\$0.00	(\$7,699)	- 100
Health South	HLSH	8/29/01	\$18.26	3/31/03	\$0.07	(\$7,117)	- 100
Oxford Health Plans	OHP	8/4/97	\$85.81	8/13/98	\$6.63	(\$6,185)	- 92
Lernout & Hauspie	LHSP	3/14/00	\$65.00	11/29/00	\$0.00	(\$6,098)	- 100
Critical Path	CPTH	8/31/00	\$309.00	11/9/04	\$0.00	(\$4,907)	- 100
McKesson HBOC	MCK	10/6/98	\$94.69	5/26/00	\$16.06	(\$4,848)	- 52
Sunbeam	SOC	3/4/98	\$52.00	10/25/01	\$0.05	(\$4,442)	- 100
Symbol Technologies	SBL	3/5/01	\$34.47	10/10/02	\$4.99	(\$4,001)	- 78
Krispy Kreme	KKD	8/18/03	\$49.37	2/24/05	\$5.36	(\$2,578)	- 89
Total						(\$905,030)	- 77

Source: Adapted from Glass Lewis & Co. 2005. Restatements: Traversing Shaky Ground. An Analysis for Investors. (June 2). Available at: www.glasslewis.com.

EXHIBIT 1.4 Regulatory Organizations Influencing Corporate Governance

Name	Description	Web Site
American Stock Exchange (AMEX)	The AMEX has been a pioneer in market innovation for more than a century and remains committed to developing successful new investment products and innovative services for companies and investors. As the nation's most diversified financial marketplace, AMEX conducts trading through an advanced centralized specialist system and is committed to providing a superior marketplace for the investing public and its members.	www.amex.com
Committee of the Sponsoring Organizations of the Treadway Commission (COSO)	COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector initiative that studied causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions.	www.coso.org
Financial Accounting Standards Board (FASB)	The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.	www.fasb.org
International Accounting Standards Board (IASB)	The IASB is an independent, privately funded accounting standard setter based in London. Board members come from nine countries and have a variety of functional backgrounds. The IASB is committed to developing, in the public interest, a single set of high-quality, understandable, and enforceable global accounting standards that require transparent and comparable information in general-purpose financial statements. In addition, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.	www.iasb.org
Municipal Securities Rulemaking Board (MSRB)	The MSRB was established in 1975 by Congress to develop rules regulating securities firms and banks involved in underwriting, trading, and selling municipal securities: bonds and notes issued by states, cities, and counties or their agencies to help finance public projects. The MSRB which is composed of members from the municipal securities dealer community and the public, sets standards for all municipal securities dealers. Like the NYSE and NASDS the MSRB is a self-regulatory organization that is subject to oversight from the SEC.	www.msrb.org

New York Stock Exchange (NYSE)	<p>The NYSE is the world's leading and most technologically advanced equities market. A broad spectrum of market participants, including listed companies, individual investors, institutional investors, and member firms, create the NYSE market. Buyers and sellers meet directly in a fair, open, and orderly market to access the best possible price through the interplay of supply and demand.</p>	www.nyse.com
Nasdaq	<p>Nasdaq is the largest electronic screen-based equity securities market in the United States, both in terms of number of listed companies and in traded share volume. With approximately 3,200 listed companies, it is home to category-defining companies that are leaders across all areas of business, including technology, retail, communications, financial services, transportation, media, and biotechnology industries.</p>	www.nasdaq.com
National Association of Securities Dealers (NASD)	<p>As the world's leading private sector provider of financial regulatory services, NASD has helped bring integrity to the markets—and confidence to investors—for more than 60 years. It has served as the primary private sector regulator of America's securities industry, overseeing the activities of more than 5,100 brokerage firms, approximately 109,300 branch offices and more than 657,690 registered securities representatives. In addition, NASD provides outsourced regulatory products and services to a number of stock markets and exchanges.</p>	www.nasd.com
National Futures Association (NFA)	<p>The NFA is the industrywide, self-regulatory organization for the U.S. futures industry. It strives every day to develop rules, programs, and services that safeguard market integrity, protect investors, and help members meet their regulatory responsibilities.</p>	www.nfa.futures.org
Public Company Accounting Oversight Board (PCAOB)	<p>The PCAOB is a private-sector, nonprofit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.</p>	www.pcaob.com
Securities and Exchange Commission (SEC)	<p>The mission of the U.S. SEC is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.</p>	www.sec.gov

Source: Extracted from Web sites presented in the exhibit.

EXHIBIT 1.5 Investor-Driven Organizations

Name	Description	Web Site
Bernstein Litowitz Berger & Grossmann LLP (BLB&G)	BLB&G is the trusted securities fraud-monitoring and litigation counsel for many of America's public pension plans as well as other institutional investors. Institutional clients rely on BLB&G to evaluate and litigate their securities claims vigorously and to keep them fully informed.	www.blbglaw.com/html/portfolio_monitoring.html
Business for Social Responsibility (BSR)	BSR is a global organization that helps member companies achieve success in ways that respect ethical values, people, communities, and the environment.	www.bsr.org/index.cfm
California Public Employees' Retirement System (CalPERS)	CalPERS' mission is to advance the financial and health security for all who participate in the system. It aims to fulfill this mission by creating and maintaining an environment that produces responsiveness to all those whom it serves.	www.calpers.ca.gov/
Conference Board (CB)	The CB creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. Working as a global, independent membership organization in the public interest, the CB conducts research, convenes conferences, makes forecasts, assesses trends, publishes information and analysis, and brings executives together to learn from one another.	www.conference-board.org/
Corporate Library (CL)	The CL is a unique and superior information resource. Its analysts are expert practitioners in the fields of corporate governance, executive compensation, ratings analysis, takeover defenses, social networking, and corporate leadership profiling.	www.thecorporatelibrary.com
CorpWatch	CorpWatch counters corporate-led globalization through education, network building and activism. It works to foster democratic control over corporations by building grassroots globalization—a diverse movement for human rights and dignity, labor rights, and environmental justice.	www.corpwatch.org
Council of Institutional Investors (CII)	The CII is an organization of large public, labor, and corporate pension funds that seeks to address investment issues that affect the size or security of plan assets. Its objectives are to encourage member funds, as major shareholders, to take an active role in protecting plan assets and to help members increase return on their investments as part of their fiduciary obligations.	www.cii.org/about/

Glass Lewis & Co. (GLC)	GLC is an independent research firm focused on identifying business, legal, governance, and financial statement risks at public companies in time for investors to act.	www.glasslewis.com/
Institutional Shareholder Services (ISS)	ISS is the world's leading provider of proxy voting and corporate governance services with over 20 years of experience. ISS serves more than 1,600 institutional and corporate clients worldwide with its core business: analyzing proxies and issuing informed research and objective vote recommendations for more than 33,000 companies across 115 markets worldwide.	www.issproxy.com
Interfaith Center on Corporate Responsibility (ICCR)	For over thirty years the ICCR has been a leader of the corporate social responsibility movement. ICCR's membership is an association of 275 faith-based institutional investors, including national denominations, religious communities, pension funds, endowments, hospital corporations, economic development funds, and publishing companies. ICCR and its members press companies to be socially and environmentally responsible. Each year ICCR-member religious institutional investors sponsor over 100 shareholder resolutions on major social and environmental issues.	www.iccr.org
Investor Responsibility Research Center (IRRC)	IRRC is the leading source of high-quality, impartial information on corporate governance and social responsibility. Founded in 1972, IRRC provides proxy research and analysis, benchmarking products, as well as proxy voting services to more than 500 institutional investors, corporations, law firms, foundations, academics, and other organizations.	www.irrc.org
Social Accountability International (SAI)	SAI is a nongovernmental, international, multi-stakeholder organization dedicated to improving workplaces and communities by developing and implementing socially responsible standards. SAI convenes key stakeholders to develop consensus-based voluntary standards, conducts cost-benefit research, accredits auditors, provides training and technical assistance, and assists corporations in improving social compliance in their supply chain.	www.sai-intl.org
State Board of Administration (SBA)	The SBA is committed to providing superior investment and trust services through prudent financial management and administration of assets while adhering to high ethical, fiduciary, and professional standards.	www.sbafla.com/

Source: Extracted from Web sites presented in the exhibit.

EXHIBIT 1.6 Nonregulatory Organizations

Name	Description	Web Site
American Association of Accountants (AAA)	The AAA promotes worldwide excellence in accounting education, research, and practice.	www.aaahq.org
American Institute of Certified Public Accountants (AICPA)	The AICPA is the national, professional organization for all certified public accountants. Its mission is to provide members with the resources, information, and leadership to enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients.	www.aicpa.org
American Society for Women Accountants (ASWA)	The mission of ASWA is to enable women in all accounting and related fields to achieve their full personal, professional, and economic potential and to contribute to the future development of their profession.	www.aswa.org
Association of Government Accountants (AGA)	AGA serves government accountability professionals by providing quality education, fostering professional development and certification, and supporting standards and research to advance government accountability.	www.agacgfm.org
Institute of Management Accountants (IMA)	The IMA is the world's leading organization dedicated to empowering management accounting and finance professionals to drive business performance.	www.imanet.org
Institute of Internal Auditors (IIA)	The IIA aims to be the global voice of the internal audit profession: advocating its value, promoting best practices, and providing exceptional service to its members.	www.theiia.org
National Association of Corporate Directors (NACD)	NACD is a national nonprofit membership organization dedicated exclusively to serving the corporate governance needs of corporate boards and individual board members.	www.nacdonline.org

Source: Extracted from Web sites presented in the exhibit.

- Independent auditors' objectivity was adversely affected by high nonaudit fees (e.g., consulting, internal control outsourcing).
- The system of internal controls and disclosures was inadequate and ineffective.
- There was a lack of proper accounting standards to deal with and recognize complex and significant off-balance sheet financial transactions.
- The gap between reported earnings and pro forma earnings, commonly referred to as operating earnings, was widening.
- The involvement in the financial reporting process of financial analysts and advisors was conflicted.
- Institutional investors were inattentive in scrutinizing and monitoring their investment in companies and their financial reports.
- There was lax enforcement and ineffective investigation and disciplining of substandard audits.

Regarding the landscape leading to the passage of SOX, Senator Paul S. Sarbanes (D-MD) stated:

*The roots of the problem lay not with the legendary "few bad apples" but rather with system and structural defects that required a statutory remedy. There was a remarkable consensus among our witnesses on the nature of the problems, notably lack of auditor independence, ineffective regulatory oversight of accountants, lax standards of corporate governance and securities analysts' conflicts of interest.*⁷²

Sarbanes-Oxley Act of 2002

Traditionally, state rather than federal legislation has significantly shaped corporate governance by specifying requirements for incorporation and defining the fiduciary duty of directors and officers. However, in light of the growing participation of millions of Americans in the capital markets, and the widespread impact of financial scandals in those markets, Congress and the American public recognized the need for a more proactive federal role. In response, the Sarbanes-Oxley Act of 2002 was signed into law on July 30, 2002, to reinforce corporate accountability and rebuild investor confidence in public financial reports. The reported financial scandals at the turn of the century and congressional responses (i.e., SOX) are not unprecedented. Similar events led to the enactment of the Securities Act of 1933, the Securities Exchange Act of 1934, and the creation of the SEC.

SOX was designed primarily to do six things:

1. Establish an independent regulatory structure for the accounting profession.
2. Set high standards and new guiding principles for corporate governance.
3. Improve the quality and transparency of financial reporting.
4. Improve the objectivity and credibility of the audit function and empower the audit committee.

5. Create more severe civil and criminal penalties for violations of the federal securities laws.
6. Increase the independence of securities analysts.⁷³

Exhibit 1.7 provides a summary of the provisions of SOX pertaining to corporate governance, financial reporting, and audit activities of public companies.

In describing the long-term benefits of compliance with the provisions of SOX, then chairman of the SEC William A. Donaldson stated:

*The Sarbanes-Oxley reforms should yield extraordinary long-term benefits in the form of improved financial reporting, better management control, and more ethical behavior by companies and gatekeepers. This, in turn, should lead to sounder corporate governance, better and more reliable reporting, improved corporate performance, enhanced investor confidence, and ultimately, a lower cost of capital.*⁷⁴

In assessing the positive impact of SOX on corporate governance, Ira M. Millstein, the well-known leader in corporate governance, states:

*SOX did directly what it was supposed to do: take the best practices in director independence and audit procedures and make them mandatory. . . . All that Sarbanes did was to take “should” and “could” and turned it into “must.” And it worked.*⁷⁵

Christopher Cox, the chairman of the SEC, in support of SOX, states:

*We have come a long way since 2002 [passage of SOX]. Investor confidence has recovered. There is greater corporate accountability. Financial reporting is more reliable and transparent. Auditor oversight is significantly improved. . . . The Act is not perfect in every respect. But the vast majority of its provisions are net contributors to the nation’s economic health. . . . While competitors in other countries are using Sarbanes-Oxley as a reason for foreign companies to list in their jurisdictions, many of those same countries are adopting provisions of the Act as part of their own regulatory regimes. . . . We will do our best to honor your legacy by ensuring that Sarbanes-Oxley works for every stakeholder—for investors, for issuers, for our economy, and for our country.*⁷⁶

Indeed, many aspects of the best practices of corporate governance (e.g., board independency, and audit committee formation) promoted by professional organizations, such as the Business Roundtable, were incorporated into the provisions of SOX. A Government Accountability Office (GAO) report concludes that regulators, investors, public companies, and auditors are in general agreement that SOX has had a positive impact on investor confidence and investor protection although its compliance cost may be disproportionately higher for smaller companies.⁷⁷ The 2006 CFO survey of 213 finance executives reveals that: (1) the

EXHIBIT 1.7 Summary of Provisions of SOX

Corporate Governance	Financial Reporting	Audit Functions	Others
<ol style="list-style-type: none"> Enhanced audit committee responsibility for hiring, firing, compensating, and overseeing auditors and preapproval of non-audit services Disclosure, in periodic reports, of whether the audit committee has at least one member who is a “financial expert” and if not, why CEO and CFO certification of the accuracy and completeness of quarterly and annual reports Management assessment and reporting of the effectiveness of disclosure controls and procedures Ban on personal loans by companies to their directors or executives other than certain regular consumer loans 	<ol style="list-style-type: none"> CEO/CFO certification of financial reports Internal control report by management Attestation and report by auditors on management’s assessment of internal controls Disclosures of off-balance sheet arrangements Disclosures of contractual obligations Disclosures of reconciliation of non-GAAP financial measures pertaining to pro forma financial information Disclosures of material correcting adjustments by auditors Disclosures of transactions involving management and principal stockholders 	<ol style="list-style-type: none"> Establishment and operation of the Public Company Accounting Oversight Board (PCAOB), an independent non-governmental agency that regulates and oversees the audit of public companies Registration with the PCAOB of public accounting firms that audit public companies PCAOB authority to issue auditing standards, inspect registered accounting firms’ operations, and investigate potential violations of securities laws Requirement that auditors be appointed, compensated, and overseen by the audit committee Many nonaudit services are prohibited from being performed contemporaneously with an audit Rotation of the lead (or coordinating) audit partner and the lead review partner every five years 	<ol style="list-style-type: none"> Professional responsibilities for attorneys appearing and practicing before the SEC Disclosures of corporate code of ethics Collection and administration of funds for victim investors Analyst conflicts of interest (Regulation AC) Whistleblower protection Debts non-dischargeable in bankruptcy Temporary freeze authority for SEC SEC censures or bars any person who is not qualified, lacks the requisite character or integrity, or engages in unethical conduct, from appearing before the SEC. Lengthened statute of limitations for securities fraud Criminalization of corporate misconduct

(continued overleaf)

EXHIBIT 1.7 (Continued)

Corporate Governance	Financial Reporting	Audit Functions	Others
6. Establishment of procedures by each audit committee for receiving, retaining, and handling complaints received by the company concerning accounting, internal controls, or auditing matters	9. Accelerated filing of changes in beneficial ownership by insiders	7. Auditors report to the audit committee	11. Criminal penalties for defrauding shareholders of public companies
7. Review of each quarterly and annual report (Forms 10-Q and 10-K) by officers	10. Real-time disclosures of information concerning material changes in financial condition or operations (Form 8-K disclosures)	8. One year cooling-off period before audit staff can take a principal officer position.	12. Retaliation against informants
8. Forfeiture by CEO or CFO of certain bonuses and profits when the company restates its financial statements due to its material non-compliance with any financial reporting requirements	11. Periodic review of published financial statements by the SEC at least once every three years	9. Auditor attestation to and reporting on management assessment of internal controls	13. Increased criminal penalties under securities laws and mail and wire fraud
9. Improper influence on conduct of audits	12. SEC-enhanced authority to determine what constitutes U.S. GAAP	10. Limitations on partner compensation	14. Future studies on consolidation of public accounts by firm, audit firm rotation, accounting standards, credit rating agencies, and investment banks
10. Insider trades during pension fund blackout periods		11. Disclosure of fees paid to the auditor	
11. Officer and director penalties for violations of securities laws or misconduct		12. Requirements for pre-approval of audit and permitted nonaudit services by the audit committee	
		13. Retention of audit work papers and documents for five years	
		14. Increased penalties for destruction of corporate audit records	

Source: Extracted from the Sarbanes-Oxley Act of 2002. (July 30). Available at: www.sec.gov/about/laws/sox2002.pdf

majority (almost 70 percent) believe that they have seen at least some improvement in their business processes resulting from compliance with provisions of SOX; (2) the vast majority, while having realized some benefits of SOX, failed to consider those benefits in the form of a lower cost of capital; and (3) more than 82 percent said they disclose more information on their financial statements (e.g., footnotes, proxies, income statement, balance sheet) in the post-SOX period.⁷⁸

In summary, SOX is considered as a process whose impact on improving the effectiveness of corporate governance will continue for years to come. In its infancy, SOX was viewed as a compliance document that often caused complications and substantial compliance costs for many companies regardless of size. As SOX is approaching its stage of maturity, it will encourage: (1) public companies to move away from their practice of checklist compliance mentality and move toward incorporating its provisions into their sustainable business strategies and governance practices; (2) regulators (SEC) and standard setters (Financial Accounting Standards Board [FASB], PCAOB, national stock exchanges) to establish more effective, efficient, and scalable implementation rules, accounting and auditing standards, and corporate governance standards to ease complexities and compliance costs of adopting its provisions; and (3) global adoption of many of its key provisions that are considered worldwide as cost-justified.

Several attempts have been taken to roll back some provisions of SOX despite the continuing corporate scandals. The Committee on Capital Markets Regulation was formed in September 2006 to study the impacts of recent regulatory reforms, including SOX, on U.S. global competitiveness, the extent to which U.S. capital markets are losing ground to foreign markets, the causes of such decline, and its effects on the financial industry and the economy.⁷⁹ The committee, while not calling for any statutory changes to SOX, recommends that the SEC relax implementation rules pertaining to Section 404 of SOX on internal controls, strengthen shareholder rights, curtail the role of state authorities, and limit auditor liability.⁸⁰ The committee's recommendations are driven by the main objective of strengthening global competitiveness of U.S. capital markets rather than protecting investors, whose role is vital to the vibrancy of the capital markets. The committee suggests that the SEC conduct a thorough cost-benefit analysis of SOX implementation rules (Section 404) that may impose a high cost on businesses, particularly smaller companies. Arthur Levitt, the former SEC chairman, believes that such analysis could impair the SEC's ability in issuing effective rules as "cost-benefit analysis is Washington speak for 'slow down the regulator'."⁸¹ The former SEC commissioner Harvey Goldschmid said that if regulators (SEC, Treasury Department) pursue the committee's recommendations, "the recent drive for accountability and deterrence would be replaced by a world where almost anything goes."⁸²

It has been argued that SOX is not the problem; SOX authorizes the SEC to issue rules to implement its provisions. Some of these rules—for example, rules concerning internal controls of Section 404—cost at least 100 times more than what was originally estimated by the SEC (e.g., SEC's estimated cost of \$91,000 per company to the first-year actual costs of on average \$9.8 million). Thus, while rolling back provisions of SOX is not desirable, making SEC-related implementation rules more effective and scalable is a step in the right direction in ensuring sustainable

efficacy of SOX. Indeed, the SEC, on December 13, 2006, approved its proposed interpretive guidance that would assist public companies of all sizes and complexity to plan and perform their annual management assessment of internal control over financial reporting under Section 404 of SOX.⁸³ This proposed interpretive guidance is intended to help public companies make their compliance more cost-effective and efficient by focusing on risk and materiality and applying a risk-based and top-down approach to internal control reporting by both management and auditors. It is expected that the SEC and the PCAOB will continue to examine ways to improve cost-effectiveness, efficiency, and scalability of Section 404 compliance. Improvements are needed in the areas of: (1) focusing on key controls, particularly company-level controls; (2) using a top-down, risk-based approach in testing only significant accounts and risks; and (3) testing important business functions including information technology systems, accounting systems, and application of complex accounting standards (e.g., derivatives, taxes), whistleblowing function, and business reviews by directors and officers.

Regulatory reforms in the United States are aimed at improving the integrity, safety, and efficiency of the capital markets while maintaining their global competitiveness. To inspire investor confidence, regulations should be perceived as being fair and in balance.⁸⁴ Fairness of regulations, while creating a level playing field for market participants and ensuring investors receive reliable information, does not guarantee success. Regulations should strike the right balance of: (1) not being so extensive so as to discourage innovation, impose unnecessary costs on affected companies and their investors, or stifle competitiveness and job creation; and (2) not being so lax so as to engage in a regulatory race to the bottom of eliminating necessary safeguards for investors. In the words of Henry Paulson, the U.S. Treasury secretary, “the right regulatory balance should marry high standards of integrity and accountability with a strong foundation for innovation, growth, and competitiveness.”⁸⁵ As this book was going to press, the U.S. Senate voted not to change SOX provisions by making Section 404 compliance optional for smaller companies, instead asking regulations to fine-tune Section 404. This symbolic support of SOX by the Senate was reviewed by many as a continuous effort by policymakers to protect investors from corporate malfeasance.

CORPORATE CULTURE AND GOVERNANCE

Corporate culture is a continuous process in which corporate leadership, including the board of directors and the top management team, sets a “right tone at the top.” It is often an informal process that establishes powerful norms and standards that influence employee behavior. Laws, regulations, rules, and standards are effective measures in changing the structure, process, and composition of corporate governance, whereas the corporate culture is developed over time and derived from shared values. The engaged board of directors can significantly influence the corporate culture by:

- Setting an appropriate tone at the top by promoting personal integrity and professional accountability.

- Rewarding high-quality and ethical performance.
- Disciplining poor performance and unethical behavior.
- Promoting reliable, relevant, and transparent financial reports.
- Maintaining the company's high reputation and stature in the industry and in the business community.

One of the most important objectives of SOX is to improve the corporate culture of public companies by requiring these companies to set the appropriate tone at the top and promote ethical behavior. In discussing the importance of setting a right tone, Stephen M. Cutler, the SEC's director of the Division of Enforcement, states:

*"Tone at the top" seems to have become a panacea for what is ill in corporate America, and an explanation for much of what has gone wrong. [In the two years post-SOX], the SEC has brought more than 1,300 civil cases and has obtained orders for disgorgement and penalties in excess of \$5 billion.*⁸⁶

Cutler suggests several ways managers can set an appropriate tone:

- Comply with the letter and the spirit of laws, rules, and regulations.
- Make character a part of the company's hiring policies and criteria.
- Make integrity, ethics, and compliance integral components of the evaluation, promotion, and compensation processes.
- Allow no tolerance for compliance risk.
- Resolve ethical violations quickly and firmly.
- Create a culture of compliance by holding managers accountable for setting the right example.
- Cultivate the culture of compliance through continuous monitoring, follow-up, and reassessment.
- Avoid a checklist mentality.⁸⁷

In the words of SEC's director of the Office of Compliance Inspections and Examinations, Lori A. Richards:

*It's not enough to have policies. It's not enough to have procedures. It's not enough to have good intentions. All of these can help. But to be successful, compliance must be an embedded part of your firm's culture.*⁸⁸

Compliance just for the sake of compliance and the development of a "compliance check-box" mentality is not enough. Corporations should create an ethical environment that encourages all corporate governance participants to do the right thing and to understand that this is vital to the company's sustainable financial performance. Indeed, a culture of compliance and ethics should be integrated into the company's corporate governance structure. Although steady progress has been

made to improve the culture of ethics and corporate governance measures for many corporate boards in the post-SOX era, significant changes have occurred more slowly than expected.⁸⁹ To integrate the culture of ethics and compliance into corporate governance effectively, corporations should set an appropriate tone at the top that promotes:

- The development of roles and responsibilities for all corporate governance functions (oversight, managerial, auditing, compliance, assurance, monitory).
- Directors, officers, and employees doing the “right thing” and understanding that this is vital to the company’s sustainable performance.
- Directors, executives, and employees accepting responsibility and accountability for their actions and the actions of those under their supervision.
- Personnel freely raising concerns and issues without fear of retaliation.
- Proper consideration of ethical issues throughout the company when difficult and complex decisions are made.
- Understanding of the incentives, opportunities, and rationalization factors affecting individuals’ decisions when the pressure exists that may drive unethical behavior.
- Proper oversight and management of all compliance activities, including ongoing monitoring of compliance programs, policies, and procedures in order to ensure their effectiveness and adoption of any changes in applicable laws and regulations.
- Directors and top officers exemplifying an ethical tone.
- Reporting of unethical and noncompliance instances through the proper channels, up to top-level management and, if necessary, to the board of directors or its designated committee (e.g., audit committee).
- Promoting the ethical culture and best practices by demonstrating ethical business decision making and cultivating ethical role models.

Warren Buffet, a veteran of corporate governance, rightfully stated that the five most dangerous words in the business culture are “Everybody else is doing it” as a rationale for business decision making.⁹⁰ This phrase has often been used to justify the morality and legitimacy of business actions. One obvious misuse of this phrase is the rationale by many companies for providing backdated or manipulated option grants to their directors and officers.

SUMMARY

Corporate governance involves a set of relationships and power-sharing among a company’s board, management, and shareholders. These relationships determine the way the board oversees management’s running of the company and how directors are accountable to shareholders. Good corporate governance should provide proper incentives for the board and management to pursue the objectives that are in the best interests of the company and its shareholders. It also lays the foundation for the integrity and efficiency of the financial markets. Conversely, poor corporate

governance reduces a company's potential and can even pave the way for financial difficulties and fraud. Simply stated, good corporate governance improves investor confidence and strengthens market integrity and efficiency, thereby promoting economic growth and financial stability. The ultimate effect of good corporate governance and moving beyond having merely an effective compliance culture is based on ethical behavior and decisions made by the company's board of directors and management and the impact of those decisions in protecting investors.

Effective corporate governance should create an appropriate balance between the shareholders, board of directors, and management while complying with market-based mechanisms, state and federal statutes, and best practices. The question that remains on the minds of many corporate governance activists is whether the historical trend of financial scandals, caused by relaxed regulations and ineffective corporate governance measures, is doomed to repeat itself. Examples of these financial scandals include corporate and accounting scandals of the early 1930s, which promoted congressional responses that included the passage of the Securities Act of 1933, the Securities Exchange Act of 1934, and the creation of the SEC; the savings and loan debacles of the 1980s, which resulted in the Federal Deposit Insurance Corporation Improvements Act of 1991; and the wave of financial scandals of high-profile companies in the late 1990s and the early 2000s, which prompted the passage of SOX. The author believes that the impacts of any potential future financial scandals would be extremely significant, since the majority of U.S. households now invest in the financial markets.

Today's investors demand more accountability, and public companies have responded by making improvements to their corporate governance practices and accountability above and beyond the regulatory compliance mandated in the post-SOX era. The emerging reforms have significantly improved the corporate governance policies and practices of many companies and thus investor confidence in corporate America. The long-term success of these reforms will best be achieved when they are perceived and proven to be effective, efficient, and scalable.

NOTES

1. According to the *Financial Dictionary*, agency theory is a theory concerning the relationship between a principal (shareholder) and an agent of the principal (company's managers). Essentially it involves the costs of resolving conflicts between the principals and agents and aligning interests of the two groups. Agency problem is a conflict of interest arising among creditors, shareholders, and management because of differing goals. These definitions can be found at: financial-dictionary.thefreedictionary.com/Agency+Theory.
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