Part One

Private Enterprise and Public Trust

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Chapter 1

The Free Market System and Business

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INTRODUCTION

This chapter presents the dynamics of relationships between capital markets and businesses as perceived by investors and transformed through corporate governance. Corporate and accounting scandals at the turn of the twenty-first century eroded public trust and investor confidence in corporate America and its financial reports. Several initiatives and reforms, including the Sarbanes-Oxley Act of 2002 (SOX), listing standards of national stock exchanges, corporate governance best practices, and business ethics guidance were established to restore investor confidence in public financial information. These reforms are a continuous process, creating new measures and practices for public companies and their directors, officers, accountants, auditors, legal counsel, financial analysts, investing banks, and others to effectively fulfill their responsibilities and discharge their accountability. This chapter provides an introduction and background as a plan for corporate governance and business ethics presented throughout the book.

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Primary Objectives

The primary objectives of this chapter are to

- Learn the free market system and business.
- Understand the role and responsibility of business in society.
- Understand the primary goal of corporate governance.
- Recognize that effective corporate governance is established through power sharing among all participants, particularly shareholders, boards of directors, and management.
- Exemplify the importance of reliable and transparent financial information.
- Be aware of the effect of corporate governance on investor confidence.
- Present various definitions of corporate governance.
- Provide an overview of corporate governance reforms.
- Introduce business ethics.
- Provide an overview of costs and benefits of corporate governance reforms.
- Address the impacts of corporate governance reforms on accountability.

THE FREE ENTERPRISE SYSTEM AND CAPITAL MARKETS

The free enterprise system is a bedrock principle of the U.S. economy, and its capital markets are the backbone of such systems. Understanding of the free enterprise system and its contribution to continuous economic growth in the United States is important in assessing the global competitiveness of U.S. financial markets. It has made the U.S. financial markets the world's largest, deepest, and safest marketplaces and home to the world's largest financial institutions. The U.S. free enterprise system has transformed from private ownership of businesses to dispersed public ownership of corporate shares by nearly 60 million Americans.

Businesses play an important role in creating safe, efficient, and competitive capital markets to ensure economic growth, low costs of capital, entrepreneurship, innovation, and job creation. Capital provided by investors to public companies is the lifeblood of the markets. Thus, investor protection in providing the most cost-effective capital is essential to the survival and competitiveness of capital markets. More than 100 million Americans have provided capital to the markets, and companies have had access to sufficient funding at the lowest cost of capital possible worldwide. Investors must not only be encouraged and rewarded for investing in the capital markets, but also protected through appropriate regulations, effective corporate governance, and optimal market mechanisms. The preservation of the integrity, reputation, and efficiency of the capital markets is the responsibility of all participants, including investors, corporations, regulators, government entities, and society at large, and serves the best interests of all participants. William Donaldson, former chairman of the U.S. Securities and Exchange Commission (SEC), regarding the importance of the reputation of the capital markets, states that "capital will always go where it is welcome, and stay where it is well treated."[1]

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Investor confidence in U.S. capital markets was eroded at the turn of the twenty-first century as a result of high-profile financial scandals, the economic downturn, the September 11, 2001, terrorist attacks, and ineffectiveness of market mechanisms. Congress responded by passing SOX to establish a new regime of investor protection. This new regulatory reform was aimed at identifying and managing conflicts of interest by improving the scope and speed of corporate disclosures. Investors providing capital and companies raising capital usually participate in markets where they feel safe through appropriate regulations and fair and transparent enforcement.

The question that remains on the minds of many corporate governance activists and critics is whether the history of financial scandals normally caused by relaxed regulations and ineffective corporate governance measures is doomed to repeat itself. Examples of these financial scandals are (1) corporate and accounting scandals of the early 1930s, which promoted congressional response with the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, and the creation of the SEC; (2) the savings and loan debacles of the 1980s and the resultant Federal Deposit Insurance Corporation (FDIC) Improvements Act of 1991; and (3) the wave of financial scandals of high-profile companies in the late 1990s and early 2000s that prompted the passage of SOX, the creation of the Public Company Accounting Oversight Board (PCAOB), and the issuance of more than twenty rules by the SEC in implementing provisions of SOX. Any future financial scandals would cause devastating impacts today, as more than half of all households in the United States are now investing in the securities markets through private investment in company shares, mutual funds, and pension funds. Moreover, as the United States moves to a more global economy and large pension funds fail (e.g., United Airlines), Americans are being forced to take on increasing responsibility to ensure the security of their financial future and retirement funds. These investors demand more accountability, and public companies have responded by making improvements in their corporate governance practices and accountability above and beyond regulatory compliance in the post-SOX era.

The free enterprise system in the United States and its dispersed capital ownership structure necessitate the effective functioning of corporate governance and business ethics guided by cost-effective, efficient, and enforceable regulations; optimal market mechanisms; and best practices. From the early stage of the free enterprise system, promoted in the book *The Wealth of Nations*, written by Adam Smith in 1776, lawmakers, regulators, economists, and business leaders shared the belief that a free and competitive market economy enables corporations to efficiently and effectively use society's resources in creating value, and market mechanisms prevent corporations from abusing their power and defrauding their stakeholders. Recent financial scandals prove that market mechanisms by themselves may not be adequate to monitor, control, and discipline business affairs, and corporate governance reforms were needed to correct the perceived failures of market mechanisms.

A healthy financial sector and efficient capital markets are vital to the economic growth and prosperity of the nation. However, U.S. capital markets in recent years have faced ever-increasing competition from other global financial markets, including those in London and Hong Kong. Ironically, it has been suggested that relaxing some market regulations in the United States can improve the capital market's competitiveness. Although regulations should not drive away good business and should attract investors seeking proper protection, they should not be perceived as constraints in entering into the capital markets. Effectiveness

of regulations and market mechanisms in protecting investors and maintaining efficient, transparent, and competitive capital markets can best be measured in terms of investor confidence in the markets. Establishing and enforcing appropriate securities laws are essential in sustaining investor confidence. Securities laws that are not cost effective, efficient, or scalable and are not enforced can contribute to the erosion of investor confidence. Market mechanisms that are not optimal or effective can make public companies susceptible to financial scandals and prone to earnings management and fraud, thus damaging the integrity of the capital markets. Although legal and regulatory laws and practices have played a role in establishing U.S. preeminence in global capital markets, the primary drivers of the shift in capital markets are economic and geographic factors. Fair and mutually beneficial relations between the U.S. and foreign capital markets can strengthen the global capital markets. Enabling U.S. investors to invest in foreign capital markets and reciprocally allowing foreign investors to access the U.S. capital markets can promote global competition and the raising of capital by profitable companies worldwide.

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. The U.S. capital markets have for several decades been regarded as the most transparent, efficient, and fair markets worldwide, which have (1) facilitated efficient allocation of a scarce resource of capital, (2) enabled public companies to raise capital for establishing or expanding their businesses, and (3) provided a safe and lucrative financial marketplace for individual investors to invest their money in order to fund their retirement goals or to save enough for their children's education. Thus, the liquidity, robustness, and safety of the capital markets are vital to the nation's economic welfare. Corporate governance reforms have made U.S. capital markets the largest, most liquid, robust, fair, and lucrative worldwide.

Lynn Turner, a former chief accountant at the SEC, in testifying before the Senate Banking Committee, states that

> *. . . the 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.*[2]

Investors are considered to be confident when stock prices are high, the news about future stock performance is optimistic, and financial information is perceived to be reliable. The financial scandals in the late 1990s and the early 2000s, along with the economic downturn, have had a substantial negative impact on investor confidence. Corporate governance reforms, including 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, its corporate governance, its financial reports, and its capital markets. Investors would like to see changes in the corporate governance structure that require not only compliance with these reforms, but also address managerial incentives and pressures, the vigilance and independence of boards of directors, the quality and independence of auditors, the objectivity of financial analysts, and shareholder democracy in director elections.

The post-SOX era is characterized by (1) legislation and regulations (SOX, SEC rules) to strengthen corporate accountability and improve corporate governance; (2) a change in the regulatory framework for the auditing profession through the establishment of the PCAOB; (3) the move toward more transparent and timely financial reports; and (4) a redefining of roles and responsibilities of those who are directly or indirectly involved in the financial reporting process (e.g., directors, officers, auditors, legal counsel, financial advisors, investors). The SEC's success in achieving its mission of protecting investors 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, or scalable and are not effectively enforced can erode investor confidence.

The improvement in investor confidence has become a daily concern and priority of public companies. As stated by three former SEC chief accountants, "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."[3] 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."[4] Investor confidence in corporate America, its financial information, and capital markets is vital in ensuring the sustainability of the free enterprise system.

THE ROLE AND RESPONSIBILITY OF BUSINESS IN SOCIETY

Public companies are a major engine of economic growth and prosperity of the free enterprise system in advanced capitalist economies such as the one in the United States. More than half of the population in the United States invest in public companies and are affected by corporations' performance. This unprecedented accumulation of economic power within public companies underscores the importance of corporate governance, accountability, and business ethical conduct. Shareholders who invest capital are often remote by distance or knowledge from those managing corporations. The report of The Conference Board Commission on Public Trust and Private Enterprise states that

> *... the corporate form has proven to be a superior means for attracting capital, organizing labor, stimulating ideas, and providing efficient systems of production and distribution. Therefore, sustaining confidence and trust in the performance of that corporate system is a matter of enormous public concern.*[5]

Corporations in the United States are viewed as creators of value for all concerned stakeholders as depicted in Figure 1.1. As separate legal entities, corporations obtain their financial capital, labor capital, and skills (managerial capital) from their stakeholders, conduct value-added activities, and return sustainable and enduring value to their stakeholders. All stakeholders contribute to the successful operation of corporations in creating value. For example, equity and debt holders provide financial capital, employees offer labor capital, management provides managerial skills, boards of directors oversee corporate affairs, and the government sets rules to protect stakeholders. In return, corporations grant (1) limited liability measuring the maximum that stakeholders, including shareholders, can lose of

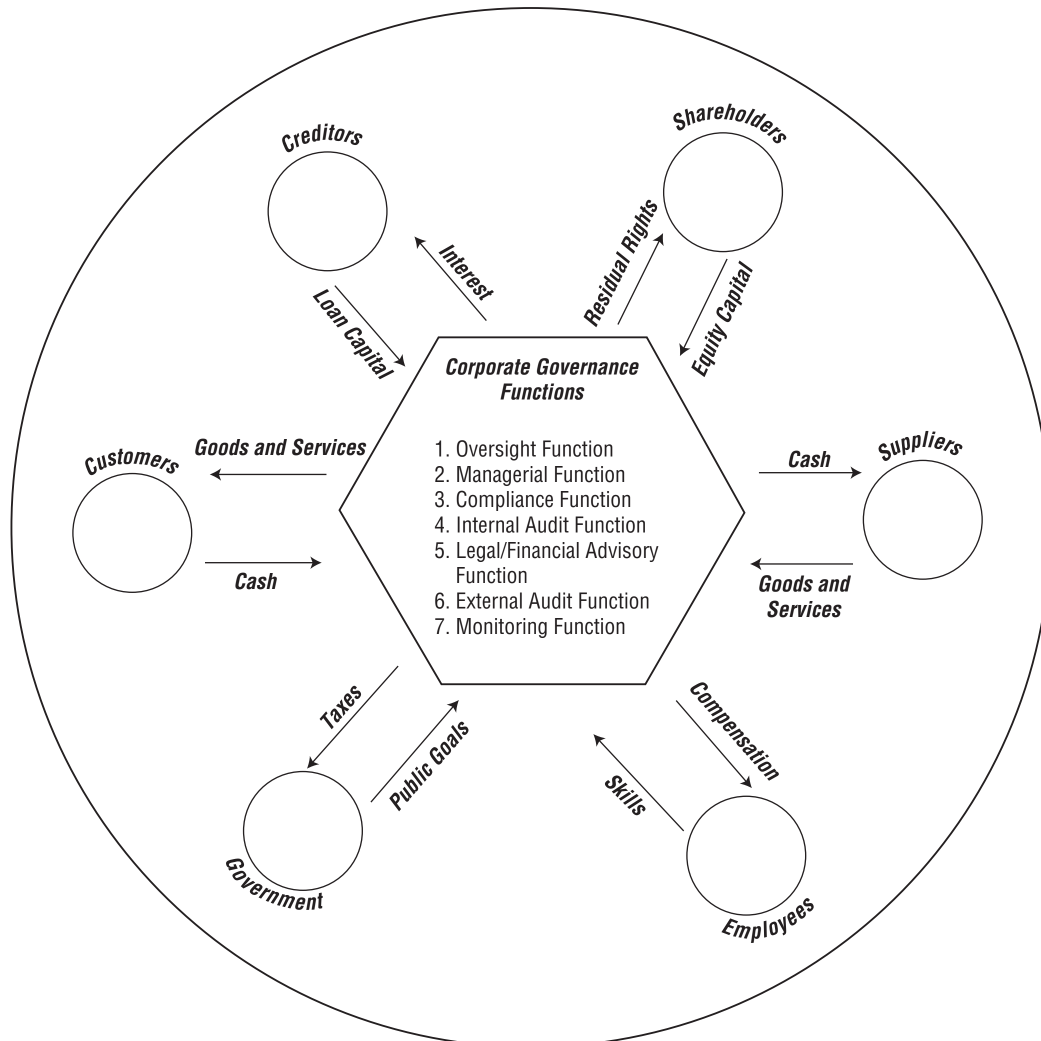

Figure 1.1 Corporations' role in society.

Source: Rezaee, Z. 2007. *Corporate Governance Post-Sarbanes-Oxley Act: Regulations, Requirements, & Integrated Processes*. John Wiley & Sons, Hoboken, NJ.

their contribution and investment in corporations; and (2) increased stakeholder value, in the normal course of their business, with shareholders having a residual claim.

All stakeholders are provided with incentives and opportunities to reward corporations for good performance and discipline them for poor performance. For example, suppliers and customers reward good corporate performance by actively and favorably doing business with the company, and discipline the company by restricting business with the company. Lenders and investors reward good performance by investing in the company at the lower desired rate of return on investment (cost of capital) and discipline poor corporate performance by

disinvesting or demanding a higher rate of return on their investment. Thus, the roles and responsibilities of each group of stakeholders are defined by a set of rules, laws, norms, standards, and commonly accepted business practices and contracts.

The rash of financial scandals has raised serious concerns about public companies' corporate governance and the quality of financial disclosures, and has contributed to the erosion of investor confidence in financial disclosures of public companies, raising the relevant question of whether companies achieved their goal of creating sustainable shareholder value, and how public company performance can be improved. The primary mission of public companies is regarded as creating enduring value, and the corporate governance structure is designed to ensure the accomplishment of this mission. The mission of corporate governance can be further classified into two goals of value creation and value protection. The value creation goal of corporate governance focuses on shareholder value creation and enhancement through the development of long-term strategies to ensure sustainable and enduring operational performance. The value protection goal concentrates on the accountability of the way the company is managed and monitored to protect the interests of shareholders and other stakeholders.

Corporate stakeholders are classified into several layers as depicted in Figure 1.2 and are categorized into three general tiers.

The First Tier: Investors

The first tier of stakeholder hierarchy is composed of investors or shareholders who own the company. Shareholders are the primary stakeholders; without them, the company would not exist. Many argue that the primary purpose of the company is to maximize shareholder wealth. Thus, the company's corporate governance structure should reduce the agency costs raised from the separation of ownership and control by aligning the interests of management with those of shareholders. Shareholders provide capital to the company in return

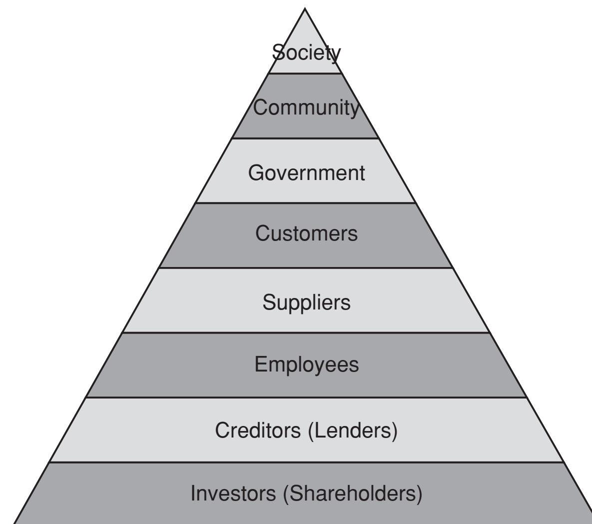

Figure 1.2 Eight layers of shareholders and stakeholders.

for sustainable return on their investment in terms of periodic dividends and stock price appreciations. Payment of dividends reduces the amount of discretionary funds available to management and, thus, can be used as a deterrent to opportunistic managerial behavior and as a vehicle for controlling management actions. Shareholders participate and shape the company's corporate governance structure by exercising their voting rights to elect the members of the board of directors who are directly responsible for protecting their interests and are ultimately accountable to them for the company's business affairs.

Corporations are owned by shareholders who have a variety of risk and return preferences. Owners can be individual investors, institutional investors, banks, pension funds, and industrial companies. Conceptually, institutional investors represent small shareholders as pensioners or beneficiaries. To ensure that institutional investors effectively protect the interests of their beneficiaries or trustees, they should disclose their corporate governance and voting policies as well as potential conflicts of interest and how they manage them. These owners have different identities, strategic interests, financial interests, and time horizons. Financial interest derives from investor motivation to obtain a desired return on investment. Financial interests of return on investment can be achieved by either dividends received from the company profits or the realization of capital gains through stock price appreciation. Institutional and individual investors are typically motivated by the maximization of financial return and exercise their control efforts through a shareholder voting process. Strategic interests are often motivated by nonfinancial objectives and are associated with attempts to exert control over a company through the use of ownership stakes. Strategic interests can be pursued to secure markets, underwrite relational contracts, manage technological dependence, protect managerial autonomy, and regulate competition between firms.

Liquidity is another factor being considered by investors when they invest in a company. Liquidity is determined by the investor's ability to sell their shares in a relatively short time and without a reduction in price or substantial cost. The liquidity preference of investors may result in a diversified portfolio, fragmented shareholders, and stable capital markets that enable exit without negatively affecting share prices. Ownership by individual and institutional investors is often motivated by financial interests and high liquidity, whereas ownership by the state, banks, and industrial corporations is typically centered around highly committed stocks with sustainable strategic interests.

Corporate governance and reforms, including state and federal laws, are aimed at protecting shareholder rights by allowing shareholders to (1) inspect and copy the company's stock ledgers, its list of shareholders, and certain books and records; (2) approve certain business transactions (e.g., mergers and acquisitions); (3) receive proxy materials; and (4) obtain significant disclosures for related party transactions. Shareholder democracy empowering shareholders to nominate, elect, or remove directors has been extensively debated in the literature. Under the current plurality voting system of uncontested director elections, even a single vote for a nominee will elect that director to a board regardless of the number of withholding votes. The majority voting system, which requires a director who received a majority of "against" or "withhold" votes to resign, has received a great deal of attention. Despite its many legal concerns and complications (e.g., plurality voting is allowed under state law), the majority voting system has been advocated by institutional investors and investor activists. A modified version of "majority voting," better known as "majority voting lite" or "Pfizer majority voting," has been suggested. Under the "majority voting lite" system, directors who receive a majority of against or withhold votes are required to submit

their resignation to the board. The company's board of directors then decides whether to accept the resignation and, if so, would appoint its own candidate.

The Second Tier: Creditors

Lenders and creditors are considered as the second tier of stakeholders in the company. A typical ownership structure of a public company usually consists of three distinct components: debt securities held by creditors, internal equity securities held by directors and officers, and external equity held by shareholders. Debt and equity securities may have a different impact on the value of the company, as well as differing effects on the company's corporate governance structure.

The proportion of debt equities to the total capital of the company determines the extent of debt holders' concerns that management may be motivated to transfer wealth from them to shareholders and also determines the agency costs assumed by debt holders and their demand for monitoring.[6] Thus, debt holders demand some control over managerial actions by entering into debt covenant contracts designed to protect their interests and determine whether breaches of contractual provisions have occurred.

The extent to which an organization derives its funding from equity or debt may significantly affect the business decisions of the company. For example, the United States and the United Kingdom rely on shareholder funding, whereas Germany derives a significant portion of its capital from creditors. As a result, the United States and UK tend to favor their shareholders, and Germany lends favorability to its creditors. Because creditors tend to be more conservative in weighing business risk (shareholders are usually more likely to encourage business decisions that would result in large capital gains, although creditors do not benefit from such gains), companies largely funded by creditors often choose to minimize risk instead of maximizing wealth.[7]

The Third Tier: Others

The third tier of stakeholders consists of employees, suppliers, customers, government, community, and society. Organizations are now realizing that their stakeholders consist of more than just corporate debt and equity holders. Stakeholders are now identified as those who influence or are influenced, either directly or indirectly, by organizational activities. Many companies today are reaching out to these stakeholders in order to overcome various challenges, such as improving customer perception and reputation, entering viable markets, and resolving conflicts with stakeholder activists. Communication with all stakeholders of the organization is central to improving decision-making processes, strengthening relationships, gathering important information, and building an accord among dissimilar views.[8]

THE ROLE OF FINANCIAL INFORMATION IN THE CAPITAL MARKETS

The sustainability and financial health of public companies, public trust, and investor confidence in financial reports play a crucial role in the integrity and efficiency of the capital markets and the economic growth and prosperity of the nation. Investors, by investing in

401(k), mutual funds, or retirement accounts, or actively playing the stock market, become interested in public companies' governance and are more sensitive to the companies' affairs and the virtues of their directors and officers, including their honesty, integrity, ethics, accountability, and reliability, and the transparent communication of these virtues to investors. The sustainability of public companies is key to keeping investor confidence high and requiring accurate financial reports for investors to make informed investment decisions. Reliability, accuracy, and transparency of financial information play a vital role in the efficiency, integrity, and safety of the capital markets. The ever-increasing demand for high-quality financial information makes the role of individuals involved in the corporate financial reporting supply chain, including the board of directors, the audit committee, management, and auditors, a value-added function under intense scrutiny. Financial disclosures under SEC regulations are necessary to provide investors with reliable, meaningful financial information so they can make informed investment decisions.

Our society, particularly the investing community, relies on the quality of corporate financial reports in making rational decisions. Accurate financial information assists investors with making informed, sound investment decisions, whereas inaccurate financial information is likely to mislead them into making bad investment decisions. William McDonough, the former chairman of the PCAOB, states that "confidence in the accuracy of accounting statements is the bedrock of investors being willing to invest, in lenders to lend and for employees knowing their firms' obligations to them can be trusted."[9] A greater number of people are now investing through retirement funds or actively managing their portfolios and are affected by the financial information disseminated to the market.

Public companies in the United States are required to file their financial reports with the SEC, including audited annual financial statements on Form 10-K, reviewed quarterly financial statements on Form 10-Q, and extraordinary transactions on a current basis on Form 8-K (e.g., departure of directors, officers, auditors), in addition to proxy financial statements submitted to investors. SOX requires financial statements filed with the SEC to be certified by the company's senior executives (chief executive officer [CEO], chief financial officer [CFO]). Section 404 of SOX also requires public companies (as of 2004, large companies known as accelerated filers) to file management and auditor reports on their internal control over financial reporting. These regulated disclosures and filings are further discussed in Chapter 6.

Financial statements are a vital source of information to the capital markets and their participants. The quality of investment and voting decisions by investors depends on the accuracy, completeness, and reliability of financial information disseminated to them by public companies. Thus, high-quality financial information improves investor decisions and, in turn, efficiency, liquidity, and safety of the capital markets, which may result in prosperity and economic growth for the nation. Financial disclosures under SEC regulations are necessary to prevent fraud and financial manipulation. Our society, particularly the investing community, relies on the quality of corporate financial reports in making rational decisions. However, there is an expectation gap between what users of financial reports expect to receive and what they actually receive. Several factors have contributed to this expectation gap, including (1) deficiencies in auditing and reporting standards in the sense that they are not suitable for the existing knowledge-based Internet economic environment, (2) lack of motivation on the part of corporate executives to completely adhere to the standards in providing high-quality and reliable financial information, (3) lack of financial

literacy and training of financial statement users to effectively use financial information in making decisions, and (4) complexity of accounting standards.

The ever-growing complexity of business transactions (e.g., derivatives, fair value measurements), recent regulatory reforms, and a litigious environment have contributed to the intricacy of accounting standards. Overly complex accounting standards may not provide the necessary guidance for preparers and auditors to produce high-quality financial information and can create a significant cost burden with little value to investors. Users of financial reports desire high-quality, reliable, useful, and transparent financial information that reflects the economic substance of the business. Regulators (SEC), standard setters (Financial Accounting Standards Board [FASB] and PCAOB), and the business community should work together to address this complexity. Although regulators should review the accuracy and completeness of financial reports as well as proper disclosures of business transactions to ensure investor protection, they should avoid second guessing professional judgments by management. Standard setters should make their reporting guidance cost effective, efficient, and scalable. Corporations should regard the dissemination of high-quality financial reports as their ultimate goal and fiduciary duty to the investing public. Management should attempt to present the economic realities of the business through financial reports and prepare them at a reasonable cost.

The reliability of financial reports and the quality of audit reports are essential to maintaining investor confidence and promoting efficient capital markets. Integrated financial and internal control reporting (IFICR) is financial information contained in published financial statements and reports on internal control over financial reporting (ICFR). Reporting of financial statements and ICFR is vital because it assists shareholders to make appropriate investment and voting decisions, enables them to exercise their ownership rights on an informed basis, and protects them from receiving misleading financial information. Public companies in the United States are required to publish audited annual financial statements prepared in conformity with generally accepted accounting principles (GAAP) along with reviewed quarterly financial reports. In the post-SOX period since 2004, the majority of public companies known as accelerated filers, with $75 million in market capitalization, have also been required to publish management and auditor reports on their ICFR. These two disclosure requirements, collectively referred to as IFICR, are intended to facilitate companies' abilities to attract investors, strengthen their competitive edge, and maintain confidence in capital markets.

Figure 1.3 shows that high-quality financial information is more accurate, complete, transparent, trustworthy, and value relevant compared to low-quality financial reports. High-quality financial reports enable users, including investors, to better assess the risk and return associated with their investment. Figure 1.4 shows that financial statements are typically scrutinized through several processes for the verification of their accuracy, completeness, and reliability. The six layers of financial statement scrutiny are (1) management certification of accuracy and completeness of financial statements in presenting fair and true financial condition and results of operation as required by Sections 302 and 906 of SOX; (2) corporate governance oversight of financial statements, particularly by the company's audit committee; (3) management certification of the effectiveness of ICFR in compliance with Section 404 of SOX; (4) independent audit reports on both fair presentation of financial statements and effectiveness of ICFR; (5) SEC reviews of published financial statements and PCAOB inspections of audit quality; and (6) monitoring of published

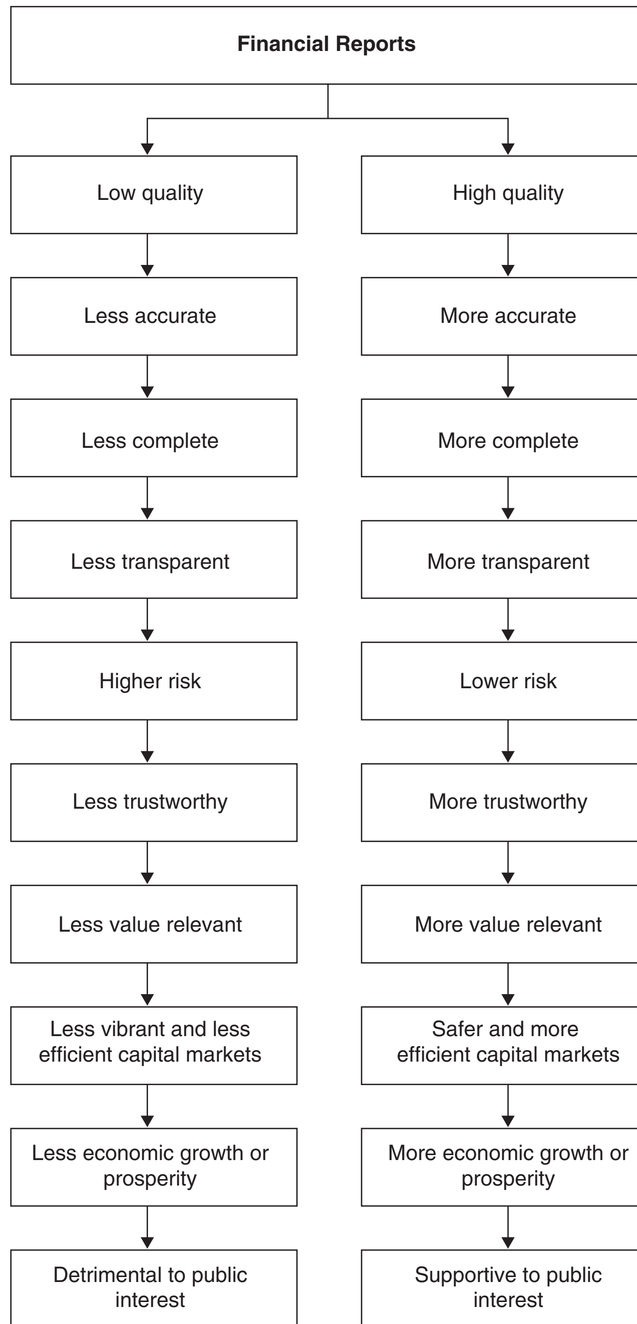

Figure 1.3 The role of financial reporting.

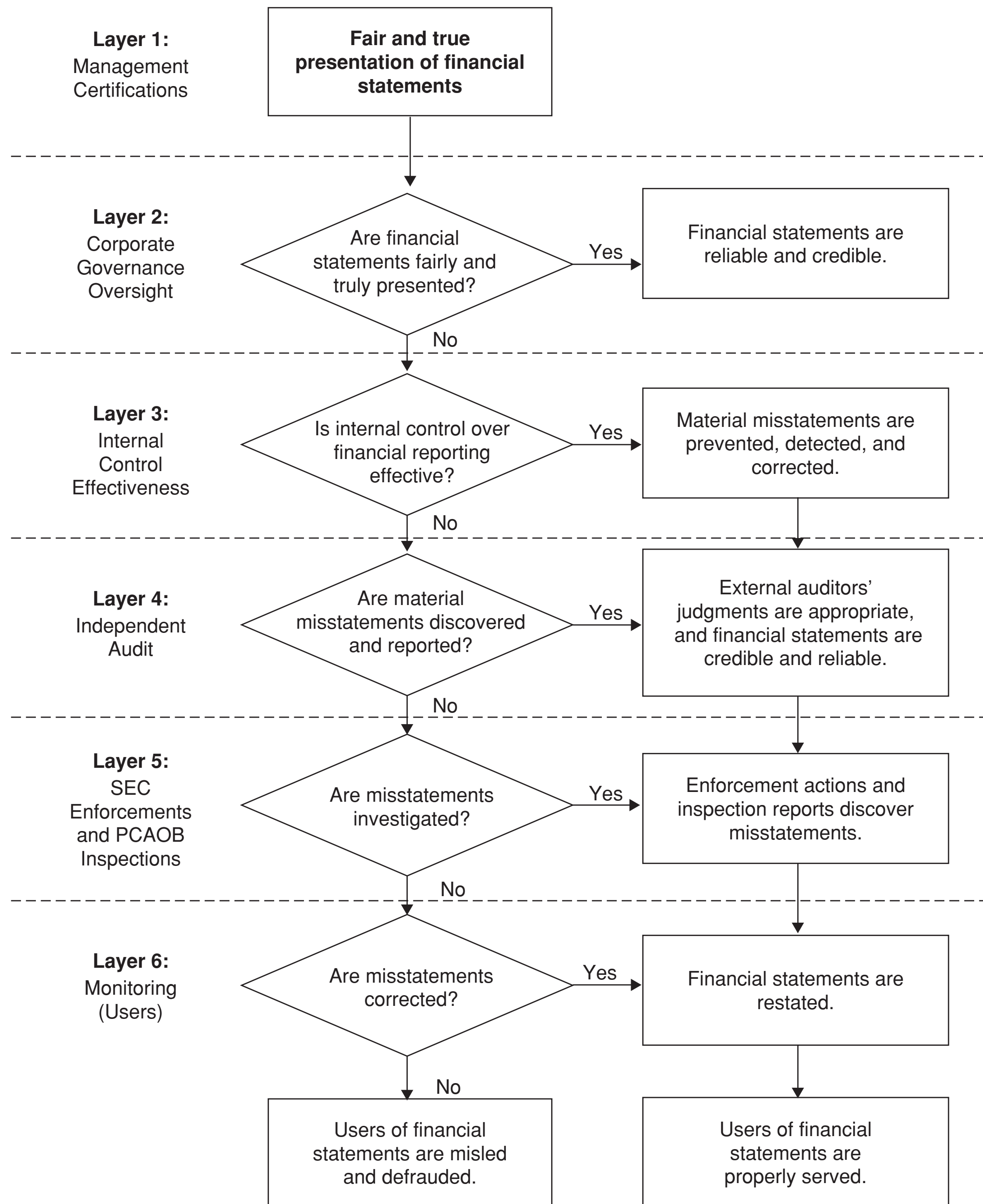

Figure 1.4 Layers of financial statement scrutiny.

financial statements by users of financial reports, particularly institutional investors and financial analysts.

Corporate governance reforms and best practices require the establishment of four key gatekeepers to deal with the perceived agency problems of asymmetric information between management and investors and to improve the quality of public financial information. These gatekeepers are (1) an independent and competent board to oversee management's strategy and performance; (2) an independent and competent external auditor to provide a high level of assurance regarding the reliability, quality, and transparency of the financial reports; (3) objective and competent legal counsel in providing legal advice and in ensuring more than mere technical compliance with applicable regulations; and (4) objective and competent financial advisors and investment bankers to advise company management and the board in conducting legitimate business affairs and transactions that have a valid economic purpose.

These gatekeepers are responsible for protecting investors from obtaining misleading financial information disseminated to the capital market by public companies in their public filings. Reported high-profile financial scandals suggest that the failures of these gatekeepers are significant contributory factors in continuing corporate malfeasance. Gatekeepers should (1) be fully independent from the company, (2) exercise professional skepticism when attesting to or relying on representations of management, (3) fulfill their professional responsibility to the investing public, and (4) withdraw from the engagement when the integrity of their work is compromised due to factors beyond their control. The value-adding activities, roles, and responsibilities of these gatekeepers and other corporate governance participants are examined in detail in Chapters 3 to 9. Effective corporate governance depends on the quality of value-adding activities of all gatekeepers. It should be noted that attorneys and financial advisors are generally viewed as advocates for those they represent as opposed to being representatives of investors. The role of the other two gatekeepers (the board of directors and the independent auditor) is legally and conceptually regarded as being a representative of investors with the keen purpose of protecting investor interests.

INTRODUCTION TO CORPORATE GOVERNANCE

Corporate governance has gained renewed interest and relevance in recent years and is now emerging as a central issue within public companies. Companies have recently undergone a series of corporate accountability reforms resulting from government regulations (SOX), the emergence of powerful institutional investors, listing standards of national stock exchanges, and guiding principles and best practices of investor activism. Corporate governance is a process affected by legal, regulatory, contractual and market-based mechanisms, and best practices to create substantiate shareholder value while protecting the interests of other shareholders. This definition implies that there is a dispersed ownership structure, and thus, the role of corporate governance is to protect shareholders and other stakeholders' interests by limiting opportunistic behavior of management who controls their interests. In a capital structure where there is concentrated ownership and a small group of shareholders can exercise ownership control, corporate governance should ensure the alignment of interests of controlling shareholders with those of minority or individual shareholders.

The primary role of all corporate governance participants, as defined in this book, should center around the fundamental theme of protecting shareholders, restoring investor confidence, and supporting strong and efficient capital markets. Corporate governance is

conceived broadly in this book in terms of institutional arrangements and mechanisms affecting and affected by the role of corporate governance participants (the board of directors, senior executives, management, auditors, financial advisors, regulators, investors, and other stakeholders). Corporate governance can be defined as a process through which shareholders induce management to act in their interests, providing a degree of investor confidence that is necessary for the capital markets to function effectively.

Effective corporate governance ensures corporate accountability, enhances the reliability and quality of public financial information, enhances the integrity and efficiency of the capital market, and, thus, improves investor confidence. Poor corporate governance can have detrimental effects on a company's potential, performance, and accountability and can pave the way for financial difficulties and even fraud. Corporate governance in the twenty-first century goes beyond focusing on shareholder value enhancement because companies play a vital role in the global economy and capital markets by relying on private sector institutions to manage personal savings and secure retirement income. Corporate governance defines a set of contracts and relationships between the company, its directors, its officers, and its stakeholders. It is expected to not only define the relationship between the company's management, board, and shareholders, but also to focus on its impact on overall economic performance and market integrity, as well as public trust of its financial information.

Public companies are required to comply with the corporate governance requirements of state and federal statutes as well as the listing standards of national stock exchanges. However, mere compliance will not guarantee effective corporate governance, and companies should integrate the best practices suggested by investor activists and professional organizations into their corporate governance structure. In addition, companies may be penalized by investors if they fail to consider best practices. Effective corporate governance can only be achieved when all participants (1) add value to the company's sustainable long-term performance; (2) effectively carry out their fiduciary duty and professional responsibilities; (3) are held accountable and personally responsible for their performance; and (4) develop a practice of not only complying with applicable regulations, but also committing to doing the right thing and observing ethical principles of professional conduct in avoiding potential conflicts of interest.

Corporate governance is ultimately about leadership and accountability (1) for efficiency and effectiveness of operations to compete in the global markets; (2) for disclosure of accurate, complete, and transparent information regarding corporate performance in areas of economic and social activities; and (3) that is transparent to ensure trustworthiness of corporations and their leaders in contributing to the achievement of the company's sustainable performance and success, the integrity and efficiency of capital markets, economic growth, prosperity of the nation, and the sustainability of the global market.

Corporate Culture and Integrity

The lack of investor confidence in corporate America and its financial reports has continued to adversely affect the vibrancy of the capital market as corporate scandals of high-profile companies such as Enron and WorldCom tarnished corporate trustworthiness. This challenged business leaders to change their culture, behavior, and attitudes to restore confidence and trust in business. Corporate culture is continuously affected by its leadership in setting a "right tone at the top" and is often informal in establishing powerful norms and standards

that influence behavior. Laws, regulations, rules, and standards are effective measures in changing the structure, process, and composition of corporate governance, whereas corporate culture is developed over time and derived from shared values. The engaged board of directors can significantly influence the corporate culture by (1) setting an appropriate "tone at the top" and promoting personal integrity and professional accountability, (2) rewarding high-quality and ethical performance, (3) disciplining poor performance and unethical behavior, and (4) maintaining the company's high reputation and stature in the industry and the business community. The extent and nature of the impact of corporate culture depends on the company's values and norms, the commitment of its directors and officers in promoting and enforcing ethical conduct, and the effectiveness of responses to internal and external changes.

The revised federal sentencing guidelines (FSG) emphasize the need for a culture of compliance and ethics.[10] This amendment revised FSG's provisions regarding compliance and ethics programs to strengthen the criteria that organizations must follow to prevent and detect criminal conduct. The revised FSG require organizations to (1) exercise due diligence to prevent and detect criminal conduct; (2) promote an organizational culture that encourages ethical conduct and compliance with applicable regulations; (3) assign oversight compliance responsibilities to specific senior executives (e.g., chief compliance officer [CCO]); (4) define specific roles and reporting relationships of personnel relevant to their compliance and ethics program responsibilities; (5) exercise oversight pertaining to the implementation of the compliance and ethics program by the company's board of directors or the organization's highest-level governing body; (6) require compliance and ethics training for everyone within the company, including directors, officers, employees, and agents, as appropriate; (7) establish proper policies, procedures, and steps to achieve compliance; (8) enforce compliance and ethics standards through disciplinary measures; (9) provide incentives for performance in accordance with compliance and ethics programs; (10) take reasonable steps to respond to and prevent criminal conduct by focusing on the establishment and maintenance of an ethical culture; and (11) assess periodically the effectiveness of the company's compliance and ethics program through monitoring, auditing to detect criminal misconduct, self-reporting, and cooperation with authorities.[11]

The compliance culture requires the establishment and implementation of proper programs, policies, and procedures to effectively comply with applicable regulations, standards, and best practices. However, compliance just for the sake of compliance and the development of a "check box" mentality is not enough. Corporations should create an ethical culture that encourages all corporate governance participants to do the right thing and understand that this is vital to the company's sustainable financial performance. To effectively integrate the culture of ethics and compliance into corporate governance, corporations should set an appropriate tone at the top that promotes (1) the development of roles and responsibilities for all corporate governance functions (oversight, managerial, auditing, compliance, assurance, monitory); (2) directors, officers, and employees to do the right thing; (3) the acceptance of responsibility and accountability of all personnel for their actions and actions of others under their supervision; (4) free discussion of concerns and issues without fear of retaliation; (5) proper consideration of ethical issues throughout the company when difficult and complex decisions are made; (6) understanding of the incentives and rationalization factors affecting individuals' decisions when the pressure that may drive unethical behavior exists; (7) proper oversight and management of all compliance activities and ongoing monitoring

of compliance policies to adopt changes in applicable laws and regulations; (8) emphasis by directors and officers on an ethical tone at the top; and (9) reporting of unethical and noncompliance instances through the proper channels to top level management and, if necessary, to the board of directors or its designated committee (e.g., audit committee).

The compliance culture can be promoted through the establishment of a centralized CCO who is primarily responsible for ensuring compliance with all applicable laws, regulations, rules, standards, codes of ethics, policies, and procedures, and oversees all compliance functions. The CCO maintains a close working relationship with the company's directors in setting compliance strategies, properly communicating procedures to business units' compliance officers, and continuously monitoring and enforcing compliance policies and procedures. The promotion and enforcement of compliance culture starts from the board of directors by possibly establishing a compliance committee to establish strategies and ensure that related functions are being overseen and monitored. Compliance policies should be enforced and monitored by managers at each reporting business unit. All employees should adhere to compliance procedures, and legal counsel should update and revise them as necessary to ensure that they are relevant and adhere to legal and regulatory changes.

Corporate Accountability

To improve corporate accountability, corporations must also assess the impact of emerging corporate governance reforms, including the provisions of SOX, SEC-related implementation rules, PCAOB professional standards, listing standards, and best practices, and ensure compliance with these reforms. Ever-increasing global initiatives have extended corporations' accountability not only to their investors, but also to all stakeholders on a variety of issues from economic measures to governance, ethical, social, and environmental performance. Traditionally, public companies have primarily focused on achieving their economic objective of making a profit and enhancing shareholder wealth by engaging in operating, investment, and financing activities to provide and distribute goods and services. This narrow focus on achieving economic performance has been criticized for ignoring other ethical responsibilities of corporations. The multiple bottom lines (MBL) objectives of economic, social, ethical, and environmental (ESEE) performance have been advocated by global business and investment communities.[12] With the MBL objectives, the primary goal is to achieve economic performance while proper consideration is given to other measures, including social, ethical, and environmental (SEE) issues. The perceived benefits of reporting both financial and nonfinancial key performance indicators (KPIs) are improved quality of information, enhanced communications with analysts and investors, and integration of the organization's operating, financial, and social performance.

In today's business environment, global businesses are under close scrutiny and profound pressures from lawmakers, regulators, the investment community, and their diverse stakeholders to accept responsibility for their MBL of governance and ESEE performance. A study released by the United Nations in October 2005 concluded that "the integration of environmental, social, and governance (ESG) issues into investment analysis, so as to more reliably predict financial performance, is clearly permissible and is, arguably, required in all jurisdictions."[13] Institutional investors should incorporate MBL performance in these areas into their investment and voting decisions.

In October 2005, Mercer Investment Consulting (Mercer IC) announced that its research of investment managers will now include systematic evaluations of "their performance with regard to 'active ownership' practices (including proxy voting and shareholder engagement) and the incorporation of environmental, social, and corporate governance (ESG) analysis into mainstream decision making."[14] Mercer also announced that it would start rating managers on their share voting habits, engagement practices, and the extent to which they incorporate ESG issues in portfolio analysis. Although the primary focus and goal of corporate governance in the foreseeable future will continue to be an economic issue of creating long-term shareholder value, the trend toward emphasis on social, ethical, and environmental issues will continue to increase as more shareholders become concerned about these issues, file proposals, and bring these proposals to a vote. Corporate accountability reporting in areas of economic, social, ethical, environmental, and governance activities is presented in Chapter 14.

INTRODUCTION TO BUSINESS ETHICS

Ethics is defined in *Merriam-Webster's Dictionary* as "a set of moral principles: a theory or system of moral values."[15] Ethics in the literature is defined as value systems by which individuals assess their and others' behavior according to a set of previously established standards driven by a variety of religious, cultural, societal, or philosophical sources.[16] Ethics is also described as "a process by which individuals, social groups, and societies evaluate their actions from a perspective of moral principles and value."[17] Although there is not a single commonly accepted definition of business ethics, obvious examples of possible violations range from manipulation of financial information and backdating practices of executive stock options grants to spying on outside directors. Ethical violations include the behavior of the convicted executives of such high-profile companies as Enron, WorldCom, Adelphia, and Tyco. The trend in business shows a decline in business ethics in recent years, which can be reversed through (1) more education of business ethics, (2) establishment of business codes of ethical conduct, and (3) enforcement of ethical conduct.

The wave of financial scandals at the turn of the twenty-first century along with congressional responses and related regulations have brought corporate governance and business ethics into the center stage of corporate accountability and business education. Given the current culture of corporate accountability and ethical business climate as reflected in the extant literature, corporate governance and business ethics education is becoming more important to business students. Reports of professional organizations have recommended that ethics, integrity, and accountability be integrated into business and accounting curriculum.

Ethics in business assumes an important underlying postulate that the majority of the business leaders, managers, and other personnel are honest and ethical in conducting their business, and the minority who engage in unethical conduct will not prevail in the long term. Thus, the corporate culture and compliance rules should provide incentives and opportunities for ethical individuals to maintain their honesty and integrity and provide measures for the minority of unethical individuals to be monitored, punished, and corrected for their unethical conduct. Companies should promote a spirit of integrity that goes beyond compliance to the letter of the law by creating a business culture of doing what is right.

Codes of business ethics and conduct are intended to govern behavior, but they cannot substitute for moral principles, culture, and character. Warren Buffet, a veteran of corporate

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governance, rightfully states that the five most dangerous words in the business culture are "everybody else is doing it" as a rationale for business decision making.[18] 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.

Corporate governance should create an ethical business environment in which all employees are encouraged and empowered to "do the right thing." Secretary of Treasury Henry Paulson believes that "we must rise above a rules-based mindset that asks 'is this legal?' and adopt a more principles-based approach that asks 'is this right?'"[19] Companies need to have ethics and business programs to address (1) their diversity of personnel services; (2) their expectations of the public and their stakeholders; (3) their legal, professional, and regulatory environment; and (4) compliance with applicable regulations, including SOX, FSG, SEC rules, and listing standards of national stock exchanges.

Business schools are being criticized for overemphasizing technical training and underemphasizing ethical considerations, professionalism, accountability, and responsibility of future business leaders, the business students.[20] The goal of business ethics education is to teach students accountability to their profession and society, and there is a general consensus among academicians and practitioners that corporate governance and business ethics should be part of business education. However, the means of and strategy for providing such education is not clear. Most states require certified public accountant (CPA) candidates to pass an ethics exam and report the ethics component in their continuing education requirements. One approach to teaching business ethics is to integrate it across the curriculum by exposing students to corporate governance issues and common ethical dilemmas and methods of resolving them.

Business ethics requires that corporations promote a culture of moral responsibility to society. Thus, in educating future business leaders, business schools attempt to incorporate and integrate business ethics into their curriculum. In light of recent high-profile cases of unethical behavior on the part of management, who once received their education in business schools, business schools are being criticized for not providing sufficient ethical education to their students. This suggests that management education should affect a person's ethics composition and shape his or her awareness and appreciation of ethical behavior and consequences. Proponents of an integrated approach suggest that ethics be an essential part of the business curriculum. Business education should introduce students to ethical issues and provide them with tools and skills to meet the ethical challenges of the business world.

There are some who believe that ethical thinking and accountability should be explored throughout the education process by either integrating them into business courses and programs or teaching them as a stand-alone subject. The National Association of State Boards of Accountancy's (NASBA's) Exposure Draft of proposed changes to the Uniform Accounting Act, Rules 5-1 and 5-2, promotes increased attention to ethics, corporate governance, communication, research, and analytical skills. The American Accounting Association (AAA) Task Force's consideration is that the strategy suggested in the proposal would not achieve NASBA's stated goals, and its implementation would impose significant costs.[21]

There are generally two schools of thought on whether ethics can be taught in the classroom among academicians, professionals, and students.[22] One view suggests that ethics can and should be taught in the classroom, and the other alludes to the fact that a person is either ethical or not and thus ethics cannot be taught. Regardless, business schools and

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particularly accounting students should be aware of their code of professional conduct, accountability, and professionalism, as well as the responsibilities of all participants in the financial reporting. Thus, this book focuses on both corporate governance and business ethics to provide students with the education to better understand their professionalism, leadership responsibilities, accountability, personal integrity, and ethical conduct.

An important aspect of the emerging trend toward increased corporate accountability and governance is reflected in the role and relevance of business ethics and codes of professional conduct. The diversity of people, existence of various value systems, and sensitivity of moral issues make it difficult to achieve a consensus and central theme for ethics. Thus, the "situation ethics theory" is used in this book to build a consensus as to appropriate ethical practices and professional responsibilities.[23]

CLASSROOM IMPLICATIONS OF THIS BOOK

This book is the first to compile corporate governance reforms, including state and federal statutes, rules, regulations, listing standards, guiding principles, and best practices, as well as business ethics theory and practice, into a single book to assist in corporate governance and business ethics education. The quality and quantity of corporate governance and ethics coverage in business texts has been criticized. Critics argue that business education is not adequate in areas such as ethics, corporate governance, professional judgment, accountability, and responsibility.

There are several plausible reasons for integrating corporate governance and business ethics education into the business curriculum:

1. Reported financial scandals (e.g., Enron, WorldCom, Global Crossing, Adelphia, Qwest) underscore the importance of vigilant corporate governance and ethical conduct by corporations.
2. SOX is intended to improve corporate governance by enforcing more accountability for public companies and requiring adoption of a code of ethics for their executives.
3. Anecdotal evidence and academic studies suggest that corporate governance and business ethics are not properly integrated into business education, and coverage of these issues should be increased.
4. Teaching and research in corporate governance and business ethics have been strongly recommended and encouraged.
5. There is an inventory of support materials for teaching business ethics and corporate governance in the post-Enron era. There are sufficient resources (textbooks such as this book, published articles, Internet Web sites, videos) to offer a stand-alone course or integrate business ethics and corporate governance modules throughout accounting courses.
6. It is easier to obtain administrative support to offer business ethics and corporate governance courses in the post-SOX era.
7. Several business schools have developed innovative strategies for engaging students in the challenge of providing ethical leadership by focusing on both positive and negative examples of everyday conduct in business.

8. There is an increasing trend toward incorporation of business ethics and corporate governance education into the business curriculum worldwide.
9. Accounting programs should integrate provisions of SOX on corporate governance, financial reporting, and audit functions into the curriculum.
10. Corporate governance has evolved from compliance requirements to a business imperative.
11. NASBA, in its Exposure Draft of Uniform Accounting Rules 5-1 and 5-2 regarding NASBA 150-hour education, emphasized the need for six semester credit hours in ethical and professional responsibilities that was subsequently tabled.
12. The Association to Advance Collegiate Schools of Business International (AACSB) has promoted the integration of business ethics and corporate governance into the business curriculum.

SUMMARY

Corporate governance involves relationships and power sharing between a company's management, board, shareholders, and other stakeholders, including the way the board oversees the running of a company by its managers and how board members are, in turn, accountable to shareholders and the company. Corporate governance also provides the structure for determining the objectives of the company, attaining those objectives, and monitoring its performance. It should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders. An effective corporate governance system helps provide a level of confidence that is necessary for the proper functioning of a market economy.

Good corporate governance lays the foundation for the integrity and efficiency of financial markets. Conversely, poor corporate governance weakens a company's potential and, at worst, can pave the way for financial difficulties and fraud. Companies that are well governed will usually outperform poorly governed companies and will be able to attract investors to help finance further growth. As a result, companies are encouraged to use their resources more efficiently, and the cost of capital is lower. Simply stated, good corporate governance strengthens market and investor confidence, integrity, and efficiency, thereby promoting economic growth and financial stability.

The Key Points of This Chapter are

- The primary goal of corporate governance is to create a right balance of power sharing among all participants, particularly shareholders, boards of directors, and management, to create and enhance shareholder value while protecting the interests of other stakeholders.
- The investment community is requiring companies to earn back public trust; therefore, the roles of individuals involved in corporate financial reporting have become a value-added function under intense scrutiny.
- Reliable and transparent financial information contributes to the efficient function of the capital markets and economic growth.
- Corporate government reforms require four key corporate gatekeepers: an independent and competent board, an independent and competent auditor, objective and competent legal counsel, and objective and competent financial advisors.
- Corporate governance, for the purpose of this book, is defined as the process affected by a set of legislative, regulatory, and legal market mechanisms; listing standards; best practices; and

efforts of all corporate governance participants, which creates a system of checks and balances with the goal of creating and enhancing sustainable value for shareholders while protecting the interests of other stakeholders.

- Market-based mechanisms alone cannot solve corporate governance problems because they are often initiated and enforced after the occurrences of management abuse and after shareholders sell their shares, depressing the price.
- Corporate governance reforms, including SOX, SEC-related implementation rules, listing standards of national stock exchanges, auditing standards of the PCAOB, guiding principles of professional organizations, and best practices, are intended to improve the vigilance and effectiveness of corporate governance; reliability, integrity, transparency, and quality of financial reports; the effectiveness of internal controls and related risk management assessment; the credibility of the audit function; the independence and objectivity of other gatekeepers, such as legal counsel, financial analysts, and shareholders; monitoring; and democracy.
- The net benefit of corporate governance reforms is expected to aid in improving investor confidence and public trust in corporate America, identify and manage potential conflicts of interest that may exist, and address the professional accountability and personal integrity of all corporate governance participants.
- Corporations should set an appropriate "tone at the top" to effectively integrate a culture of ethics and compliance.
- Global initiatives have extended corporations' accountability, not only to their investors, but also to all stakeholders, on a variety of issues from economic measures to governance, ethical, social, and environmental performance. Therefore, corporations are focusing on MBL objectives of ESEE performance.

KEY TERMS

corporate accountability reporting
corporate culture
corporate gatekeeper
corporate governance
ethical accountability
federal sentencing guidelines
Generally Accepted Accounting Principles (GAAP)
listing standards
multiple bottom lines (MBL)
Public Company Accounting Oversight Board (PCAOB)
Sarbanes-Oxley Act of 2002 (SOX)
Securities Act of 1933
Securities Exchange Act of 1934
Securities and Exchange Commission (SEC)
social accountability

REVIEW QUESTIONS

1. What is the primary goal of corporate governance?
2. What is the primary mission of a public company?
3. What is the role of a corporate governance gatekeeper?
4. Corporate governance reforms and best practices require the establishment of four key gatekeepers to deal with the perceived agency problems of asymmetric information between management and investors and to improve the quality of public financial information. Who are these gatekeepers and what role do they play in corporate governance?
5. How does an effective corporate governance structure improve investor confidence?

6. What is the primary intent of corporate governance reforms?
7. What benefits are obtained by the proper implementation of SOX?
8. How can the board of directors influence the corporate culture?
9. What is the intention of organizational codes of business ethics and conduct?
10. What are the three key best practices that make corporate governance effective?
11. Why is there no universal definition of corporate governance?
12. How have SOX provisions, SEC-related rules, and listing standards influenced the corporate governance structure?
13. What business entities are currently affected by SOX?
14. What is the difference between a shareholder and a stakeholder aspect of corporate governance?
15. What are the primary differences between financial reporting and corporate accountability reporting?
16. What is the relationship between corporations and stakeholders, and what is the corporations' role in that relationship?
17. What is the primary difference between the first and second tier of the stakeholder hierarchy?
18. To whom are corporations accountable?
19. Explain the relationship between corporations and the capital markets in the United States.

DISCUSSION QUESTIONS

1. In your own words, briefly explain the concepts of value creation and value protection.
2. Has Sarbanes-Oxley thus far had a positive, negative, or neutral effect on public companies? Defend your answer.
3. Discuss the following quote from Lori A. Richards, the SEC's director of the Office of Compliance Inspections and Examinations:

   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.
4. What are the benefits of an MBL approach in evaluating the organization KPIs related to both financial and nonfinancial information?
5. Who are first-tier, second-tier, and third-tier stakeholders, and why are they significant to the organization?
6. What is the significance of quality financial statements and other financial reporting information?
7. What are the responsibilities of corporate governance gatekeepers?
8. What should the board of directors do to promote a positive corporate culture?

9. Will compliance with applicable laws, rules, and regulations ensure effective corporate governance? Explain your answer.
10. What are some reasons for integrating corporate governance and business ethics education into the business curriculum?
11. As noted in the text, corporate governance has no universally accepted definition. Define corporate governance and explain your definition.
12. The following is a list of eight entities and conventional systems that shape corporate governance. Provide examples of how or what they have done.
    (a) Federal legislation
    (b) State statutes
    (c) SEC regulation
    (d) The courts
    (e) Listing standards
    (f) Investor activists
    (g) Investors
    (h) Other corporate governance participants
13. The book mentions many examples of the give–take relationship between corporations and society. What are some other examples of the corporation–society relationship? Provide a minimum of three examples.
14. Discuss the significance and importance of investors (shareholders) as the first tier of the stakeholder hierarchy.

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