Agency Assurance: The Role of the Audit Committee in Corporate Governance

D I S S E R T A T I O N
of the University of St. Gallen,
Graduate School of Business Administration,
Economics, Law and Social Sciences (HSG)
to obtain the title of
Doctor Oeconomiae

submitted by

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Dissertation no. 3233

SIB Press
Reutlingen, 2006
The University of St. Gallen, Graduate School of Business Administration, Economics, Law and Social Sciences (HSG) hereby consents to the printing of the present dissertation, without hereby expressing any opinion on the views herein expressed.

St. Gallen, June 12, 2006

The President:

Prof. Ernst Mohr, PhD
Acknowledgements

I am very fortunate to have received inspiration, support, advice, and encouragement from Prof. Dr. Martin Hilb and a positive academic and professional atmosphere in his Multicultural Management program at the University of St. Gallen. I also value the input of Prof. Dr. Dres. h.c. Rolf Dubs, who was critically supportive and provided important words of motivation at the times they were most needed. I highly appreciate these uncommon efforts and the relationships that have developed from them.

I want to thank Prof. Dr. Dennis De, who as my colleague and former dean at the School of International Business of Reutlingen University, has always been fully confident and helpful in my pursuit of the doctoral degree.

Finally, I am truly blessed by the love and understanding of my wife, Tina, and my children, Peter and Monica.

Reutlingen, June 30, 2006

Robert M. Lo Bue
Abstract

The incidence and recurrence of fraud, omission, and error at many of the world’s largest and most admired corporations have led the way to attempts at reform through external legislative and regulatory means. This dissertation presents options for reform of the audit committee that are directed at identifying and removing structural obstacles to corporate governance of an internal firm nature. The overall goal is to assist boards of directors in meeting the highly raised expectations for their performance in the 21st century.

Corporate and society leaders should be looking for effective methods of both bonding and monitoring, in an appropriate balance, for governance activities. Boards are small organizational groups who have limited time to engage in their responsibilities. Therefore, they are fully dependent on management-supplied information (MSI) to be productive and effective. However, agency theory predicts that high conflicts of interest will impede information quality. The extremely high compensation for top executives and investment analysts has assisted in raising the transparency barrier standing between management and stakeholders.

The agency assurance model introduced here specifically directs the audit committee operationally in three areas:

1. constitution – examining its purpose, character, and rights for effective oversight of MSI;
2. classification – employing knowledge management, accounting principles, and transaction costs for relevant development of MSI; and
3. communication – enhancing transparency, channels, and shareholder relations for fair distribution of MSI.

In respect to these three factors, the audit committee can play a central role in improving the verification, validation, and vetting of MSI to lower the transparency barrier; strengthen the governance environment; and improve board, management, and firm performance.

The agency assurance model asks the audit committees to concern themselves with the goal of identifying and attaining the true and fair view of firm results for the users of MSI. The concept of differentiation costs is offered to support the true and fair view by requiring the recognition of the costs incurred in development or acquisition of most forms of explicit knowledge as official assets in the audited financial statements. Strategic management theory and value-based reporting place great worth on many of these differentiation costs related to development of intangible assets, while today’s accounting principles continue to leave most of them unrecognized.
To Tina
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## Abbreviations

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<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
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<tr>
<td>a.k.a.</td>
<td>also known as</td>
</tr>
<tr>
<td>CA</td>
<td>Computer Associates</td>
</tr>
<tr>
<td>CAD</td>
<td>computer aided design</td>
</tr>
<tr>
<td>CAE</td>
<td>chief audit executive</td>
</tr>
<tr>
<td>CalPERS</td>
<td>California Public Employees Retirement System</td>
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<td>CEO</td>
<td>chief executive officer</td>
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<tr>
<td>CFO</td>
<td>chief financial officer</td>
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<td>CICA</td>
<td>Canadian Institute of Chartered Accountants</td>
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<td>CERN</td>
<td>European Organisation for Nuclear Research</td>
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<td>Cisco</td>
<td>Cisco Systems</td>
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<td>COSO</td>
<td>Committee of Sponsoring Organizations of the Treadway Commission</td>
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<tr>
<td>CRM</td>
<td>customer relationship management</td>
</tr>
<tr>
<td>DJIA</td>
<td>Dow Jones Industrial Average</td>
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<td>E&amp;Y</td>
<td>Ernst &amp; Young</td>
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<td>EDGAR</td>
<td>Electronic Data Gathering, Analysis, and Retrieval</td>
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<td>EDI</td>
<td>electronic data interchange</td>
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<td>Employee Retirement Income Security Act – US</td>
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<td>EVA®</td>
<td>Economic Value Added®</td>
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<td>Federal Bureau of Investigation – US</td>
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<td>FCS</td>
<td>first customer shipment</td>
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<td>FD</td>
<td>fair disclosure</td>
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<td>Food and Drug Administration – US</td>
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<td>The Fed</td>
<td>Federal Reserve Board – US</td>
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<td>FEI</td>
<td>Financial Executives International</td>
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<tr>
<td>FIFO</td>
<td>first-in-first-out</td>
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<td>FSC</td>
<td>Foreign Sales Corporation</td>
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<td>ftp</td>
<td>file transfer protocol</td>
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<td>G3</td>
<td>third generation telecommunications standard</td>
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<tr>
<td>G&amp;A</td>
<td>general and administrative</td>
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<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<tr>
<td>GAAS</td>
<td>generally accepted auditing standards</td>
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<tr>
<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<td>GE</td>
<td>General Electric – US</td>
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<td>Glaxo</td>
<td>GlaxoSmithKline</td>
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<tr>
<td>HTML</td>
<td>Hypertext Mark-Up Language</td>
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<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<td>IA</td>
<td>intellectual assets</td>
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<td>IAM</td>
<td>Intellectual Asset Management</td>
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<td>International Accounting Standards</td>
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<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
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<td>IC</td>
<td>intellectual capital</td>
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<tr>
<td>ICGN</td>
<td>International Corporate Governance Network</td>
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<tr>
<td>ICT</td>
<td>information and communications technology</td>
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<tr>
<td>IFAC</td>
<td>International Federation of Accountants</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<tr>
<td>IL</td>
<td>intellectual liabilities</td>
</tr>
<tr>
<td>IMG</td>
<td>International Management Group</td>
</tr>
<tr>
<td>IPO</td>
<td>initial public offering</td>
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<tr>
<td>IR</td>
<td>investor relations</td>
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<tr>
<td>KM</td>
<td>knowledge management</td>
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<tr>
<td>LLC</td>
<td>Limited Liability Company</td>
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<tr>
<td>LLP</td>
<td>Limited Liability Partnership</td>
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<tr>
<td>M&amp;A</td>
<td>mergers and acquisitions</td>
</tr>
<tr>
<td>M/B</td>
<td>market to book</td>
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<tr>
<td>MD&amp;A</td>
<td>management’s discussion and analysis</td>
</tr>
<tr>
<td>MSI</td>
<td>management-supplied information</td>
</tr>
<tr>
<td>NASD</td>
<td>National Association of Securities Dealers</td>
</tr>
<tr>
<td>NDA</td>
<td>non-disclosure agreement</td>
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<tr>
<td>NGO</td>
<td>non-governmental organization</td>
</tr>
<tr>
<td>NPV</td>
<td>net present value</td>
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<td>NYSE</td>
<td>New York Stock Exchange</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Cooperation and Development</td>
</tr>
<tr>
<td>PC</td>
<td>personal computer</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board – US</td>
</tr>
<tr>
<td>PGA</td>
<td>Professional Golfers Association</td>
</tr>
<tr>
<td>PR</td>
<td>public relations</td>
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<tr>
<td>R&amp;D</td>
<td>research and development</td>
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<tr>
<td>ROI</td>
<td>return on investment</td>
</tr>
<tr>
<td>RSS</td>
<td>Rich Site Summary</td>
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<tr>
<td>SCAS</td>
<td>Special Committee on Assurance Services</td>
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<td>SEC</td>
<td>Securities and Exchange Commission – US</td>
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<td>SPE</td>
<td>Special Purpose Entity</td>
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<tr>
<td>SRO</td>
<td>self-regulating organization</td>
</tr>
<tr>
<td>SWIB</td>
<td>State of Wisconsin Investment Board</td>
</tr>
<tr>
<td>UC</td>
<td>University of California</td>
</tr>
<tr>
<td>UK</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>US</td>
<td>United States of America</td>
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<tr>
<td>VC</td>
<td>venture capitalist</td>
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<tr>
<td>WAP</td>
<td>Wireless Application Protocol</td>
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<tr>
<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>WTO</td>
<td>World Trade Organization</td>
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<tr>
<td>www</td>
<td>World Wide Web</td>
</tr>
<tr>
<td>XBRL</td>
<td>eXtensible Business Reporting Language</td>
</tr>
<tr>
<td>XML</td>
<td>eXtensible Mark-up Language</td>
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CHAPTER 1.

The Compelling Need for Corporate Governance Reform

1.1 Fallout of the Stock Market Crash of 2000

1.1.1 Incurred Losses and Unrealized Gains

Aftermath. There is no other word more appropriate for describing the contemporary situation of the world economy early in the 21st century. The stock market bubble burst, and over a matter of weeks, global wealth was reduced by trillions of dollars. Hundreds of thousands lost their jobs or even worse, saw their prospects for living above the mere subsistence level fade away. Much of the world has been experiencing an economic turnaround, but it is most appropriately called a ‘sputtering recovery’. The relatively long time it is taking for stability in the financial markets to take hold constantly reminds us we remain living with the after-effects of a post disaster period.

Some find comfort in the fact that the loss of wealth was mainly ‘on paper’. What they mean by this is that most of the wealth that vanished was actually created over a relatively short period of just a few years at the close of the 20th century. Prices for shares of the worlds’ corporations were bid up by investors to unsustainable levels. In the aftermath those prices have ‘simply’ returned to pre-bubble levels. Investors are still rich, just not as rich as they had come to believe they were. Unfortunately, this is only the case on an aggregate level. The fallout was very damaging to many less fortunate members and groups of society.

It is true that there were many investors with losses whose earlier gains offset these losses. While they are no doubt disappointed, they will get by without much effect on their lifestyles. However there are also many who lost almost everything. They are the late entrants to the stock markets, the young and foreign investors enticed not only by the gains experienced by their American ‘neighbors but also by the misleading messages of professional financial advisors and corporate executives, who themselves received inordinate amounts of compensation in stock options, commissions, and bonuses as markets climbed, money which they did not have to return as markets crashed. They are ex-employees of now bankrupt organizations whose savings were primarily invested in company stock, who have neither their savings nor their job in
that corporation to regain their wealth. They are retirees and the infirmed without further opportunity to work to support themselves. They are also the many dependents — young children and aged parents — of the now destitute.

More difficult to measure, but no less important, is the ‘opportunity cost’ of these disastrous investments. What real and sustainable wealth could have been created if these funds had not been put into shadowy organizations of inflated value in telecommunications like WorldCom, in internet services like Adelphia, and in energy trading like Enron, as well as in government bail-outs of their respective pension funds? Alternatively, these investments could have been directed at education, at bricks and mortar-related and clean-energy producing real businesses, and at shoring-up government social security funds. With the proper information to discern good ideas from bad ones, the economic actors forming Adam Smith’s ‘invisible hand’ of capitalism could have placed these trillions of capital in alternative investments with long-term value to society.

In end effect, we are all placed in the current situation where we have been robbed of the possible wealth that could have been earned from these alternative opportunities. We thought we were investors supporting new business ideas for a new virtual age. We were actually middlemen buying and selling opportunistically, but unaware of huge risks associated with these speculative transactions. Or worse, we were willing speculators siphoning off profits from the productive efforts of others.

1.1.2 The Acceptable Role and Responsibility of Corporations

Ownership in corporations is not intended as a mechanism of speculation, but as a legal means of pooling of capital, divisible into shares of property rights, i.e. common stock, to enable firms to make large-scale investments.\(^1\) Anyone interested in the economic well-being of today’s global society, therefore, must be concerned foremost with corporations’ potential as economic producers. The world’s largest industrial companies, financial institutions, and service providers themselves have revenues exceeding the productive output of many nations. Their direct employees can number in the hundreds of thousands, and a majority of these employees are likely to be heads of households with dependent spouses, children, and parents. The economic reach of

\(^1\) Alchian (1991).
these companies measured in sales or employment is truly global, transcending national borders and political jurisdictions.

The economic, social, and environmental influence of corporate entities spread like a haze to cover the world landscape during the second half of the 20th century. The rebuilding of much of Europe into an economic union; transition of post-war Japan; modernization of South Korea, Taiwan, Singapore, and other Asian nations; collapse of the Soviet bloc as an economic system and subsequent ‘westernization’ of Eastern European economies; and embrace of a market-based economic system by The Peoples Republic of China have fuelled the acceptance of corporate business entities and share ownership as day-to-day elements of modern life.

Governments of nations in all corners of the globe willingly cede authority over the far reaches of these corporate entities to other governments in order for their own economies and citizens to enjoy the benefits of participation in the global market. Beginning roughly in the 1980’s in the West, through business-oriented political policies of the United States (US) and the run-up towards the European Union’s 1992 economic agenda, and then in the 1990’s in the East, following the collapse of the Soviet system and the opening of markets in China, privatization of industry reached epic proportions. Despite the current quagmire of the Doha Round and the disaster at the Cancun talks for the World Trade Organization (WTO), during these two seminal decades leading up to the 21st century, WTO member nations embraced substantial lowering and even outright removal of barriers to trade. The leading economically developed nations not only were willing to enter into a multilateral trade negotiation system, the General Agreement on Tariffs and Trade (GATT), they were also willing to subject themselves to the enforcement provisions of the WTO, GATT’s follow-on regime. This incentivized growth of international commerce and development of global markets, while GATT and the WTO, in turn, embraced most all of the world’s nations, not only the most highly developed ones.

More recent trends in outsourcing and divestment of non-core business functions and the encouragement of employees transitioning into mobile ‘free agents’ may tend to reduce corporations’ average size, but they do not minimize their vast international influence.\(^2\) Rather, many successful corporations have reformed themselves with a

new role as powerful centralized coordinators of assets and activities of these sole proprietors, partnerships and smaller corporations.\textsuperscript{3} Liberalization of trade has also positively affected policies for financial controls and foreign direct investment, leading to more and larger opportunities for cross-border mergers and acquisitions and establishment of foreign subsidiary corporations.

Information and Communications Technology (ICT) infrastructure makes these primarily electronically networked production systems possible, not reducing the power of corporations, but providing them with an even greater reach into markets and the supply chain as well as their respective customers and suppliers.\textsuperscript{4} But even major enabling building blocks of the ICT infrastructure have been produced through efforts of scientists funded by society in general, not by business. For example, the world wide web (www) was developed out of a project idea proposed by Tim Berners-Lee to the European Organisation for Nuclear Research (commonly known as CERN), for sharing scientific papers and project documentation among members from various nations.\textsuperscript{5} The openness of government-funded research as well as the access to technology this openness has facilitated provides substantial opportunity for businesses to invent and exploit proprietary commercial applications derived from the ever expanding public knowledge base.

1.1.3 Loss of Trust in Corporate Leadership

During the second half of the last century corporations have become more highly accepted and encouraged by society, with the support of political, academic and community officials. Unfortunately, upon entering the new century, a crisis of confidence in corporate leadership has erupted. What managed to set off this most recent measurable loss of public trust has been the particularly disappointing evidence of widespread unethical and often illegal behavior unearthed among a very high number of prominent executive managers in the corporate world. Many high profile cases have been exposed in the US, and the following Table 1-1 exposes the sorry contradiction of many of the worst examples of behavior and the compensation earned by the leaders of these organizations.

\textsuperscript{3} Marcus & Wallace (1997), p. 325.
\textsuperscript{4} Meyer & Davis (1998).
\textsuperscript{5} Cailliau (ca. 1995).
Table 1-1. Pay for Performance Contradictions.

<table>
<thead>
<tr>
<th>Company</th>
<th>CEO</th>
<th>Allegations</th>
<th>Investigating Agencies</th>
<th>1999-2001 Total Compensation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tyco</td>
<td>L.D. Koslowski</td>
<td>CEO improperly profited from asset purchases with company funds, SEC reviewing most recent financial statements</td>
<td>SEC, Manhattan DA</td>
<td>$331,755,196</td>
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<tr>
<td>Quaest</td>
<td>J.P. McNichol</td>
<td>Inflated revenue using network capacity swaps, improperly accounted for $1.1 billion in revenue over several years</td>
<td>DOJ, SEC, FBI, US Attorney in CO</td>
<td>$263,332,104</td>
</tr>
<tr>
<td>Enron</td>
<td>K.L. Lay</td>
<td>Used off-the-books partnerships to hide debt and boost profits, Manipulated Texas power market, bribed foreign governments to win contracts abroad</td>
<td>DOJ, SEC, TX Public Utility Commission</td>
<td>$350,834,250</td>
</tr>
<tr>
<td>AOL Time Warner</td>
<td>J.M. Levin</td>
<td>Inflated sales by booking barrier deals and ads sold on behalf of others</td>
<td>SEC, DOJ</td>
<td>$178,364,000</td>
</tr>
<tr>
<td>El Paso</td>
<td>W.A. White</td>
<td>Executed artificial round trip energy trades to boost volume</td>
<td>SEC, US Attorney in TX</td>
<td>$85,860,000</td>
</tr>
<tr>
<td>WorldCom</td>
<td>B.J. Ebbers</td>
<td>Overstated earnings by over $7 billion, $400 million in off-the-books loans to CEO, SEC charged the company with fraud, CFO and controller arrested</td>
<td>SEC, DOJ, US Attorney in NY</td>
<td>$32,366,459</td>
</tr>
<tr>
<td>Halliburton</td>
<td>D.J. Lear (2001)</td>
<td>Improperly booked construction cost overruns before customers agreed to pay for them</td>
<td>SEC</td>
<td>$12,366,459</td>
</tr>
<tr>
<td>FMC Financial Services</td>
<td>J.E. Rohr</td>
<td>Inflated financial results to boost income by $1.5 billion</td>
<td>SEC</td>
<td>$22,189,000</td>
</tr>
<tr>
<td>Dynegy</td>
<td>C.L. Watson</td>
<td>Executed artificial round trip energy trades to boost volume and cash flow</td>
<td>SEC, CFTC, US Attorney in TX</td>
<td>$19,530,064</td>
</tr>
<tr>
<td>Kmart</td>
<td>C. Conaway (2000-01)</td>
<td>Improper accounting intended to mislead investors, issues include vendor contracts and general liability reserves</td>
<td>SEC, US Attorney in MI</td>
<td>$18,074,194</td>
</tr>
<tr>
<td>Xerox</td>
<td>P.A. Allaire (2000-01)</td>
<td>Failed financial results to boost income by $1.5 billion</td>
<td>SEC</td>
<td>$17,497,167</td>
</tr>
<tr>
<td>Peregine Systems</td>
<td>S.P. Gardner</td>
<td>Overstated $100 million in revenues over three years</td>
<td>SEC</td>
<td>$16,359,119</td>
</tr>
<tr>
<td>Network Associates</td>
<td>G. Samenuk (2001)</td>
<td>Failed financial results to boost income by $1.5 billion</td>
<td>SEC, NY Attorney General</td>
<td>$3,836,276</td>
</tr>
<tr>
<td>Duke Energy</td>
<td>R.B. Priole</td>
<td>Executed 23 artificial round trip energy trades to boost volume</td>
<td>SEC, CFTC, FRB, US Army in TX</td>
<td>$14,391,200</td>
</tr>
<tr>
<td>Railence Energy</td>
<td>R.S. Lutsk</td>
<td>Shams round trip trades that boosted reported revenue by $88 million over three years</td>
<td>SEC, CFTC</td>
<td>$10,390,902</td>
</tr>
<tr>
<td>Mirant</td>
<td>S.M. Fuller</td>
<td>Possible sham energy trades. Admitted to overstating assets and liabilities</td>
<td>SEC</td>
<td>$7,586,000</td>
</tr>
<tr>
<td>Homestore, Inc</td>
<td>S.H. Wolff</td>
<td>Executed artificial round trip energy trades to boost volume</td>
<td>SEC</td>
<td>$4,530,154</td>
</tr>
<tr>
<td>Adalplata Communications*</td>
<td>J.J. Rigas</td>
<td>$3.1 billion in off-balance sheet loans to founders, overstated results by inflating capital expenses and hiding debt. Arrests for securities fraud</td>
<td>SEC, Federal grand jury in PA and NY</td>
<td>$4,350,162</td>
</tr>
<tr>
<td>Hanover Compressor</td>
<td>M.J. McLean</td>
<td>Restated 2000 and 2001 earnings, admitted to improperly accounting for revenue</td>
<td>SEC</td>
<td>$3,774,345</td>
</tr>
</tbody>
</table>

*2001 compensation not available. Figure is for 1999-2000 only. Total compensation does not include $360 million in 1999-2001 stock sales by Gary Weinick.
**2001 compensation not available. Figure is for 1999-2000 only.

Methodology: We compared the pay of 23 public companies that have been involved in government inquiries of their accounting practices, limiting ourselves to companies with market capitalizations that reached at least $1 billion at some point since January 2000. We excluded cases of insider trading such as the Enron scandal. We constructed our Book Cookers universe using the Forbes Scandal Sheet, available at http://www.forbes.com/2000/1226/scandal.html and an extensive search of press reports. The resulting Book Cookers universe is comprehensive, but it is not necessarily exhaustive.

Sources for CEO Pay Business Week's April 15, 2002 executive compensation survey, corporate filings with the Securities and Exchange Commission, and schedules filed with the U.S. Bankruptcy Court. We used Business Week's method of calculating total compensation, which includes salary, bonus, "other compensation," restricted stock awards, long-term incentive payouts, and the value realized from the exercise of stock options. CEO pay figures do not include profits from sales of personal stock holdings that were not connected to options grants, since these sales are not counted in Business Week's research.

Other international leaders, however, have had little time to claim a superior corporate governance system. They, as well, have seen similar unfortunate experiences come to light, in Europe as well as in Asia, examples of which are listed below in Table 1-2.

Table 1-2. Select International Corporate Scandals

<table>
<thead>
<tr>
<th>Country</th>
<th>Firm Name</th>
<th>Industry</th>
<th>Amount (millions)</th>
<th>General Reason Loss/Error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Lernout &amp; Hauspie</td>
<td>Software</td>
<td>$100</td>
<td>Transfer to overseas subsidiary investment loss</td>
</tr>
<tr>
<td>Germany</td>
<td>Flow-Tex</td>
<td>Machinery</td>
<td>€2,000</td>
<td>Unsubstantiated leases/loans</td>
</tr>
<tr>
<td></td>
<td>Deutsche Telekom</td>
<td>Telecomm</td>
<td>€2,000</td>
<td>Inflated real estate values at privatization</td>
</tr>
<tr>
<td>Italy</td>
<td>Parmalat</td>
<td>Food &amp; Dairy</td>
<td>€12,000</td>
<td>Inflating cash balances, other unrecognized losses</td>
</tr>
<tr>
<td>Japan</td>
<td>Mitsubishi Trucks</td>
<td>Automotive</td>
<td>$450</td>
<td>Undisclosed warranty liabilities at acquisition by DaimlerChrysler</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Royal Dutch Shell</td>
<td>Oil &amp; Energy</td>
<td>$35,000</td>
<td>Overvaluation of oil reserves</td>
</tr>
<tr>
<td></td>
<td>Royal Ahold</td>
<td>Retail Food</td>
<td>$1,000</td>
<td>Revenue recognition of US unearned supplier incentives</td>
</tr>
<tr>
<td>South Korea</td>
<td>Daewoo Group</td>
<td>Chaebol Conglomerate</td>
<td>$80,000 (in debt)</td>
<td>Unreported liabilities, excessive debt in economy</td>
</tr>
</tbody>
</table>

Source: Own representation from various open media sources.

The Asian financial crisis of 1997 had already laid bare the widespread issues of intransparency and unfair dealings of the primarily closely held and family controlled corporate giants of that region.⁶ Reforms which were recommended to lead Asian firms to emulate their western counterparts more ‘advanced’ corporate governance systems were already being implemented,⁷ although not all would agree that they were

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progressing quickly enough, when the drastic fall of stock markets worldwide underscored the surprising failings of governance in the west. Currently, the calls for the US and many other corporate governance systems and related regulations to be overhauled are widespread.

Certainly many of the cases that have come to light expose a dearth of ethics in the business and financial community. However, that issue has often been highlighted in the past when a slew of scandals has arisen. Rather than simply trusting in a more enlightened ethical environment resulting from shortcomings being exposed, each period of increased incidence of scandal has been followed by a period of heavy regulatory induced reform, for example the securities laws of the Great Depression era in the US or the Cadbury Committee reform proposals implemented and enacted in laws throughout Europe and Asia throughout the 1990’s. Currently, the Sarbanes-Oxley Act of 2002 in the US, also receiving much attention in Europe,\(^8\) embodies the bulk of current reforms being implemented and institutionalized.

The top section of a recent illustration taken from *The Economist*, as displayed in Table 1-3 below, lists many of the initiatives implemented directly through US Securities and Exchange Commission (SEC) government regulations decreed by Sarbanes-Oxley. In addition, the bottom section shows some of the recent standards being required by the New York Stock Exchange for its listed companies.\(^9\) As can be seen from the actual rules implemented by the SEC, which are described in the right-hand column, the Economist (representing, as well, other similar ideas published by the wider business press\(^{10}\)) is of the opinion that major proposed reforms have been watered down and weakened through the efforts of the management lobby. In addition, subsequent to the publication of these opinions, significant criticism of the NYSE Board of Directors over the compensation package of its former chairman, Richard Grasso, has led to further mistrust in the legitimacy of the exchange’s role in setting and enforcing investor-oriented corporate governance standards for its member companies. Out of this flurry of reform activity, therefore, the regulatory prescriptions that are being implemented could be in danger of falling short in protecting the interests of individual investors and society in general.

\(^8\) Salzberger (2003).
\(^{10}\) Mondics (2003), as published in *The Philadelphia Inquirer*. 
Table 1-3. Reforms proposed versus those implemented.

<table>
<thead>
<tr>
<th>New rules on corporate governance</th>
<th>FROM THE SEC:</th>
<th>Tough new rules...</th>
<th>Though not as tough as some</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Area</strong></td>
<td><strong>Tough new rules...</strong></td>
<td><strong>Though not as tough as some</strong></td>
<td></td>
</tr>
<tr>
<td>Accounting</td>
<td>Tight restrictions on Enron-style off-balance-sheet vehicles</td>
<td>Definition of expert widened; level of liability too low for some</td>
<td></td>
</tr>
<tr>
<td>Audit committees</td>
<td>Must state if it contains a &quot;financial expert&quot;</td>
<td>Chairman yet to be appointed</td>
<td></td>
</tr>
<tr>
<td>Auditing standards</td>
<td>To be overseen by new Public Company Accounting Oversight Board, ending industry self-regulation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auditors</td>
<td>Barred from much non-audit work, such as consulting Lead partners to be rotated every five years</td>
<td>Still allowed to advise on tax Allowed to do non-audit work for client immediately after stepping down as auditor Definition of &quot;audit&quot; widened to cover some work that was previously &quot;non-audit&quot;</td>
<td></td>
</tr>
<tr>
<td>Financial disclosure</td>
<td>Accounts to be filed faster CEOs and CFOs to attest to accuracy of accounts Use of “pro forma” accounts limited</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Executive behaviour</td>
<td>Share sales to be disclosed sooner Executives barred from selling if employees cannot sell</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lawyers</td>
<td>Have to ensure client senior managers and board informed of security-law violation</td>
<td>Original proposal that lawyers be forced to inform the SEC of potential violation may be watered down or dropped altogether</td>
<td></td>
</tr>
<tr>
<td>Mutual funds</td>
<td>Funds to disclose how they use &quot;proxy&quot; votes</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| FROM THE NYSE:                   | | |
| Board composition                | Must be a majority of non-executive (independent) directors | | |
| Non-executive power              | Non-executives must meet regularly without executives Lead non-executive must be named | | |
| Scrutiny of decision-making      | Compensation, nominating and audit committees to be entirely non-executives | | |
| Public accountability            | Must publish corporate governance guidelines setting cut for example, provision for annual evaluation of the board and the boss | | |

Sources: SEC, NYSE; The Economist.

Fortunately, the press, as one component category of the financial media, is generally free in most of the world to report openly to the public on what it perceives to be shortcomings in the practices and performance of management and of regulators, as

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well. Also positive is that the financial media is just one important contributor to the complex system of corporate governance that, having developed over the last few centuries, is in place today. Corporate governance identifies the responsible standards for evaluating the operating and financial performance of corporations, in effect, for business’ *effectivity* and *efficiency*. It also establishes guidelines for holding the managers and directors of these corporations accountable for their decisions and actions to shareholders, stakeholders, and society in general, in effect, for the organization’s *efficacy*.

The World Bank Group illustrates the corporate governance system in Figure 1-1 below, as being dependent primarily on internal representatives and external agents who form a network of participants of influence on the firm and its leaders. Starting from left and moving to the right in Figure 1-1, these “discipline factors” are:

1. internal shareholders whose ownership rights include the ability to vote for or against corporate initiatives and appointments;
2. internal corporate officers with delegated strategic and operational decision authority over the assets and resources of the organization, i.e. the board of directors and executive managers;
3. external stakeholders interested in protecting their personal interests in their relationships or interactions with the corporation;
4. external agents qualified to perform audits, reviews, and valuations of the organization;
5. external regulators setting governance, accounting and audit standards and enacting and enforcing related laws; and
6. external actors employing competitive economic forces in the business and financial markets.

The various participants in the network, coming from vastly different, ‘unrelated’ organizations with a variety of interests, should provide checks and balances to protect against undue, unfair, or unreasonable influences coming from any group of participants. In addition, these different groups should be in the position to hold each other accountable in performing their respective critical governance responsibilities appropriately.
Above all in the network of participants, the board of directors is the single, legally designated organization elected by the shareholders to represent not only their interests, but also society’s interests in general, by providing guidance to management regarding the strategy and operations of the business. It has taken the current crisis for board members, corporate executives, the investment community, auditors, government officials, etc. to finally accept the urgent necessity for reform. But curiously, it is difficult to find directors, in groups or as individuals, who are involved in the lobbying activities surrounding reform proposals. Rather, it is more often management that claims to represent company interests in the reform debate.

However, management is in the special position of having direct control over company assets and investment decisions. It can be shown that management sits at the center of the moral hazard responsible for most of the recent corporate scandals. This moral hazard consists of higher stakes conflicts of interest directing their decisions in their personal favor. Management has too often been able to disguise their conflicts and support their decisions by employing a higher incidence of information asymmetry, misleading the public through intransparent and inaccurate disclosures.
1.2 Recognition of the Moral Hazard

1.2.1 Higher Incidence of Information Asymmetry

To understand how the corporate governance system of checks and balances failed, it is important to answer the question, “What caused the catastrophic reversal of trust in the financial markets for corporate shares at the turn of the century in 2000?” It is now known that the public was fed false as well as falsified investment information as related to securities of publicly traded corporations. As time advanced it also appears that the frequency and size of the misleading disclosures, that is the incidence and impact of information asymmetry, grew.

First, dissatisfaction with financial reporting standards was almost universal, leading to new and different reporting methods which were more easily accepted, whether or not they were more accurate or truthful. Many investment allocation decisions were made with resultant wrong or biased information. Second, corporate executives, who are entrusted to act as agents of the shareholding owners, either themselves believed, or they did not fully question, the false information, or they even participated in its falsification. They failed to fulfill their fiduciary responsibilities to society in favor of supporting their own personal interests. Third, the professional accounting firms routinely missed key indicators and issues during their legally required audits of companies, while financial analysts and investment advisors continued to recommend the purchase of company securities, sometimes long after it was clear to them that such investments were no longer advisable. The public depends entirely upon these certified public accountants and licensed financial advisors to have the professional training and methods in place to appropriately and independently evaluate the financial condition of these businesses.

Finally, and most critically, the board of directors of each of these corporations was unable to protect the interests of their stakeholders, i.e. owners, claimants, employees, suppliers, customers, and society in general. Relying on the same faulty disclosure system as the investors, they did not realize the risks inherent in the company’s business practices. Despite their apparent positions as insiders with authority over management, directors, usually unwittingly, allowed company executives, investment bankers, and auditors to expropriate company assets to support their own personal interests ahead of corporate interests.
1.2.2 Systemic Conflicts of Interest

Boards of Directors were unable to govern effectively in an environment of untrustworthy information. Conflicts of interest crowded into each critical advisory relation and became entrenched in the evaluation system. Self-regulation in the internal accounting function as well as in the external audit and financial communities was grossly ineffective in curbing conflicts, allowing errors of omission to creep into their evaluation procedures. The maverick entrepreneurial spirit and its associated aggressive negotiation and management style demonstrated by company executives were highly valued. But it can be shown that no new restrictions were implemented to defend against a heightened moral hazard associated with this personality type. Entrepreneurs are less prone than others to accept the role of steward or to be held responsible through reporting, clear requirements of officers of public corporations.

Boards were greatly disappointed by these advisory groups, especially as boards are fully dependent upon their advisors, and have little choice but to put their trust in them. Because boards are relatively small in size, directors cannot be expected to duplicate the tasks of these groups. Instead, they must rely on accepted systems of communication of these groups in order to evaluate the activities and decisions of management. Wherever conflicts of interest go unrecognized or unchecked, however, effectivity of communication is disturbed. Information becomes less and less transparent. Asymmetry of information lends itself to being employed by board advisors, and at times by board members themselves, as a sophisticated tool to further their personal interests over the welfare of society.

Directors also did not recognize their own heightened moral hazard, dimming their judgmental ability and tarnishing their choices. Their internal and external critical review systems broke down, exposing serious weaknesses and gaps in boards’ abilities to govern today’s complex corporate organizations. It did not help that America’s corporate governance system was being compared to all other national governance systems and was often held as the benchmark standard for measurement. Intransparency was confounded further by overconfidence in this flawed system. America’s traditional economic liberalism and management professionalism were too easily accepted as strong inherent benefits for investors, providing market-based checks and balances as substitutes for detailed legal regulation and for diligent board
oversight. However, that inheritance was being corrupted through, among other systemic conflict of interest factors, inbreeding of close directors’ relationships with company management and intricate director interlocks across organizations.

In the 1990’s themes of business ethics, social and environmental responsibility, board governance renewal, and like reforms were prominent in corporate director circles. All of these themes added constructively to discussion in the self-regulation governance environment. Leading company executives appeared to embrace these ideals and the instructive benefits arising from them. Were the intentions displayed by these executives disingenuous? Apparently, they were in a number of high profile and highly damaging cases, especially Kenneth Lay at Enron, Dennis Kozlowski at Tyco, Sam Wacksal at ImClone Systems, Calisto Tanzi at Parmalat, and Manfred Schmider at FlowTex, among countless others. Thankfully, the seriousness with which these reforms were addressed and the sincerity evidenced from numerous change initiatives adopted had a profoundly positive effect on many organizations. Unfortunately, the clamour arising from the misdeeds of a significant minority has all but drowned out the quietly sound stewardship of the majority of corporate leaders. From an economic and social view as well, the impact felt by the public from the fallout of the actions of this significant irresponsible minority is alarming.

1.2.3 High Stakes → High Risk-Taking

Conflicts of interest between management of large organizations and their shareholder investors have been identified as an issue as early as Adam Smith’s era of the mid-18th century. Conflicts of shareholder interests versus those of management were elaborated upon by Adolph A. Berle and Gardiner C. Means, Jr. in the early 1930’s, when they defined the problem of agency in modern corporations as the separation of ownership from control. The original SEC regulations were put in place at that time specifically to guard against management expropriating shareholder wealth and misleading investors with partial, inaccurate, or false disclosures. Those regulations served the public substantially unchanged for almost 70 years until the Sarbanes-Oxley Act was passed in mid-2002.

In fact, a great amount of trust and confidence existed in the system of checks and balances which had evolved over centuries, with significant dependence on self-governance. Strong faith was placed, apparently rationally, in the management and
board structures providing leadership; within the financial markets for issuing and trading corporate securities; and among the audit, accounting, and financial analysis communities in setting standards for information and review practices. Inside the corporate sphere, the governance system appeared to function strongly for decades through the controlling combination of self-regulation and liberal market forces.

However, one critical element particularly influenced and changed the behavior of the participants in the governance system in the last few decades. The personal interests of management and their advisors changed dramatically in proportion to society’s interests, which are represented by the interests of stakeholders, and more specifically, by those of shareholders. Figure 2 below illustrates how conflicts of interest erect a transparency barrier between these two main groups, management and stakeholders, and that higher stakes, i.e. a greater value accruing to personal interests, contribute in raising the barrier. Information asymmetry is the resulting dichotomy of knowledge held by the two main interest groups.

**Figure 1-2. The Transparency Barrier**

Source: Own Representation.
Significantly higher stakes were accessible to executives in the incentive stock options, exit payout guarantees, and other forms of compensation they were granted. Princeton University economist Paul Krugman has noted that the compensation of the chief executive officers (CEO’s) of publicly traded American corporations grew from an average of 40 times the pay of the average worker’s compensation in the corporation in 1970 to as much as 1000 times in 2000, just before the crisis erupted. Following the crisis, Krugman stated that the situation has not improved, but that the pay gap has actually widened.13

Over this same time period, especially through the 1990’s, investment bankers were earning fees and advising on deals whose values were significantly over a full order of magnitude greater than they had experienced just a short period before. Their mergers and acquisitions (M&A) and strategy consulting clearly dominated their quasi-regulatory role as financial analysts advising the public on the state of the corporations they were following. The brokerage side of the investment banking business was persistently under competitive pressure especially due to competition in trading fees from discount brokers operating by telephone and the internet. The mammoth size of mergers and acquisition deals and initial public offering placements generated huge fees, customarily based on a percentage of the deal, for the investment bankers advising or underwriting the deals. In the period 1970-1980, for example, the volume of M&A deals in the US averaged $22.8 billion per year and 1.3% of US gross domestic product (GDP). By the period 1993-1999, the yearly average volume had grown to $647.1 billion and 8.4% of GDP. M&A activity outside of the US evidenced a similarly dramatic pattern.14

The largest audit firms found that they, too, could earn far greater fees per hour consulting on creative and proprietary internal reporting and planning systems rather than on legally required audit services or on their voluntary participation in the advancement of public accounting and auditing standards. The entire accounting profession suffers under an audit fee commoditization crisis that is in great part self-made. Rather than promoting the internal advisory value of the audit in today’s complex economy, public accountants choose to differentiate audit hours from consulting hours, as well as the hourly fees associated with these two activities.

Audits have become a loss-leading, market-entry product, a commodity used to open doors to client relationships for more high-profile and high-pay consulting services.

1.3 Governmental Oversight and Regulatory Reforms

Some observers and economists want to find fault additionally with the US federal government for its supposed contribution to the stock market bubble phenomenon. Particularly, they single out the Federal Reserve Board (The Fed) for not raising interest rates with the intention to discourage equity price inflation. However, this ignores the Fed’s arguments that consumer and wholesale price inflation was under control, the US dollar was neither over- nor undervalued in world currency markets, and the unemployment rate was at or near the target full employment rate. The 1990’s boom also brought relief to the federal government debt burden as years of deficit spending were replaced by surpluses. Not willing to jeopardize these substantial benefits for the sake of stock market investors alone, in 1996, Fed Chairman Alan Greenspan chose to warn the public clearly of “irrational exuberance” in the equity markets, long before they peaked. In fact, we can see now in the post-bubble period that interest rates were kept high enough that the Fed did have room to bring them down a notch at a time to help stimulate the economy in the face of a possible recession and significantly higher unemployment, as measured and reported in a recent J.P. Morgan Chase study.

In hindsight, it can be argued that the US federal government has committed a misstep, however, specifically under the auspices of the Securities and Exchange Commission. The SEC failed to see the breakdown in self-regulation that accompanied the equity market bubble, and did not place enough pressure on the various actors for them to head off harmful practices and decisions. The US Congress stepped in to fill this gap, primarily through Sarbanes-Oxley, creating the Public Company Accounting Oversight Board (PCAOB) and legislating more of the principles of public company corporate governance directly. Through the PCAOB, the government now intends to exert pressure on the accounting standards bodies directly to take tougher stances in US Generally Accepted Accounting Principles (GAAP) than the external auditors and the internal financial and operational executives have been willing to implement.

17 The Economist (2003-9).
Through the latter measures, the government is making its first substantial revision to its direct oversight of the securities markets and company boards of directors since the early 1930’s Depression era landmark legislation. The government also formally stripped the NASDAQ stock exchange of its corporate governance self-regulatory role in 2002 and was seriously considering doing the same to the New York Stock Exchange (NYSE) in early 2004. In this way, the US is joining the many nations throughout the world who have recently enacted direct and specific government requirements for governance of public corporations as recommended by the Organisation for Economic Cooperation and Development (OECD) in the 1999 and 2004 versions of its Principles of Corporate Governance.

This new wave of legislation also appears to target for reform the “culprits” in the scandals identified earlier: accountants and auditors, financial securities analysts, company executives and board members. Congress even pressured the executive branch successfully to remove the SEC Chairman, Harvey Pitt, because of an assumed conflict of interest. Before his SEC chairmanship, Pitt worked as an attorney defending the accounting industry under the then existing governance system. His replacement at the SEC was William Donaldson, who earned respect for his chairmanship of the New York Stock Exchange, where he showed a seriousness of purpose in leading the exchange in its quasi-regulatory role. This leadership change at the SEC was considered necessary to ensure that the full will of the government was engaged in carrying through with the enforcement of both the new and old regulations, and that reforms would be pursued with haste and vigor.

However, can there be confidence in new regulation as the sole solution when, in actuality, it appears that in many of the high profile cases, members of all of these groups have acted illegally and simply disregarded or purposefully circumvented existing regulations and accounting standards? The government seems confident that the old regulations are sufficient in these cases to bring the accused to trial and find them guilty of illegal activities under the prior existing code of law. Still, it is disconcerting that there appears to have been intent to break existing laws. Therefore, there may also be a willingness to break the new laws, especially if the legislature and regulators have only addressed surface symptoms and not root causes. As an ominous indication, in a review of the big news stories of the prior year, the cover page of the Sunday Business section of the New York Times on January 1, 2006 declared:
“The Big Winner, Again, Is ‘Scandalot’”.

Fortunately, the media has done well to inform the public of the various scandals as they have arisen. Unfortunately, the press has done less well in pressuring regulators to act on “the usual hubris, greed, and accounting tricks to prop up stock prices” which continue to play out in the executive ranks of too many public corporations. If history is a guide, it will not take too long for the resonance of the scandals to still itself, and for more problems of similar magnitude to develop when the furor dissipates and the limelight dims.

19 Ibid.
CHAPTER 2.

The Agency Assurance Model

2.1 The Role of the Audit Committee of the Board of Directors in Reform

With the stakes so high and the potential for future damage so vast, it could be quite risky to rely on new regulations alone to provide the prescription for change. Regulators historically have been chasing the business community, and they are likely to continue to do so, as business adapts at an increasing rate of change ahead of them. In the mean time, due to the relatively high incidence of scandal already experienced, even if only experienced by a minority of corporations, all public firms must now reckon with a higher level of government-imposed constraints.

Almost predictably, some executives are already complaining about the additional compliance burden that the added bureaucracy has imposed, even describing the Sarbanes-Oxley Act as a “ball and chain” of requirements. They claim that the associated added cost to doing business has an unacceptable economic impact, that it is a disincentive to investment for small and medium size businesses. Although this argument ignores the huge economic cost of the scandals of the past few years, the management lobby still uses such reasoning to elicit a sympathetic ear from elected government representatives.

Due to management’s predisposition to mistrust regulatory constraints, influenced by their own conflicts of interest, for the vast majority of the reforms being implemented or considered, it is the board of directors that must step up and accept the leadership role. More specifically, it is the audit committee that will be left to address the impact of the reforms on management practices as well as board of directors’ review of those practices. Committee members must, in addition, be willing to recommend and implement even tougher reforms that management has not embraced, in order to fulfill the board’s governance responsibilities, and rebuild public trust in the corporate form.

Shareholders are the legally recognized owners of the concern, providing investment capital at the most critical, and often most risky, periods of the business’ development. Investors in corporations enjoy the legally accepted advantage of limited liability.
That is, as owners who remain independent of the day-to-day activities of the firm, they are sheltered from personal responsibility for management’s activities that may harm other citizens. The investor risks only the capital previously invested by him or her in the corporation. The investor cannot be called to provide more capital when corporate liabilities exceed the funds available to reimburse them. Nevertheless, a shareholder’s full ownership rights are at risk, for example, when creditors are allowed to take the company over in bankruptcy. The shareholder then foregoes any future benefit that may accrue from the concern’s operations.

Public financial markets provide greater access and higher efficiency for both *buyers*, the investors who are offering their excess capital, and *sellers*, the owners of firms who are providing investment choices. New investors are most required at the founding or establishment of the company, during periods of planned rapid growth and expansion, when existing owners or creditors choose to divest in the firm, and when a turnaround from prior poor results requires reinvestment. During these crucial times, a higher disclosure requirement and activity level of *management-supplied information* (MSI) is expected to allow investors to assess the expected returns against the associated risks.

British and American common law considers managers in corporations as agents hired to operate the business and control its assets, on behalf of the shareholders. The law requires agents, in general, to act in the best interests of the citizens who have hired them, pursuing the agreed purpose for which they were hired, without breaking any other laws in the pursuit. Managers, therefore, are not sheltered from the reach of the law nor limited in liability for their personal behavior. Specific laws are not required to hold them accountable. Actions such as negligence and dealing for personal interest can be disciplined by the common law system.2

The board of directors itself is a legal construct and regulatory imperative. Corporation registration laws throughout the world recognize the agency issue, and offer the board structure as its solution. The board is an entity that has been granted the right of representation of shareholders, through election of its directors. Concurrently, the board accepts the responsibility of supervising management, through

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1 Mendels (2003).
2 LaPorta, et al. (2000).
directors’ appointment of company executive officers. Towards these two purposes, the board enjoys two main powers:

approval - hiring, funding authority, strategic direction, and rewarding or removal - firing, setting limits, withdrawing support, and divestment.

All of these rights, responsibilities, purposes, and powers are policed through review and audit of information – primarily management-supplied information. Official management controlled sources of such information include public disclosures; analyst meetings, agency filings; most internal and external audit findings; audited financial reports; prospectuses; resolutions for annual, interim, and special meetings of shareholders; board meeting presentations and discussions; and even company advertising, promotions, and announcements expected to have a material impact. Unofficial (but legitimate) sources include articles in the business press, criminal charges from government investigators, as well as complaints from internal whistle blowers and reports of auditors in a small minority of situations.

The board of directors and the audit committee thereof are almost exclusively dependent and bound by MSI. The audit committee, at the bequest of the full board, examines information that has been accumulated, summarized, formatted, and edited by management and their finance and accounting officers and, in the case of accounting information for public reporting, tested by corporate auditors. It oversees this audit process as the final step in a multiple step process of information production and verification. The final ‘product’ must be reasonable and present fairly the results and expectations of the business. And then to be of any value to the organizations’ stakeholders, MSI disclosures must be accessible and timely for input into their decision support mechanisms.

2.2 The Triaxial Construct: Constitution, Classification, Communication

2.2.1 Agency Assurance: Definition and Framework

Agency theory identifies the moral and functional dilemma in public corporations resulting from the separation of ownership from control (i.e. shareholders from
management).\textsuperscript{5} The American Institute of Certified Public Accountants (AICPA) formed its Special Committee on Assurance Services (SCAS) in 1994 under the direction of committee chairman Robert K. Elliott “to identify new services in the wider area of the assurance function, an area that includes the basic audit, but goes beyond it.”\textsuperscript{6} This message and terminology are being borrowed and transferred to the audit committee, to call for the role of the committee to be similarly expanded in scope beyond the basic review of auditors’ work. The central idea proposed here is that the distinguishing purpose of the audit committee can be labelled \textit{agency assurance}.

Agency assurance identifies the audit committee’s main objective as validation of the integrity and sufficiency of management-supplied information for public consumption. It also seeks to identify and recommend the expansion of elements of audit committee responsibility necessary to reduce information asymmetry and mitigate the impact of conflicts of interest in the corporate governance system. The MSI of critical importance is that which is specifically related to fair firm participation in capital markets and to effective board supervision of management. This effort must be pursued to protect the interests of stakeholders, who are the shareholders and a broadly inclusive definition of \textit{creditors}, anyone who makes a significant investment in the organization, for example, customers, lenders, suppliers, and employees as well as individual citizens and communities represented by their government officials. Validated and sufficient MSI is necessary in order that these stakeholders are able to make adequately informed decisions regarding their participation with the corporation, especially regarding the \textit{financial prospects} and \textit{risk profile} of the organization.

The triaxial construct of the agency assurance model is illustrated in Figure 2-1 below. The model identifies that various forms of management-supplied information, as represented by the spectrum on the right hand side of the figure, are often produced and communicated as if they are not closely related to each other, which serves to inflame information asymmetry. The model attempts to demonstrate that, just as a rainbow of visible colors actually fuses to form invisible (but revealing) rays of light, all forms of MSI should be recognizable as elements which, when bound together, produce the most \textit{enlightened} understanding of the corporation. The three axes of constitution, classification, and communication in the agency assurance model are like

\begin{itemize}
  \item \textsuperscript{5} Bricker & Chandar (2000).
  \item \textsuperscript{6} Ruud & Beer (1998), p. 430.
\end{itemize}
the faces of a prism required to reveal MSI as complementary, not contradictory, in presenting the true and fair view of the business’ results and prospects.

**Figure 2-1. The Agency Assurance Model**

![Figure 2-1](image)

Source: Own representation.

**2.2.2 The Constitution Axis**

The constitution axis encompasses the audit committee’s character and rights, two sides of the same coin. The first critical aspect of character calls for committee members to be individually qualified for the challenge of the position. They must possess skills well developed to enable them to understand both the business complexity and the information production and verification process, in order that they can have reasonable confidence in the content and applicability of management-supplied information. As elected representatives of the shareholders, they must be able and willing to make responsible decisions and proposals within the overall board framework and structure, and to ensure that shareholders and other stakeholders receive relevant information through appropriate and timely communication channels. They should have organizational capabilities for assigning and agreeing upon responsibilities in a collegial environment and for planning and following a review schedule that allows them to fulfill their responsibilities effectively and expeditiously.

Academic research and regulatory initiatives that support the character aspect of the constitution axis also include investigations into the composition of boards. Beside
their individual qualifications, directors must be selected to form a team of broadly complementary capabilities. All members also bring backgrounds that include their personal and professional relationships with family, friends, colleagues, and other acquaintances. Unfortunately, these relationships raise a great number of concerns about the risk of conflicts of interest in board decisions.\(^8\) This is why independence is generally accepted as a critical consideration in board make-up. However, the definition of independence and the degree of its necessity remain difficult to agree upon, especially when considering that board member qualifications and talent scarcity are also critical issues affecting director recruitment.

Just as individual board members must be credibly qualified to supervise management, management, as agents of the owners, must recognize and accept their own legal subjugation and responsibility to the elected board. Board members have rights that management and other agents must acknowledge and respect. The current executive culture places an imbalance of value on rugged individualism and entrepreneurial independence. There certainly is value in focus on shared goals and a singleness of purpose, but the single-party political system that exists in most corporations can also slip precariously into functioning much like Soviet style socialism.\(^9\) The audit committee should support the entire board of directors in reclaiming its rights as the legally elected governing entity of the corporation.

The board should reassert itself in its responsibility of appointing and leading management, and reclaim its privilege of recruiting and nominating its own future members. The cases of Enron, FlowTex, Parmalat, Adelphia, and Tyco show how a board can publicly display an appearance of control and responsibility when management and its advisors clearly are working under a different set of rules, using undisclosed or intransparent information for their own personal benefit. GlaxoSmithKline, Mannesmann, General Electric, Computer Associates, Disney, ABB, and the NYSE illustrate the need for more disciplined oversight by the board over executive compensation, another method management has employed in pursuing its own interests over the best interests of company stakeholders.

\(^8\) Krantz (2002).
2.2.3 The Classification Axis

There certainly is a limit to the depth and breadth of qualifications and time commitment to be expected of committee members, as with any directors. The effectiveness of their rights of access to information could also be compromised if the information is not effectively summarized and presented due to sheer volume of pages of reports. Therefore, the classification scheme for financial reporting should hold as its highest aim the relevance of reporting to board members in performing their duties. Standards for summarization and presentation should be measured by the extent of their transparency, i.e. their ability to be understood. Financial (accounting and planning) and risk management reports especially should not be overly complex in language and structure.

Proper principles of accounting and risk classification should assist in a more straightforward evaluation of both firm and management performance. Financial reporting standards in most western countries requiring accrual accounting instead of cash accounting were established in the first half of the 20th century. Despite the transition from a predominantly goods (products) based economy to a clearly service based economy, accountants still are not recognizing as assets most of the activities performed within the worlds’ corporations by scientists, engineers, marketers, and other professionals. The output of these resources are basically being expensed as incurred, which in most cases is quite close to when paid, i.e. cash basis accounting.

Over the decades, the proliferation of digital computing and revolutionary advances in communications, relational databases, accounting software and other related technologies have removed any technical barriers to the accurate accumulation and categorization of the costs incurred and the liabilities acquired to produce the revenues and assets of today’s service economy. Well-accepted financial valuation methods, like Stern Stewart’s trademarked Economic Value Added® (EVA®) formula, regularly attempt to adjust the figures in published financial statements to account for investments in internally developed intangible assets. As a European Union study published in 2003 points out, “there is a growing body of evidence that links inadequate reporting of intangibles to the declining usefulness of external financial

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reporting.”11 The same study, however, declares that what is “missing, however, is an appropriate information infrastructure to enable intangible assets to be identified, measured, reported and managed effectively.”12

The agency assurance classification axis encompasses an infrastructure that attempts to address these and other concerns, based on a draft proposal submitted by the author to the US Financial Accounting Standards Board (FASB) in 2001 in reply to the FASB Special Report: Business and Financial Reporting, Challenges from the New Economy.13 Central to the classification axis is the recognition that knowledge can be defined as “justified true belief”, and it is manifested in two basic, distinct forms – explicit and tacit. Explicit knowledge can be codified, that is, communicated in a recognized written, spoken, or gestured language, and so it is the easier to comprehend than tacit knowledge. This more obscure concept to grasp has been described by Michael Polanyi in his seminal work The Tacit Dimension simply as, “We can know more than we can tell.”14 The infrastructure recommended here is that all intangible assets are knowledge-based that can be categorized as either explicit or tacit. The actual costs incurred for the former, which could be identified as differentiation costs, would be classified as assets, and those of the latter as expenses, for financial statement disclosure purposes.

The main obstacle to acceptance of this knowledge management basis for classification, is that a significant amount of traditional expenses will be re-categorized as assets in the accounting system. Once categorized as assets, an appropriate useful life and amortization scheme will need to be established for each separately identifiable resource. Accountants will also have to use judgement in determining whether or not the value of these assets have become impaired at the end of each accounting period. The concern is that this change from tradition violates the virtually sacrosanct conservatism concept of accounting principles.

Agency assurance, however, counters this by arguing that a true and fair view in the economic environment of the 21st century is just as important to accounting principles, as is conservatism. There should be little difference in finding appropriate accounting

14 Polanyi (1966).
methods for dealing with a larger group of intangible assets, i.e. internally developed intangibles, than the decisions already made over many decades for all tangible and purchased intangible assets in the accrual accounting system. The proposed classification scheme is also more consistent with well accepted and relevant economic theories (identified later in the chapter) developed over the last decades to describe better the contemporary knowledge-based, service-dominated economy. Conservatism must be relegated a more balanced consideration in the overall set of generally accepted accounting principles, in order to raise the public’s trust in the usefulness of financial statements from today’s unacceptably low levels.

In addition, the knowledge management basis of classification should help to address the concern that financial reporting is used to link management incentive performance rewards more directly and reliably with firm operational performance measurements. Because of the general dissatisfaction with financial reports prepared using current accounting standards, it has been easier to choose stock price performance, which is easily measured, as a performance indicator. This has also led to widespread employment of stock price based executive incentive compensation systems, i.e. stock options. However, stock price is influenced by both objective performance and subjective perception. Bubbles and overcorrections have shown that equity prices can be an inaccurate indicator. They can be potentially inflated or deflated, especially in the short term, by collective financial market influences, including hype, scandal, error, misrepresentation, and other information asymmetry related factors. An additional advantage of a knowledge management basis could enhance the general acceptance of the agency assurance classification scheme.

Issues of classification are evidenced in the current public debate and recent decision of the Sarbanes-Oxley Act in the U.S., which introduced the Public Company Accounting Oversight Board as a new federal regulatory body. Almost immediately after its formation, the PCAOB called for further discussions on the harmonization of International Accounting Standards (IAS) required by the European Union for corporations in member countries within five years, and US Generally Accepted Accounting Principles, the body of quasi-regulations that has been privately administered by the American Institute of Certified Public Accountants through its Financial Accounting Standards Board. The clear reason given for putting a priority on these discussions was the criticism that, over the years, US GAAP has transformed
itself into a rules-based system. This has had the dangerous effect of appearing to allow or even incentivize company accountants to invent rules where none previously existed, one of the major flaws addressed in most of the cases of financial fraud or earnings restatements as found at WorldCom, FreddieMac, AT&T, Royal Ahold, and Enron, et al.\textsuperscript{15}

### 2.2.4 The Communication Axis

Finally, communication is the consummation of the entire process. Without communication, all value of the process remains locked up in the firm. No rational external investor would be interested in participating in the firm without the requirement of reasonable and timely communication of financial results, management decisions, and corporate risks. All stakeholders apply their influence on the corporation based on the information that they receive, a major portion of which stems from management. The audit committee is clearly responsible for the direct or indirect review and certification of all of this MSI. Communication to the public is arguably the reason why regulators insist upon certification, and communication is the next step after certification. Therefore, the committee should also examine, review, and approve the communication functions and processes of the corporation’s management, including both shareholder relations and public relations.

In late 2000, the SEC introduced the most critical guidelines for investor communications since the original securities laws of the 1930’s were enacted. Regulation FD, for fair disclosure, addressed the two-tier disclosure system where financial market analysts received earnings “guidance” and notice of material events from corporate officers in advance of the required public disclosures.\textsuperscript{16} Although seriously debated at the time, with the advantage of hindsight in the wake of the Sarbanes-Oxley legislation, it is clear that Regulation FD was necessary and that it only addressed a single side of the multidimensional issue of information asymmetry in financial communications. Corporate insider trading and mutual fund market timing scandals at firms like ImClone Systems and Putnam, respectively, also have contributed recently to discredit the notion of corporate disclosure fairness.

\textsuperscript{15} The Economist (2002–2).
\textsuperscript{16} SEC (2000).
Audit committees must not only address communications made by their own officers and shareholder relations staff, they need to consider also reviewing the transparency of statements and reports of external agents with influence in the financial markets. The cases of Henry Blodget at Merrill Lynch, Jack Grubman at Salomon Smith Barney (subsidiary of Citicorp), and Frank Quattrone at Credit Suisse First Boston represent the widespread criticism of the investment banking industry. These and other high profile investment advisory analysts were making buy recommendations to the public of their client companies’ shares throughout the 1990’s, while their own internal analyses and actions over the same period were to sell.

In response to these hype-related actions being exposed, it seems another form of intransparency has surfaced, that is to downplay positive results. There were indications in 2003 that financial analysts at investment banks may have made overly conservative earnings estimates as a form of “conditioning” of investors to help keep stock prices rising as companies’ actual announced earnings “beat” the estimates. The accounting profession’s own criticism of the usefulness of standard financial reports while promoting value based reporting, as well as the government’s requirements of standard risk language in every prospectus (regardless of the actual risk content of the proposed transaction), provide further examples of intransparency, even though these external agents’ intentions were to improve information asymmetry.

An organization needs more transparent financial statements and announcements and a rigorous MSI disclosure regime for its shareholders and stakeholders, which takes responsibility for the information distribution channel and serves analysts and other financial information intermediaries. Microeconomic supply and demand logic calls for building trust in the shareholder base. Existing equity holders’ confidence in the corporation will lead to a scarcity of shares willing to be sold, while good communications practices also create demand from outside investors, helping to support or drive up the price of the shares, i.e. the company value.

Confidence in the stock markets overall will provide the vehicle for liquidity for shareholders when they need it in the future, and for management to acquire large blocks of investment funds. The result should be a higher loyalty from shareholders, poking holes in the short-term investment logic so often criticized by CEO’s and

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CFO’s (chief financial officers). This requires a communications philosophy leaning more in the direction of shareholder relations than towards investor relations. ImClone Systems, Merrill Lynch, Citicorp/Salomon Bros., Credit Suisse First Boston, and Putnam, among others, provide concrete examples of why credibility in communications in the financial markets has been questionable.

2.3 The Agency Assurance Model – A Theoretical Construct

Despite the impression that hype has made on financial markets, it is not the communication process alone that allows for a fair estimate of value and risk to be placed on the firm in financial markets for its debt, i.e. bonds and loans, and equity, i.e. shares. It is rather the confidence of the integrated system of constitution, classification, and communication, the three interrelated axes of the agency assurance model, under the leadership of the audit committee of the board of directors. Three well accepted modern economic theories of the firm are shown to support the inclusion of the three axes in the agency assurance model:

1. Berle’s and Means’ agency theory,
2. Coase’ transaction cost theory, and
3. Spence’s signalling theory.

They are not mutually exclusive theories; rather, as illustrated in Figure 2-2 below, they act in concert, forming a web of economic interactions and transactions. To facilitate the introduction of these ideas, each model axis can be paired with the one of the three theories where the relationship of axis to theory is most direct. In this structure, constitution would address primarily the issues raised by agency theory, classification would recognize foremost the influence of transaction cost theory, and communication would illuminate the role of signalling theory on firm performance.

Agency theory illustrates the permanent potential for conflicts of interest inherent in the corporate system. The separation of ownership from control can never be completely resolved. Agency costs are the product of the actions of actors participating in the corporate governance system. The firm normally bears the majority of these costs originating from active shareholders, boards of directors, and company managers. The share price ultimately reflects the effectiveness and efficiency of these activities. However, firm stakeholders and society in general
inevitably bear a substantial portion of these costs, even a majority, especially as a result of fraud, as at Enron, WorldCom, and Parmalat, or systemic intransparency of risks, as in the post retirement pension and medical benefits of airlines, automobile, steel, and other legacy industries.

**Figure 2-2. The Web of Economic Influences in Agency Assurance**

Source: Own representation.

Transaction cost theory explains how firms become established in competitive markets for goods and services despite their apparent role in adding costs to the supply chain. Transaction costs are borne by the buyers in these markets because the supplying firms deliver their unique and identifiable value. For these firms, profit indicators such as gross profit, operating profit, and net profit margins are achieved through the appropriate matching of revenues and all expenses. More accurate margins, achieved through changes to accounting and auditing standards, can improve the explanation of how specific firms are able to compete, i.e. transact, as viable, sought-after sellers. Both internal and external interested parties can then become better informed of how the firm delivers to buyers at sustainable, attractive transaction costs in their markets.
Signalling theory identifies factors that can affect information asymmetry in various types of markets, those for labor, goods, and services as well as for stocks and bonds.\textsuperscript{18} Agency assurance focuses signalling on the information under management’s control, which managers may be reluctant to share with the board of directors or shareholders, either out of simple ignorance and misunderstanding or out of self-interest. MSI can support a true and fair view of firm results, as well as a healthy disclosure regime thereof, only when managers and users alike are confident that accounting principles make economic sense in financial reports.

Each of the theories helps to shed light on the nature of all three axes of the agency assurance construct. These theories provide a bridge between the dispersed external disciplinary factors and the focused internal operating activities of the firm. Although these theories cross this bridge leading to the firm, they do not, so to say, step into the firm, just as public shareholders generally are not active shareholders. However, the closer viewpoint that agency assurance offers should allow the disciplinary factors to perform their governance responsibilities with a far greater confidence in the MSI of which they are intrinsically dependent.

Short case examinations and brief examples of the many misdeeds, errors, and failures being made public during this historically unique current period provide a valuable opportunity for evidence of the normally private inner-sanctum of executive and board decisions. These observations along with those of early adopters’ of reform practices and experiences of successful firms are examples of qualitative data supplementing and supporting many of the recommendations of the agency assurance model, especially relating to the communication and classification axes. While the constitution axis relies primarily on the premise of agency theory, analysis of regulations, case precedent, and common law historical developments relating to the roles of elected directors and managers as agents as a legal concept are also explored. Summary and analysis of new regulations and practices proposed and debated by various sources and implemented by specific firms also support the proposed remedies of the agency assurance model.

The findings of other researchers are combined with public sources including major stock exchanges, government regulators, accounting boards, audit firms, major

\textsuperscript{18} Morris (1987), p. 47.
economic development agencies, and other special interest organizations contributing to corporate governance debate in order to identify a consensus of the audit committee’s accepted purpose. The agency assurance model will then be used to refine further this purpose and bound the areas of responsibility of the audit committee. Then in understanding the role of the board of directors, of which the audit committee is an important subset, the acceptable set of influences over the day-to-day activities of the committee can be established. It is a positive step if illicit activities and corporate governance errors and failures can be more frequently exposed \textit{ex post}. However, it is an even more important step that reforms along the lines of the agency assurance model could assist in the \textit{ex ante} avoidance or mitigation of the impact of these issues, through lowering the transparency barrier and aligning interests of management with those of stakeholders more closely.

This argument must be fully enveloped in the absolute expectation that the agency assurance construct is implemented in an environment of ethical behavior. In his chapter in \textit{Ethics in International Management}, Andre’ Habisch stated,

\begin{quote}
“The respect of property rights remains crucial not only for the single business enterprise; it determines the functioning of the economic system as a whole.”\end{quote}\textsuperscript{19}

Legislation itself has among its greatest values defining acceptable behavior and placing a measured penalty on crime. Nevertheless, it would be terribly inefficient for society if the laws and principles governing firms had no ethical instructional value, and we were left with a police state where, because of the high likelihood of illicit activity, every profitable result and productive act is suspect until passing through formal investigation.

CHAPTER 3.

Constitution – The Authority of the Board of Directors

In this and following chapters, the triaxial dimensions of the agency assurance model are introduced, assembled, and examined in detail.

3.1 The Positioning of the Board in the Corporate Governance System

To validate the agency assurance model, it is important to establish the legitimacy of the audit committee as an acceptable mechanism in the corporate governance universe, and to do this, the critical role of the board of directors must first be understood. The concept of an elected board of directors, known also as governors or trustees, representing the interests of shareholders with delegated authority over executive management predates agency theory by centuries. This is because the issues resulting from the separation of ownership from control, especially the problems arising from conflicts of interest for management and physical distance of the owners, were identified long before the “agency theory” label was applied to the situation. By the time Adam Smith first published *The Wealth of Nations* in 1776, joint stock companies had been operating for centuries themselves, dating at least back to the Muscovy Company, formed to support trade between England and Russia in the 16th century.¹

Many of these predecessors to today’s corporations had exhibited market volatility in peaks and valleys of their share prices. Economists had also observed valuation bubbles where prices became irrationally inflated. When returns failed to materialize to the levels that had been hyped, and when unexpected or unforewarned risks appeared, the bubbles would burst suddenly. Share prices deflated commensurately and the companies suffered insolvency and dissolution. Some well-known examples of these organizations date to the pre-colonial and colonial eras in America. The Virginia Company was chartered by King James from 1606 to 1624 and was responsible for the Jamestown settlement.² The British East India Company lost a

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¹ Sellers, et al. (1977), p. 3.
shipment of its tea in the Boston Tea Party protest after the Tea Act of 1773 granted the Company exclusive rights to the American market.³

The resemblance of board of director’s role in governance to the political system of representational democracy is not coincidental. Both share Anglo-Saxon roots and a mostly parallel historical development. While elected representation by the board imitates the political model for governance, it is also historically grounded in economic factors including division of labor and specialization of resources. Society makes provision for recognizing the corporate form as a legal person, with defined rights and responsibilities, in order to achieve higher effectiveness and efficiency in the allocation of economic resource inputs and diversification of investment funding sources. The board is expected to be composed of professionals who are called to act as overseers of management on behalf of the interests of owners and society. The board helps to solve the logistical problem of time and distance for multiple shareholders with funds for investment but who do not necessarily possess interest, commitment, or expertise required in running a business. The corporate form and its affiliated board of directors are virtually ubiquitous world organizations. Virtually every nation, regardless of its system of government, has embraced these concepts as both indispensable and inseparable.

Even after the scandals that have been exposed, public securities markets have shown remarkable resiliency. Post-Bubble, shares are traded in the hundreds of millions on a daily basis in the NYSE alone. Although this high level of seemingly risky behavior may be remarkable, it is not irrational. That is because the system of corporate governance, a mixture of regulatory, quasi-regulatory, contractual, and generally accepted rules of engagement allow participants to expect the capitalistic economic system, where shareholding is a fundamental element or even “right,” to function for them in a fair manner. Without such an expectation, there could be no rational basis for their trust, and there would be no financial market activity. It is also interesting to note that a number of economists, including John Maynard Keynes in 1931, have even seen stock market price bubbles positively for their potential to supply concentrated capital to major discrete/discontinuous innovations in economic cycles.⁴

To understand further the logical foundation for the public’s continued trust in corporate securities, the World Bank’s chart of actors in Figure 1-1 of Chapter 1 provides some evidence. The chart illustrates the sophistication of the system of corporate governance that has been constructed through history to guide the developed world’s corporations and financial markets. Of the disciplinary actors listed in the chart, the constituents are segregated into internal and external groups. The board of directors is presented as a unique, prominent, and central internal element of the system. According to the chart, the board of directors is placed as a *go-between* of the shareholders, who sit above the board, and management, below. This illustrates clearly both the directors’ representational role, and the hierarchy of accountability of the internal actors. The board is directly elected by the shareholders and actively “appoints and monitors” management, who, in turn, “reports to” the board, i.e. through mutual sharing and understanding of MSI.

Shareholders, although owners, are generally not involved entrepreneurs. They are more often anonymous equity investors who are primarily interested in three things:

1. the safety of their initial investment,
2. the opportunity to receive dividends, and
3. the potential to realize capital gains.

Their initial investment is clear; it is the amount they paid to acquire the shares, usually in a public stock market. Dividends are excess cash generated by the corporation, determined by the board of directors to be unnecessary for reinvestment in the business. Owners receive these distributions of cash in any period where they remain shareholders in the firm and the board has declared a dividend. A capital gain is the profit the owners make at the sale of their shares, the hoped for “buy low, sell high” benefit of their investment.

Shares are also valued by some shareholders, especially those who hold a blockholding minority or majority interest of the company’s shares, because they represent a legal contract granting the shareholder a defined fraction of ownership in a single economic actor in society – i.e. a specific corporation with limited liability. Although a clear majority of investors also only want to purchase shares in corporations whose activities are considered legal and moral, and there is also a
growing interest in financing firms who pursue only “socially responsible” business practices, what corporations actually do is only an afterthought for most shareholders.

Most individual investors are not active participants in the decisions of the corporations they own, nor knowledgeable about most of the activities, relationships, and personalities involved in the business. In fact, most shareholders would consider themselves fully unqualified in a direct decision-making role. They are not only disinterested in having such a responsibility, they do not recognize any necessity for being involved themselves. It would be ludicrous even to ask them to explain, with no active involvement and in such an anonymous role, how they could expect to ever see their initial investment again, let alone anticipate dividends and capital gains as a return on their investment.

Management’s active responsibilities are to develop strategy, policies, and practices and operate the core functions of the business. From the apparent perspective of the media and most other outside observers of corporations, as well as many rank-and-file employees, not only these responsibilities but also all other strategic decisions and approvals are made by top management. And certainly, boards have readily entrusted such responsibilities to CEO’s, CFO’s, and the other officers that make up the management team. This is dictated by resource restrictions of the board structure and directors’ time as will be discussed in later chapters. However, from the perspectives of shareholders, who have elected the board of directors to represent their interests, and of governments, which legislate and regulate the corporate structure granting authority to an elected board of directors, the board is also clearly responsible for strategy and other material decisions.

The OECD Principles recognize the practical resource limits facing directors in fulfilling these responsibilities, and call on the external actors of the corporate governance system, including company stakeholders, to fulfill additional supporting roles complementary to the board’s purpose. Perhaps purposely and tellingly, the chart also points the stakeholders and other external agents primarily in the direction of the board. Plus numerous representational agents, which include among them institutional, banking, and other financial market analysts, as well as regulatory and tax authorities, potentially provide much varied and valuable expertise in support of governance goals for shareholders, stakeholders, and society in general.
3.2 Stakeholder Roles and Responsibilities

The justification for giving stakeholders standing in the board’s objectives, and not only for directors to give their exclusive consideration to shareholders’ interests, stems from two primary foundations. The first foundation is related to the economy in two ways. On one hand, stakeholders are highly dependent on the firm for their economic livelihood, in comparable measure to shareholders. On the other hand, possibly even more importantly, stakeholders’ make their own contribution to adding value to the economy through their interaction with the firm which also rivals investors’ contribution. The second foundation is related to agency theory. Supporting the economic concept of *property rights* in relation to agency, Eugene Fama stated:

> “Each factor in a firm is owned by somebody. The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs. In this ‘nexus of contracts’ perspective, ownership of the firm is an irrelevant concept.”

Not only shareholders, but also executives must accept the fact that control over the firm is not only split between them. Stakeholders, as well, possess a share of control over the firm’s activities. Margaret M. Blair is widely recognized as a leading researcher and advocate in presenting to corporate directors the critical nature of including the rights of employees as stakeholders on par with those of the shareholders. The employees she is most concerned about are the large group that are hired and managed by the top executive officers of the corporation, although executives, to a major extent, are also included in the employee grouping. Blair effectively argues that shareholders in modern corporations, by legal definition, receive the exclusive benefit of limited liability in return for accepting a subjugated position behind creditors, suppliers, and employees for distribution of firm profits. Shareholders are therefore “last in line” to receive the residual portion of profits available after payment of these hierarchical claimants.

Blair purposefully distances herself from stakeholder theory first popularized in the 1980’s because of its non-specificity (i.e. non-quantifiability). Instead, she concentrates on measuring the value of employee claims on the corporation to illustrate their special position, one where they have their financial livelihood at risk.

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She uses estimates from labor economists that show that firm-specific wages that employees receive are at least equivalent to over 10% of total compensation, which means that only the other 90% or less is actual costs for employees’ generic skills. The 10% portion, therefore, is actually not economic cost, but is a contribution to economic surplus or wealth (i.e. economic “rents”). Moreover, this surplus is approximately the same size as corporate profits, which represents the economic surplus accruing to shareholders. This, she argues, places employees in an equivalent claimant position to shareholders in what they have at risk.6

Rather than distancing herself from stakeholder theory, however, Blair could have applied her quantitative approach to a number of other stakeholder groups, without diminishing, in fact probably strengthening, the argument in favor of employee protection. Suppliers charge firms not only for their costs but also for a competitive profit margin. The average profit margin percentage of all suppliers is arguably equivalent to that of all corporate customers, therefore, the argument could be extended to at least this group of stakeholders. The approach could also be taken further to include government stakeholders who are entitled to collect taxes from firms and their employees. Tax revenue is then paid out to provide for investments in infrastructure, basic research, and education, which all contribute to wealth creation in the most basic understanding of macroeconomics. And finally, all of these surplus rents originated from payments by customer and client stakeholders of the firms.

All of the stakeholder examples are quite compelling in establishing legitimate claims on the firm. However, to use this as an additional argument for management, suppliers, government, and customers having equivalence to the claims of shareholders may not be appropriate. In all of the examples, other than for investors, the stakeholders receive a tangible payment either in cash or in goods and services, if not immediately, in due time. None of the surplus rents is withheld, except perhaps in bankruptcy. In contrast, a significant portion of corporate profits are retained and reinvested in firms. Consider that some of the world’s most highly valued firms in the financial markets, e.g. Cisco Systems, Microsoft, and many other high-tech firms, normally pay out no common share dividends.7 Perhaps a combination of Blair’s

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6 Blair (1996), pp. 5-16.
7 Microsoft paid out an extraordinary dividend in the 4th quarter of 2004.
quantitative approach combined with the following qualitative argument will better support the critical objective of protection of employees’ rights.

A simple but compelling argument in favor of a special position for employees is that, as a group, employees are responsible for addressing the needs of all of the other stakeholders. These needs can be utilitarian - valuable products, services, and employment, or obligatory – legal, morale, and financial. The level of responsibility also supports agency theory by pointing out that employees possess a significant share of control over the firm. The more that senior executives delegate authority and responsibility to their middle managers and employees, the greater this control is dispersed. The greater the responsibility placed on them, logically, the more the employees will expect or demand in increased compensation.

Growth in executive pay, however, has grown much faster than that of employees in general. This has apparently raised an issue in conflicts of interests in executives, and now has the potential of infecting the broader employee population as this disparity becomes more recognized publicly. Fama’s framework addresses this issue in its description of the disciplinary nature of the management labor market, assuming there are no structural impediments to a freely priced, competitive market for managers’ services. Fama further clarified that:

“The role of the board in this framework is to provide a relatively low-cost mechanism for replacing or reordering top managers…”8

3.3 Corporate Governance - A Balanced Approach

While the World Bank chart in Figure 1-1 provides an elemental view of the corporate governance system of actors, Solomon and Solomon recently took upon themselves the assignment to clarify the definition of corporate governance. They examined and analyzed the contents of other researcher’s definitions and they surveyed some groups of external actors to find which definitions they preferred over the others. After careful consideration of many of these different perspectives, they developed and offered their own conception, as follows:

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“We suggest that corporate governance is the system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their shareholders and act in a socially responsible way in all areas of their business activity.”

This suggestion is closely compatible with the World Bank view. As a synthesis of many viewpoints, including those of Solomon and Solomon themselves, this definition further supports the rationality of investors’ continued favorable expectations for publicly traded securities.

The OECD Principles present the key preferential responsibilities of the board, which are grouped into three main categories:

1. “strategic guidance of the company,”
2. “effective monitoring of management,” and
3. “accountability to the company and the shareholders.”

These categories have been selectively bounded in practice having been tested and filtered through history in the developed economies of the world. They have evolved and become generally accepted today through the influence of regulators and other governance experts. The audit committee’s purpose must be highly related and coordinated with these suggested board activities, particularly in the committee’s practices surrounding management-supplied information.

Further detailed recommendations regarding the role of the board comes from various researchers, where the two main theoretical perspectives of corporate governance have emerged in research literature. Sundaramurthy and Lewis have summarized these ideas in an article in *The Academy of Management Review* and illustrated them as shown in Figure 3-1 below. The tabular form of their illustration serves extremely well in distilling the contents of these two models for ease of understanding. The authors have descriptively labeled the two camps as control and collaboration.

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Figure 3-1. Two Contrasting Approaches to Corporate Governance

<table>
<thead>
<tr>
<th>Control</th>
<th>Collaboration</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Theoretical Basis</strong></td>
<td><strong>Stewardship theory</strong></td>
</tr>
<tr>
<td>Agency theory</td>
<td>Sociocology and psychology</td>
</tr>
<tr>
<td>(economics and finance)</td>
<td></td>
</tr>
<tr>
<td><strong>Assumptions</strong></td>
<td></td>
</tr>
<tr>
<td>Individualist</td>
<td>Collectivists</td>
</tr>
<tr>
<td>Opportunism</td>
<td>Cooperation</td>
</tr>
<tr>
<td>Extrinsic</td>
<td></td>
</tr>
<tr>
<td>Goal conflict</td>
<td>Management-owner relations</td>
</tr>
<tr>
<td>(risk differential)</td>
<td>Goal alignment</td>
</tr>
<tr>
<td>Distrust</td>
<td>(firm identification)</td>
</tr>
<tr>
<td></td>
<td>Trust</td>
</tr>
<tr>
<td><strong>Prescriptions</strong></td>
<td></td>
</tr>
<tr>
<td>Discipline and monitor</td>
<td>Service and advise</td>
</tr>
<tr>
<td>Outsiders</td>
<td></td>
</tr>
<tr>
<td>Nonduality</td>
<td></td>
</tr>
<tr>
<td>Reduces goal conflict, avoids increasing risk differential</td>
<td>Fosters firm identification and long-term relations</td>
</tr>
<tr>
<td>Constrained self serving behavior</td>
<td></td>
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<td></td>
<td></td>
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<td></td>
<td></td>
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</tbody>
</table>

**Source:** Sundaramurthy and Lewis (2003), p. 398.

Starting at the top and continuing to the bottom of the table, the following explanation is presented to provide succinct definitions for the terms used from the table, in order to both condense and reinforce Sundaramurthy’s and Lewis’ key observations.

**Two Contrasting Approaches** – Corporate governance research has been presented as distinctly disparate theoretical camps. The *control* camp could be considered as the right side of the brain approach, with apparently clear-cut quantitative and structural objectives and measures. The *collaboration* camp, it follows, is the left side of the brain approach, where complex interconnections of social relationships are formed to achieve consensus and harmony.

**Theoretical Basis** – *Agency theory* warns of the separation of ownership from control and identifies additional agency costs in modern corporations, while
stewardship theory assumes benefits from a unity of shareholders representatives’ and management’s relational understanding that results from identification with a specific entity.11

Assumptions – descriptors of observed behaviors that fit each specific model and support each theoretical basis.

Human tendencies – as individualists managers are psychologically centered on fulfillment of their own personal needs and direct their efforts opportunistically, placing high value of their own contribution, and expecting to be rewarded commensurately, however, as members of societal groups, managers appreciate the accomplishments that only occur through cooperative effort and have needs that are satisfied only by collective association and recognition.

Motivation – individuals are self-motivated and their participation is secured when fulfilling their personal interests extrinsic to the organization, whereas people are seen as seeking participation and responding positively to their contribution in achieving goals clearly intrinsic to the organization.

Management-owner relations – an environment of distrust exists because of inevitable goal conflicts and risk differential between management’s personal interests and shareholders’ interests although a common ground is found through firm identification by managers and shareholders alike which inherently leads to goal alignment and heightened feelings of trust.

Prescriptions – corporate governance discipline factors that are discussed regularly in theoretical and practical literature but which are advised to be implemented differently in each camp to engender a positive result or to avoid a negative reaction.

Board’s primary role – the board’s first allegiance is to shareholders so when owner and agent interests are separated the board must monitor management’s activities and establish its authority as an agent of discipline on behalf of shareholders, but when interests are shared, directors are free to align with all players equally, devoting time to advise management in confidence regarding the strategic objectives of the organization and to perform their elevated service to society.

Board structure – board nonduality dictates that directors should be primarily or exclusively non-executive outsiders whose personal interests are not intertwined with managers or sub-contractors of the firm, while in firms led by a chairman who is also chief executive, CEO duality can provide advantages when some board members are loyal insiders with intimate knowledge of, and inseparable social ties to, the firm.

11 See Tosi, et al. (2003) for descriptions and analysis of the relative benefits of both approaches.
**Executive stock ownership** – when managers are also part owners of the firm, benefits to governance are identified in both camps, because sharing ownership interests and risks reduces goal conflict and avoids increasing risk differential by bridging the ownership and control divide and fosters firm identification and long-term relations in businesses that are collaborative social organizations.

**Market for corporate control** – the very real opportunity for the company to be acquired by another firm or group of investors, who believe they can produce more company value than current top management is achieving, constrains self serving behavior by holding management accountable for maximising organizational interests, but the pressure from this threat is demotivating and curbs psychological commitment through its potentially arbitrary nature, when takeovers that are entirely outside of management influence are made possible by natural cycles of the economy and financial markets.

The behaviors and remedies suggested above can be viewed as distinctly different, even operating exclusively of one another. However, all of these descriptions have been presented here purposely in integrated fashion to show how they may be interrelated and interlinked and, therefore, have the potential to place influences on each other.

Later in their article, Sundaramurthy and Lewis go further to show how following either single approach, control or collaboration, without considering the contrasting approach in governing a corporation, could lead to organizational disaster. They warn that dysfunctional results follow from either “reinforcing cycles of control” or from “reinforcing cycles of collaboration”. Within each of the continuous cycles of control, an additional dosage of distrust infects relationships, and organization performance deteriorates. With each of the continuous cycles of collaboration, an additional measure of groupthink invades decision-making, and performance deteriorates.

The authors offer three activities as remedies against undesirable reinforcement of a single approach. Two of the remedies incorporate critical elements of both control and collaboration, breaking down the polarized thinking that is found in much of the literature internal to the organization. Suggestions of such “self correcting cycles” pairs the authors consider are first, “embracing trust and conflict”, and second, “promoting diversity and shared understandings”. They predict that integrating approaches from both control and collaboration can bolster or reinforce positive performance by putting each aspect through refinement tests posed by the other. The
third remedy they identify is “external interventions” of market or legal forces. This could include acquisitions by competitors or corporate raiders, creditor and judicial involvement in potential bankruptcy, or even government takeover.

Sundaramurthy and Lewis echo many others who also see corporate governance theory becoming categorized under two segregated polar headings. By bringing together the many individual critical aspects and opinions of research into their article and illustration, the authors propose a prescription for effectively integrating these two seemingly opposing governance forces. Agency assurance embraces the conclusion that the elements of both contrasting approaches should be employed to provide a healthy balance in the psyche of the organization. Healthy behaviour, which balances the interests of shareholders who have their capital and wealth at risk with the interests of managers who have their reputations and livelihoods at risk, is more likely to surface from a well-adjusted personality than a dysfunctional one. A balanced organization is more likely to identify its position in and make a responsible contribution to society. The character of the board of directors and audit committee will play a crucial, central role in how this balance is achieved. Finally, because an appropriate balance would be difficult, if not impossible, to ensure at all times and in all corporations, external interventions will always have a place in the governance system of freely competitive markets.

3.4 Supervisory Activities and Agency Costs

The news stories of the scandals that are exposed on a fairly frequent basis, and that continue to plague many corporations, are continual reminders of the real consequences of separation of ownership from control. The significant investment and economic losses incurred because of management fraud and other conflicts of interest, which Jensen and Meckling identified as agency costs, are a direct testimony to the consequences of agency theory. These events are extreme examples of the residual loss which the authors showed must be expected when one person controls any portion of the property rights of another. A more wary investing public and institutional financial community could also be adding to residual losses by raising the cost of investment capital to corporations. Suppression of stock prices either reduces the amounts that firms can raise, sometimes stifling investments in worthy new ventures,

12 Jensen & Meckling (1976).
or it increases the equity dilution required to raise the needed amount. The intricate
detail of new internal control plans, systems, reports and disclosure requirements of
new laws and regulations enacted in response to these scandals, with the requirements
of the Sarbanes-Oxley Act as the most recognizable example, are also a substantial
source of another form of agency costs, monitoring costs, of which Sundaramurthy and
Lewis’s control approach is directly derived.

Management needs to recapture their shareholders’ trust through initiatives which
prove their loyalty to investor interests and measurably substitute for and reduce the
impact of residual losses and monitoring costs. Although these initiatives result in
increasing the final category of Jensen and Meckling’s agency costs, i.e. bonding
costs, it should be expected that an investment in bonding is made rationally in order
to achieve lower agency costs overall. An investment in monitoring, more generally,
is made in order to mitigate the effects from residual losses, but it is not a good trade-
off for bonding. Bonding is a form of pursuing loyalty-building between management
and shareholders, as illustrated by Sundaramurthy and Lewis’s collaboration
approach. Loyalty should assist in reducing the motivation for self-dealing and the
dishonesty inherent in fraud by managers. It could also produce the result in company
performance from a greater number of managers’ decisions being more closely aligned
with shareholders’ interests. Finally, it can decrease monitoring costs because less
time and effort can be spent in oversight projects when management interests and
activities stray less often from shareholder expectations.

3.5 Board Interlocks and Expanding the Definition of Independence

Bonding functions most effectively when management conforms its own interests in
the direction of that of the shareholders. Board members, by the nature of their
position, are also expected to represent the interests of shareholders and other
stakeholders. The board should seek a healthy bonding relationship to management,
but it is a mistake for directors to reverse the directional intent of bonding.
Unfortunately, interlocking relationships intertwining directors and managers of public
corporations, have contributed to the transparency barrier. It is difficult to discern
whether managers are succeeding in conforming to shareholders’ interests or directors
are seeking to conform to management’s interests. The issue of board independence,
therefore, is the greatest threat to all of the agency remedies proposed for a well functioning corporate governance system.

Managers, who are also directors, are professional insiders who bring valuable direct experiential knowledge and information to the board. While they also bring vested personal interest, they cannot help but also harbor conflicts of interest. Nikos Vafeas points out that studies, by Baysinger and Butler as early as 1985 and Byrd and Hickman in 1992, have indicated evidence of bias in the decisions of directors with a fiduciary relationship to the firm they represent.\(^\text{13}\) Even if they are non-management outsiders, they could have connections to the firm, such as:

1. customers - consumers or members of the distribution channel, such as wholesalers, retailers, and sales agents
2. suppliers – of products, components or services including management services such as strategy consulting
3. joint venture executives
4. family members and personal friends of management
5. acquaintances of management with similar personal interests and professional responsibilities at other corporations, often with reciprocal arrangements sitting on the boards of each other’s firms or subsidiaries

Robert Monks has led detailed studies mapping out a myriad of these interlocking relationships between the boards and their directors of many publicly traded companies.\(^\text{14}\) The issue and impact of conflict of interest arises from these relationships, directly adding to residual losses.

Such conflicts of interest are not evident only in obvious cases of malfeasance and dereliction of duty. They also make it difficult for the vast majority of well intentioned board members to make rational and fair decisions. How can they maximise the interests of one organization if that decision has a negative impact on another, when they are representing both organizations in a board or management capacity? These conflicts also surface because it is more difficult for a board member to hold management accountable in a particular situation, when this same board

\(^{13}\) Vafeas (2001–1).
\(^{14}\) The Corporate Library LLC (2003).
member being a member of management in another firm may be under scrutiny of the board of this other firm facing a similar issue.

This situation of insular relationships also results in creating an artificial shortage of board members. Recent legal requirements and voluntary expectations for boards to have a majority of directors who are independent already stretch board nominating committees to search beyond the talent pool that is readily apparent to them and upon which they have comfortably drawn their candidates. Interlocks further limit access in some cases for more talented outsiders, whose unexploited potential contribution to corporate governance of firms is clearly an economic loss. Greater diversity and choice are measurably beneficial in any hiring situation, and board appointments are not excluded from this consideration. Plus, the demands of time and attention on board members have grown dramatically over the last decade, physically requiring a larger overall population of potential board members to oversee corporations.

3.6 Disciplinary Influences Over Management

While universal acceptance of the board of directors concept is a highly important evidentiary factor, it does not eliminate the possibility of discovery or development of a better lead actor in the corporate governance sphere. Researchers, regulators, and corporate leaders have in this interest explored various mechanisms for increasing management accountability. The external influences of the World Bank’s chart in Figure 1-1 naturally hold important responsibilities but from a distant perspective placed on the outside looking into the corporation. These influences are most generally not limited to just one or even to a few corporations. Rather, these actors are assigned to review, recommend, critique, evaluate, assess, audit, analyze, or comment on many different and separate organizations. In order to perform their broad responsibilities, they follow professional standards, which provide a consistency in presentation for the stakeholders and shareholders using this information.

These regulatory and quasi-regulatory bodies, therefore, perform a valid and necessary macroeconomic societal role, but, unfortunately, possess no direct link to the corporation. They also have no responsibility to make choices or decisions for the corporation. Most can even choose not to be involved with the corporation, and have no obligation to perform any service, enter into any contract, or to associate themselves with this entity in any way. Only government entities – representatives,
bureaucrats, tax authorities – are “required” to engage themselves with these corporations. However, this is not a unique engagement, it is a general requirement applied to any and all corporations within their jurisdictional authority.

Even the outside accountants realized a dramatic change during the 1990’s, where their treasured independence was slowly eroded away. The Sarbanes-Oxley Act imposed a critical remedy for these conflicts of interest in the accounting profession with its detailed restrictions placed on audit firms’ consulting activities for their audit client companies. The audit firms first proposed *Chinese firewalls* between the audit and consulting divisions of the companies, where top partners of the firms promised that the audit and consulting businesses would be managed completely separately from one another. They promised further that there would be no discussions of client opportunities, no co-marketing of services, and no intermingling of project staff. However, the size of consulting contracts that audit firms had held at firms with major failings, who had passed clean audits by these same firms, provided too much evidence against the partners’ recommendations. The new laws restrict severely the types of consulting that accounting firms can engage in with their audit clients. In most cases, the accounting firms chose to separate legally the audit and consulting businesses into completely, legally separated, independent companies, with disparate managers, directors, and owners.

M.C. Jensen, particularly, has reduced the field of corporate governance influence down to four categories of serious consideration:

1. “Capital markets.”
2. “The legal/political/regulatory system.”
3. “Product and factor markets.”
4. “The internal control system headed by the board of directors.”

The first category, capital markets, is rejected by Jensen because of the measured low incidence of experience of takeover threats in most countries. Also, when takeovers do occur, management often has initiated them for their own personal interests of “pure ego” and influenced by the “hunger for fees” of their investment banking M&A advisors. The second category, the legal system, is dismissed for being “too blunt” to achieve sustaining results. The generic application of laws lacks precision over day-
to-day management of individual companies and specific transactions. The third category, product and capital markets, is highly criticized as being effective primarily ex post. This remedy shows its results often too late to avoid critical or “fatal” failure of vitally important business segments of the firm.\textsuperscript{15} It must also be said that management is hired for their expertise to operate and compete in these commercial markets. Therefore, they could use their many relationships in the markets to manipulate them towards fulfilling their personal interests.

One research group, LaPorta, et al., comments that of the first three above influences, legal reforms oriented to the protection of investor’s interests including securities and banking regulations and commercial and bankruptcy laws, as well as regulators and court systems which enforce them, contribute best to the overall national system of corporate governance across all publicly traded firms. When financial institutions dominate governance, however, blockholdings and other concentrations tend to develop that do not protect all investors on a fair, level playing field. Market forces alone, i.e. the threat of takeover of a poor performing management team, do not protect minority investors from expropriation by dominant players.\textsuperscript{16}

Regarding the fourth category listed above, the internal control system, Jensen stops short of rejecting the board of directors’ role of authority in corporate governance. However, he is also highly critical of their leadership, as well as of the efforts of the other disciplinary actors. Due to the seemingly widespread internal control system failures that major international corporations have experienced, Jensen calls for major reform of the system. What are the key sources of this disappointing performance? Are the expectations for the main disciplinary factors of corporate governance of the World Bank chart misplaced? Certainly, management has disappointed because it suffers by nature from inherent personal conflict of interest. The board, therefore, must address and correct its own issue of interlocks to free it of its relational conflicts of interest. Otherwise, the shareholders themselves, as highly dispersed as they are, will be left without a representative entity looking out primarily for their equity interests.


\textsuperscript{16} LaPorta, et al. (2000).
3.7 Staying on Board

The OECD Principles devote the sixth of its six sections to “the responsibilities of the board” with, as noted earlier, the most critical responsibility categories including “strategic guidance,” “monitoring of management,” and “accountability to the company and shareholders.”\(^\text{17}\) Of the ten criteria established by the International Corporate Governance Network (ICGN), as listed in Appendix 1, one section is dedicated to guidelines for the composition of the board, while five of the remaining nine criteria highlight specifically the board’s responsibilities and activities as well as its leadership role in governance. As could be properly expected, therefore, The Economist has recently observed that in the midst of major business scandals and increasing integration of economies internationally, countries all over the world have their focus on reform of the boardroom for improving their nations’ corporate governance systems.\(^\text{18}\)

Therefore, agency assurance holds that the board of directors construct, an historical development and legal imperative, maintains its singular position of responsibility, central to the corporate governance system. The evidence of both theory and practice presented in this chapter converge on the board, and no credible alternative has emerged to supplant it in this key position it holds. The audit committee as a sub-unit of the board inherits its position of authority and its legitimacy from the full board of directors. Without this authority, the committee would not be able to inherit the clearly vital main aspects of its character from the board. Without its legitimacy, the committee could not command the respect from management and other stakeholders required to assert its rights and fulfill its responsibilities.

The audit committee operates, first, within the generally accepted structure and workings of the full board and, second, as a standalone entity. In this chapter, the main theories and accepted practices relating to identifying and bounding the critical responsibilities of the board were reviewed. To complete the view of the constitution axis of the agency assurance model, in the following two chapters the audit committee’s roles and functions in support of the critical duties of the board will be established and described more specifically.

\(^{17}\) OECD (2004-1).
\(^{18}\) The Economist (2003-1).
CHAPTER 4.

Constitution – The Responsibilities of the Audit Committee

"The Governance of the corporation is now as important in the world economy as the government of countries."

James Wolfensohn, The World Bank

4.1 The Key Activities of the Audit Committee

Even throughout the 1990’s optimistic outlook of continual increases in share prices in the world’s stock markets, James Wolfensohn, along with other leaders of the world’s leading organizations which support economic development, recognized that corporate governance mattered greatly in market-oriented economies. With the world’s recent high profile corporate financial setbacks, including bankruptcies, dissolutions, and other failures involving many international corporations, the board of directors is receiving unprecedented pressure. Public and investor attention is directed critically at the board because of apparent or outright management fraud and strategic failure that went undetected. Boards have been particularly criticized for their seeming absence from or lack of due care in their supervisory role evidenced by their ignorance of fraudulent activities or seeming rubber-stamp approval policy in favor of management’s choices for strategic direction.

Agency assurance places the audit committee in a leading authoritative position in the flow of information critical to these supervisory responsibilities of the board. The committee is a direct intercepting agent of management-supplied information for the board and shareholders. The audit committee is a construct that has developed historically as a manifestly critical necessity within the workings of the board of directors. One of the first and foremost responsibilities performed by the board has been to review and accept the company’s financial statements and associated management commentary prior to their general release to the shareholders, creditors, government, and broader public. During the last few decades, the number of reporting rules has expanded while the rules have also become more complex, in parallel to what has been occurring in the business environment overall. As boards became larger and

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more distant from the company’s operations, the formal audit committee of the board of directors was formed to provide for a more focused effort on financial statements and the audit function.

The first meaningful wave of active audit committees appearing in boards of corporations was in the 1960’s. However, their influence was generally considered to be limited and their necessity was questioned until the NYSE required all of its listed companies to establish them by June 30, 1978. The Company Act of Singapore in 1989 made audit committees a requirement for listing in the Singapore Stock Exchange, and in 1992 the London Stock Exchange also mandated audit committees for the boards of its listed companies. The Federal Deposit Insurance Corporation Improvement Act of 1991 was the first direct legal requirement in the US of audit committees, in banks with over $500 million in assets. Finally, in 2002, the Sarbanes-Oxley Act made audit committees mandatory in practically all publicly traded corporations in the US.

The financial statements of publicly traded corporations in virtually all countries of the world are legally required by national governments to be released to the public at least once per year. In the US, the requirement for public disclosure of financial results is more frequent, quarterly, and accelerated, within 60 days following the end of each fiscal period. Prior to Sarbanes-Oxley, corporations had been allowed 90 days to report. The reduction in preparation time was made because legislators worried that the extra days were being used by managers to delay bad news or, even worse, provided them with time to hide poor results. Moreover, the vast majority of companies were managing to release their results to the public in the month following their fiscal quarter end date.

Effective in 2005, the EU adopted the US quarterly frequency standard for reporting for most public corporations. This was a major historical move from the longstanding, traditional annual reporting standard throughout Europe. The EU ruling had been the subject of significant debate in the various member countries. The debate centered on negative concerns regarding the perceived short-term philosophy of US managers and

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5 Vanasco (1994), p. 34.
investors being driven by quarterly reporting requirements, and, to a lesser extent, worries about the extra costs involved in compliance were also discussed. In the end, the benefits of a higher level of transparency from quarterly reporting in today’s modern economic environment were expected to outweigh any philosophical concerns or added costs.

It is generally a national regulatory requirement that the publicly-released financial statements of these companies have undergone a complete annual audit by an independent, external public accounting firm. The firm must be led by licensed audit professionals, such as certified public accountants in the US, chartered accountants in the United Kingdom (UK), and other similar designations internationally. The performance requirements of their work are governed by generally accepted auditing standards. Sarbanes-Oxley and its Public Company Accounting Oversight Board added an additional federal government registration and certification process through which audit firms must pass before being allowed to continue in or enter into the market for public company audit services. The PCAOB also has been given oversight responsibility for auditing standards.

However, it is critical that it is universally understood that management, which employs an internal accounting group of its own, controls the accounting and reporting system and the flow of information therein. Management prepares the corporation’s financial statements from voluminous details of its business transactions assembled by the internal enterprise-wide information system that feeds the accounting and reporting system. The external auditors’ responsibility is to audit the prepared financial statements, along with management’s process and controls used in their preparation, prior to their release.

The audit committee as an institution, along with other standing committees, provides for detailed specialization within the board. This smaller group, usually three members in publicly traded corporations, is expected to dedicate its time and attention to a more attentive review of financial statements and the audit results. The board delegates the bulk of the accounting review work to the audit committee members, who are, hopefully, appropriately qualified in analyzing financial statements and adept at interpreting financial jargon. Understandably, this delegation is restrictively made to an internal group that consists exclusively of directors, a subgroup of all of the
board members. This particular oversight responsibility is too close to the heart of the board’s overall purpose to have been delegated externally.

It is broadly accepted that it is management’s responsibility to prepare and communicate the financial statements and related disclosures, and it is the external auditor’s responsibility to review and verify them. This is why, on behalf of the full board, the audit committee members’ activities are mainly directed towards analyzing and understanding management’s financial reporting systems, processes, and output as well as the reports of the independent auditor’s findings. In 1998, the New York Stock Exchange and the National Association of Securities Dealers (NASD) formed the Blue Ribbon Committee on Improving the Effectiveness of Audit Committees, and their report states “the audit committee must be the ‘first among equals’ of this process.”

It was not until Sarbanes-Oxley in 2002 that the Blue Ribbon Committee’s recommendation was given legal teeth. Now the enacted legislation requires that any external auditing firm performing work inside the company is chosen by and reports to the audit committee, no longer by and to management. In addition, the committee has the legal right to consult outside legal counsel in the course of performing its duties. Management must also include a formal report on the status of its internal controls in the company annual report, and the external auditors must formally attest to this report. Similar provisions are in place or being considered internationally, which give the audit committee substantially equivalent legal powers, as in, for example, Canada and Germany.

While the chief audit executive (CAE) of the corporation, who leads the internal audit function, does not also report directly to the audit committee, the SEC has recognized this as a potential for additional reform. As the committee members may feel necessary, they can now discuss uncovered and unresolved issues at any time with the independent auditors and should not be impeded by management in discussion with internal company auditors and accountants. Committee members are required to raise red flags of issues of a material value with the full board and to report illegal activities

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to government authorities. From the specialized activities of the committee, it is expected that the full board and all stakeholders will gain a higher level of confidence in the integrity and reliability of the company’s audited financial statements and disclosures.

4.2 The True and Fair View

In many countries, the gold standard for measuring the accuracy and usefulness, respectively, of published financial statements is called the *true and fair view*. The US, in one of those attempts at language clarification that, like legalese, only appears to serve to make things less transparent, prefers the *fair presentation* standard. In the US, the auditors’ representation letters often contain the phrase “presents fairly in all material respects the financial condition of the company” to affirm compliance to standards. Regardless of these semantics, a company who receives either the true and fair view or fair presentation designation is said to have passed a *clean audit* and has been issued an *unqualified opinion* by their independent auditors.

If an elementary macroeconomic approach were to be applied to management-supplied information, the audit committee would be concerned only with the accounting statements and auditor’s opinion. Those companies that successfully achieve a clean audit would be rewarded for their *quality of earnings* by a higher share price or lower interest rate on debt in the financial markets. Those that fail this test would be appropriately penalized, even to the point of sale or liquidation of the company. As defined earlier in Chapter 3, this is also known as the *market for corporate control*. One severe example of this is Adelphia Communications whose joint purchase by its rival competitors in the US, Comcast and Time-Warner, for $14 billion was being discussed in 2005. This could be the last result of the fallout from alleged fraud by founding Rigas family members uncovered at Adelphia a few years earlier. Another telling example is FlowTex in Germany, which has been closed by its bankruptcy committee of leading creditors. Founding chief executive Manfred Schmider and others have been imprisoned for leading a two billion Euros leasing scandal, the largest case of financial statement fraud in German history.

Further, the accounting statements and disclosures that manage to show a true and fair view of financial performance provide a mechanism for ranking the success of the reporting companies. The financial markets should theoretically employ financial
statements to distribute financial rewards competitively to participants. Those companies that perform better, through balanced measures of higher profitability, faster turnover in use of assets, and lower cost sourcing of financing, should enjoy relatively more favorable rewards than those that perform less well in these indices. However, the theoretical economic view of financial statements is correct only if its assumption is correct that the financial statements actually provide a true and fair view of the company. Not only fraud and error in financial reporting makes this assumption invalid, but even accurate compliance to accounting standards that may not provide a fair representation also could skew the quality of earnings.

Agency assurance exposes the contemporary situation that a complete true and fair view is usually no longer presented by the audited financial statements alone. To illustrate this, the model introduced earlier in Chapter 2 has been expanded, see Figure 4-1 below, to include a spectrum of six of the most important categories of disclosure, five of which supplement traditional reporting.

**Figure 4-1. The Spectrum of Management-Supplied Information**

From the perspective of increasingly sophisticated financial markets made up in substantial levels of capital from both individual and institutional investors, far more information than just accounting reports and disclosures is sought out for evaluating a company and the financial securities it has on offer. Some of this information is also employed by the board of directors and external investment analysts to make material adjustments to the financial statements on a non-disclosed pro forma basis to provide a
better measurement for evaluating management performance. Internal to the company, as well, management and their consulting advisors have become more than somewhat dismissive and critical of financial statements prepared using GAAP standards. In the 21st century, a broader array of MSI, therefore, is commonly being employed and disclosed, not only to supplement, but also to replace financial statements. This represents the development of a more highly accepted measurement system, i.e. a preference for management’s own truer and fairer view, of company financial performance. The agency assurance model, therefore, applies the three axes of constitution, classification, and communication to all modern corporate MSI, not just to standard financial statements and reports on controls.

4.3 The Constitution Axis: The Audit Committee’s Place

The constitution axis of the agency assurance model appoints, as an official agent to the board, the audit committee to lead the verification of the existing internal measures and external disclosures that make up MSI. In addition to its thorough review of information presented by management, the committee is expected to make serious suggestions for changes, improvements, and additions of elements to MSI. The committee’s activities should not only be directed at influencing management, but also at the external auditors and the professional standards of accountants, investment analysts, regulators, and other corporate governance external discipline factors. Constitution also establishes the audit committee as the logical qualified agent for the validation, through the classification axis, and vetting, through the communication axis, of MSI.

The Audit Committee is an official entity of the board of directors. The audit committee in the boards of publicly listed companies is established or being added as a legal requirement in most developed countries. This committee has come to be generally accepted as offering the advantage of both higher efficiency and better effectiveness than the entire group of board members attempting to delve into all of the same details of the financial statement production and disclosure process. It is invariably a small, intimate group comprised of only a handful of board members. As a unique entity made up of people, the committee will possess, by nature, an original identity and a distinct personality.
In this chapter and the two following, the constitution axis of the agency assurance model presents the audit committee as a working organizational structure consisting of its purpose, character, and rights. The main activities and general make-up of the audit committee are critically reviewed to establish how its purpose and character are currently understood. This examination of the audit committee as it commonly operates in practice is combined with a review of the theoretical basis for its responsibilities to illuminate constitution, as illustrated in Figure 4-2 below, as the foundation axis of the agency assurance model.

Figure 4-2. Constitution Axis of the Agency Assurance Model.

Source: Own representation.

To operate effectively, the committee as a personal entity needs first to identify its purpose, which guides and governs its specific activities. Next, a certain character within the committee will have to be formed to apply itself to its purpose in a qualified and dignified manner. Finally, without a set of given rights, the committee will not have the respect of position necessary to pursue its purpose, exercise judgement, take corrective action, and generally exercise authority over management.

4.4 Purpose of the Audit Committee

4.4.1 Information Leadership

Agency assurance directs attention to the accuracy and reliability of the quality and quantity of information that management prepares and presents. It appoints the audit committee as the leader of the MSI process in recognition of the predicament of agency theory. Management must be directed at the target of reducing overall agency
costs, especially residual losses, preferring bonding to monitoring as the relatively more positive and desirable activity. However, with the background of early 21st century fraud and error in many organizations, agency assurance recognizes critically that monitoring is still necessary in today’s imperfect governance environment. The transparency barrier erected from conflicts of interest and asymmetry of information cannot be completely broken down even by the most well intentioned, highly equipped, and ethically oriented managers and directors.

To provide a formal perspective in setting reasonable expectations that the public should have of the audit committee’s performance in this setting, it is important first to establish and understand the committee’s purpose, which is determined by two key components:

1. **aim** – the universal, overriding objectives and commensurate resolve necessary to accomplish them expected of audit committees in general, and

2. **charter** - detailed assignments and activities that are drawn up by each board of directors in a document unique to each organization.

The aim has its primary benefits in providing the members of the committee with an internal identity that they can bond with as individuals and as a small group. The charter provides a delineation of the committee’s role for outsiders to understand and accept where the committee is placed in bonding and monitoring activities in the overall corporate governance scheme.

### 4.4.2 Aim: The Key Objectives of the Work of the Audit Committee

The audit committee as an institution arose from within corporate boards as a practical means for division of labor among the directors. The NYSE identified the potential value for better governance that the audit committee could produce and made it a requirement for its listed companies. As its trading volume and prominence grew, the NASD, which runs the NASDAQ stock exchange, followed the NYSE lead. Because they are self-regulating organizations (SRO’s), the NYSE, NASD, and other public securities exchanges were almost fully entrusted by the SEC to impose corporate governance rules, rather than the federal government imposing its own detailed regulations. Therefore, for many years, some exchanges may have required audit committees in their listed companies, but they did so with much flexibility allowed.
Individual boards themselves were left to define what it was that the committee was responsible to do. The result may have unfortunately meant that in many corporations the audit committee name was merely a label, not necessarily an indicator of an effective institution.\textsuperscript{11}

The audit committee was nonetheless widely recommended and promoted by external agents such as researchers, regulators, and the audit profession in the later part of the 20\textsuperscript{th} century. It received broad recognition through a historical endorsement in 1987 from the National Commission on Fraudulent Financial Reporting, commonly referred to as the Treadway Commission.\textsuperscript{12} Incidents of fraud were a major issue in the early and mid-1980’s, and the Treadway Commission clearly recognized and warned of the dramatic economic impact that had resulted, and still was likely to result, from fraud in large corporations operating on national and international scales.\textsuperscript{13}

However, perhaps because the Treadway Commission was made up almost exclusively of executive managers in public corporations, financial institutions, and securities exchanges, it also referred to fraud as an “infrequent” event.\textsuperscript{14} This may have unfortunately helped contribute to the overall environment of tolerance for a lax attitude and even outright disregard for financial reporting standards by internal managers, even when external agents believed that the seemingly widespread recognition and adoption of the Commission’s recommendations heralded a major control improvement.

The Blue Ribbon Committee was formed by the NYSE and NASD specifically to make recommendations for improving audit committees in their listed corporations. In its published report, the committee concluded:

“\textit{A key element of board oversight is working with management to achieve corporate legal and ethical compliance. Such oversight includes ensuring that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders.}"

\begin{itemize}
\item \textsuperscript{11} Pomeranz (1997), p. 282.
\item \textsuperscript{12} Pomeranz (1997), p. 281. The Commission’s chairman was James C. Treadway, Jr., who was also chief legal counsel of a major Wall Street securities brokerage and investment firm.
\item \textsuperscript{13} National Commission on Fraudulent Financial Reporting (1987), p. 1.
\item \textsuperscript{14} Ibid.
\end{itemize}
This oversight function is typically delegated by the full board to the audit committee, pursuant to the board’s general ability under state law to delegate certain of its duties to committees.”15

Sarbanes-Oxley has formally enacted many of these suggestions by assigning key duties and authority to the audit committee of US nationally listed and traded public corporations. The SEC regulations adopted in response to the legislation state:

“Under Section 3(a)(58) of the Exchange Act, as added by Section 205 of the Sarbanes-Oxley Act, the term audit committee is defined as:

- A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
- If no such committee exists with respect to an issuer, the entire board of directors of the issuer.”16

In other words, if the board of directors does not act to appoint an audit committee, then the full board is also deemed to be the audit committee and must meet all its legal requirements. For example, since Sarbanes-Oxley now requires that all members of the audit committee are independent, then the entire board in this situation could be restricted to consisting only of independent directors. Generally, the independence provision excludes any director from serving as an audit committee member who is a member of management, anyone who is contracting for business with the corporation, or anyone who would be logically perceived as being employed by or similarly affiliated with the corporation.17

Outside the US, audit committees are gaining legal recognition and standing as well. For example, the latest federal German Corporate Governance Code requires the Aufsichtsrat, the outside directors who form together the entire supervisory board in the dual board system, to establish an audit committee. The Vorstand, the internal company executives of the management board, must respect its authority.18 Specifically, the government’s translation of the official German law states:

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17 Ibid.
18 Regierungskommission Deutscher Corporate Governance Kodex (2003).
“The Supervisory Board shall set up an Audit Committee which, in particular, handles issues of accounting and risk management, the necessary independence required of the auditor, the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement. The Chairman of the Audit Committee should not be a former member of the Management Board of the company.”

Independence is not restricted further, but that appears to be because members of the management board have long been restricted from simultaneous membership in the supervisory board of their company. There is no such restriction for former managers, which has led to the oft-criticized practice of appointing chief executives upon retirement as the heads of supervisory boards of their firms.

Even though there are now general corporate governance codes and audit committee requirements laid down in the laws in the US, Germany, and many other countries, stock exchanges are still delegated broad authority for rulemaking. Many of the world’s largest corporations, whether they are headquartered in the US or not, choose to list themselves on the NYSE because of the prestige, publicity, and worldwide investor access this listing brings with it. The NYSE is identified as an SRO by the SEC, and the NYSE guidelines read as follows:

"The audit committee must have a written charter that addresses:

(i) the committee’s purpose – which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the listed company’s financial statements, (2) the listed company’s compliance with legal and regulatory requirements, (3) the independent auditor’s qualifications and independence, and (4) the performance of the listed company’s internal audit function and independent auditors; and

(B) prepare an audit committee report as required by the SEC to be included in the listed company’s annual proxy statement…"

The NASD, also an SEC recognized SRO, requires a charter, and lists similar requirements as above, but defines the purpose in a more limited way as follows:

“overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer…”

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19 Government Commission, German Corporate Governance Code (2003), Section and Paragraph 5.3.2, pp. 8-9.
20 NYSE (2004), Sect. 303A Par. 7 (c) (i), p. 11.
The NYSE and NASD rules continue on to list duties and responsibilities clearly related to the above purpose with one important addition. In the US, as directed by Sarbanes-Oxley, the SEC requires the audit committee to set up and publicize “Procedures for Handling Complaints”, and both the NYSE and NASD have included this in their new rules.\(^{22}\) This is more commonly called a *whistleblower* complaint procedure, which instructs employees and close contractors of the company how they can report questionable accounting, reporting, and auditing practices they may have observed at the company. The Blue Ribbon Committee had recommended that the audit committee should be responsible for ensuring properly functioning internal controls. This complaint procedure is important as a substitute provision, therefore, because the SEC did not require the internal audit function of the company to be placed directly under the supervision of the audit committee, as was adopted concerning the external auditors.

The audit committee is required by the NYSE to “discuss policies with respect to risk assessment and risk management”, which is similar to a provision in the German Code.\(^{23}\) The NASD, however, does not include a provision for overview of risks in its audit committee rules.\(^{24}\) The NYSE also requires the audit committee to stipulate how its own performance should be evaluated.\(^{25}\) The German Code states that all supervisory board directors should be compensated by a fixed amount and an additional amount that is performance-oriented.\(^{26}\)

Out of all of these recommendations of commissions, stock exchange SRO’s, regulatory rulemakers, and legislative requirements, along with expectations of the public in general, a new direction is evident, but a universally governing aim of the audit committee is still not clear. Is the committee an assistant to the board or does it have, more specifically, its own responsibilities? Is it another higher level, final auditor of the financial results? Is it a *super auditor* of the internal and external auditors? Is it a quality assurance investigator of the information systems controls and underlying business processes, therefore a *super business consultant* for company functions? Is it a fraud detector and ethics policy enforcer, a *super police force* of all

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\(^{23}\) NYSE (2004), Sect. 303A Par. 7 (c) (iii) (D), p. 12.

\(^{24}\) NASD (2003), Sect. IM-4350-4 Rule 4350(d).

\(^{25}\) NYSE (2004), Sect. 303A Par. 7 (c) (ii), p. 11.

\(^{26}\) Regierungskommission Deutscher Corporate Governance Kodex (2003), Section and Paragraph 5.4.5, p. 10.
company managers? Or is it the ultimate protector of company assets from all risks, including expropriation or negligence by management, a super bodyguard of all company property? Because expectations vary to a marked degree, they appear not to produce a consensus definition for a governing aim that is universal, but they do assist in bringing one in closer focus.

The aim of the audit committee should not be as fluid and flexible as it is today. Interestingly, in most committees, commissions, legislative bodies, regulatory agencies, etc., the aim for the audit committee is left up to the individual firm to define. It is even not often explicitly stated who in the firm should provide the definition, although it appears to be left to the discretion of the board of directors. The Committee of Sponsoring Organizations of the Treadway Commission, commonly known as “COSO”, established guidelines for the internal control system in corporations and other organizations. COSO’s 1994 *Internal Control – Integrated Framework* states:

> “Although audit committees have received increased emphasis over the years, they are not universally required, nor are their specific duties and activities prescribed. Audit committees of different entities have different responsibilities, and their levels of involvement vary.”

The Blue Ribbon Committee Report of 1999 described the situation similarly as:

> “While the listing standards of the primary U.S. securities exchanges mandate that companies have an audit committee, these listing standards do not stipulate with much specificity how an audit committee should be comprised and, moreover, how it should function. Similarly, neither state corporate law nor federal securities law lend much guidance on audit committee structure or role.”

Years later, post Sarbanes-Oxley, these observations remain greatly unchanged. Therefore, the purpose for the audit committee is suggested here in the agency assurance model in order to help avoid a second Expectations Gap, similar to that under which external auditors continue to suffer, from infecting public perception of the audit committee.

Agency assurance recognizes an expanded purpose for the audit committee, however, with important realistic expectations. The audit committee, and the board of directors

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in entirety for that matter, is not made up of super heroes but of talented and gifted individuals. In recognition of the challenge that the modern business environment places on directors and the elevated expectations for measurement of their performance, the following is proposed:

The aim of the audit committee is to motivate and evaluate management’s performance in presenting the true and fair view of the organization’s financial condition, including its operational performance and risk profile. The audit committee directs management to meet the information needs of the board of directors sufficiently towards fulfilling all purposes of their critical supervisory function, which includes both monitoring and strategy in measured balance, and to comply with all legal and ethical disclosure requirements of the company.

The committee is the final evaluator of the quality and quantity of MSI delivered to the board of directors. This evaluation includes the review of information to be further disseminated to both current and prospective shareholders as well as to any recipients, as required by law, of company information of a material financial reporting nature. This evaluation will be made with due care by the audit committee members, who can expect the full cooperation of and access to management, their subcontractors, and other corporate agents. Reasonable standards of performance of the committee will be expected as long as equal respect is granted for expectations of time commitment from its members. Meeting and project schedules will be set for committee members in light of similar expectations of involvement of active board members in general. The independence provisions for all members of the audit committee in the law provide the audit committee with its own, specific authority in these matters.

4.4.3 Charter: The Main Activities of the Work of the Audit Committee

Combining both the aim and charter can assist in forming an instructional and practical purpose for the audit committee. Actual activities performed and new ones required can be assembled as input to a governing charter documented for each corporation. The NYSE and NASD require the audit committee of each listed company to prepare and publish a charter. At a minimum, the charter is supposed to include provisions that meet the requirements of the US Exchange and Sarbanes-Oxley Acts, SEC regulations, and additional SRO rules that apply to the committee. However, there are

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28 Blue Ribbon Committee (1999), pp. 20.
no official charter standards and there are no structured, helpful listings of minimum requirements for a charter provided by any of these sources.

As lawmakers, regulators, and rulemakers have a habit of doing, each party cites the others. The legislature, the U.S. Congress, sets some demands and requires the regulator, the SEC, to take action. The SEC, with some specific direction, turns to the SRO’s, the securities exchanges, to recommend the actual rules for approval. The final approved rules published by the exchanges require their respective listed companies to ensure, as a first priority, that the charter includes all provisions delineated by the legislature. The audit committee directors of every individual company who are charged with compliance must attempt to make sense of these circular references in order to produce the required charter. Therefore, they do so undoubtedly with the assistance of legal counsel, which the legislator has given the audit committee the right to employ directly.

Thankfully, some basic assistance for the task of preparing an audit committee charter can be found in the public domain. The original Treadway Commission, which primarily advises companies for the needs of better internal control practices, included “Good Practice Guidelines for the Audit Committee” in its 1987 report, which are reproduced in Appendix 2.29 The Treadway Commission did not project a strong endorsement of the guidelines, however, by stating:

“The Commission is not prescribing these additional measures, and therefore has not included them as recommendations, but offers this guidance in the form of … Good Practice Guidelines, which companies can consider within the exercise of their judgment.”30

In its report recommendations, the Blue Ribbon Committee slightly more clearly calls for the NYSE and NASD SRO requirement of a charter in each corporation to govern audit committee activities.31 To illustrate this, a handful of sample charters were published in Appendix C of the 1999 Blue Ribbon Committee Report. The first of the samples provided by the Committee had been previously published by the AICPA and

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31 Blue Ribbon Committee (1999), p.28.
is reproduced in Appendix 3. With similar language to the above Treadway Commission statement, the Committee introduced the charter samples as follows:

“The Committee recommends that every audit committee consider the contents of the section of this Report entitled ‘Guiding Principles for Audit Committee Best Practices,’ which is designed to guide the development of the substantive content of an audit committee charter. We also encourage audit committees to refer to the sample charters included in Appendix C and the publications included in the Bibliography to this Report as a starting point for best practices to be considered. Ultimately, the market will be the judge of whether each committee’s disclosed guidelines are adequate.”

Further, the AICPA has published an Audit Committee Toolkit that includes a straightforward, but simplistic Audit Committee Charter Matrix in two dimensional spreadsheet form. The various best practices elements for a charter are included in the Matrix, which has been updated to include the post Sarbanes-Oxley requirements. It also contains some additional recommended elements not necessarily required by law. A small section of the Matrix is shown in Table 4-1 below, and the entire spreadsheet document can be found in Appendix 4.

The toolkit differs from the other charter samples because it lists the charter provisions as objectives in the far left column of the document. Additional columns with suggested content are provided by the AICPA in order that the Toolkit can be used as a project plan for the implementation of the operational steps, deliverable objectives, and schedule timeframe for accomplishing committee duties and responsibilities. Finally, the far right column is left blank to register actual completion of the charter provisions, and to track the timeframe required to complete projects. What is missing from the Matrix and Toolkit, however, is a reference or citation to the applicable sections of legislation, SEC regulations, and SRO rules for each charter provision.

Despite the Blue Ribbon Committee’s above efforts and declared expectations, officially it requested the SEC only to require companies to report whether or not they have a written charter, and only if they do, also report on whether or not the committee complied with the charter provisions. This approach has left wiggle room for public

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33 Blue Ribbon Committee (1999), p.28.
34 AICPA (2004–2).
35 Blue Ribbon Committee (1999), p.28.
companies traded on regional exchanges to avoid the compliance requirement. It had been seen as a potential costly administrative burden to smaller corporations.

Table 4-1. The “Audit Committee Charter Matrix” Format

<table>
<thead>
<tr>
<th>Audit Committee Charter</th>
<th>Steps to Accomplish the Objective</th>
<th>When to Achieve (Frequency Due Date)</th>
<th>Date Completed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Each member of the Audit Committee shall be a member of the board of directors, in good standing, and shall be independent in order to serve on this committee.</td>
<td>Test for independence, based on the regulations under the Act and any other regulations that may be operative.</td>
<td>Indicate in the Audit Committee minutes whenever a new member is appointed; acknowledge that independence has been verified.</td>
<td>Affirm annually or whenever a change in status by any Audit Committee member occurs.</td>
</tr>
<tr>
<td>2. At least one member of the Audit Committee shall be designated as a financial expert. (See the tool “Audit Committee Financial Expert Decision Tree” in this toolkit.)</td>
<td>Ascertain that at least one member of the audit committee meets the requirements of a financial expert under the regulations of the Act.</td>
<td>Indicate in Audit Committee meeting minutes which member of the audit committee is designated as the financial expert.</td>
<td>Affirm annually, unless there is a change in status.</td>
</tr>
</tbody>
</table>


Even post Sarbanes-Oxley, the SEC has not yet formally required audit committees to produce a charter. Public corporations in the US must only comply with the following disclosure rule for charters:

“issuers must disclose whether the audit committee is governed by a charter, and if so, include a copy of the charter as an appendix to the proxy statement at least once every three years.”

The SEC does recognize, however, that the NYSE and NASD can require their listed companies to have an audit committee charter. In fact the SEC sees the value of a charter requirement being included in the SRO rules of the exchanges, as follows:

36 SEC (2003-1).
“the Commission believes that requiring companies to specify the enhanced audit committee responsibilities in their formal written charters, and to delineate how the committee carries out those responsibilities, will help to assure that the audit committee, management, investors, and the company's auditors recognize the function of the audit committee and the relationship among the parties.”

Despite this SEC endorsement, the laws and regulations do not actually provide any minimum standards on the content of a charter, nor require that the content is even legally accurate or current. The establishment or presence of a charter is neither remedy of breach nor proof of compliance. It seems instead that, similar to implementation of ISO 9000 quality standards for manufacturing operations, it is hoped that the process of preparing, documenting, and disclosing a charter that fits the particular needs of the organization will lead to a higher level of audit committee performance. Finally, of course, with or without a charter, directors must comply with all applicable laws, regulations, and rules applicable to audit committees.

4.5 Character of the Audit Committee

4.5.1 Equipping the Audited Committee

Any workgroup that has expectations placed on it for performance must possess the ability and preparation necessary to achieve them. The workgroup also should have control over adequate resources to complete its required activities successfully. The audit committee is a separately identified and commissioned workgroup. The new laws that specifically name it have dictated its minimum size, at least three directors. It also has segregated it, in some dimension, from the board of directors out of which it is derived. The requirement of full independence of its members, while not placing the same restriction on membership of the full board, imbues the audit committee with a distinct personality of its own. It therefore inherits responsibility that cannot be separated from its personality.

In fact, the audit committee is being singled out in the respect of character. None of the specific financial expert qualification standards expected of committee members is applied in turn to regular board membership. There are curiously no similarly constructed qualification standards or debate over suitability of members of the

37 SEC (2003-2).
nominating committee or compensation committee that would require them to be experienced in human resources management. Participation in strategic decision-making is open to any board appointee, regardless of background and similarly with no legal qualification requirements.

To address this situation, as defined earlier, the constitution axis of the model associates the expectations and activities of the audit committee with its purpose. The model matches the committee’s identified purpose with a definition for its character. While the purpose is an abstract, indifferent set of requirements, character speaks to the personal capability and intent to fulfill those requirements. Character is determined by three key components:

1. qualifications – the ability, background, and individual, personal preparation of each of the members,

2. composition – the configuration of members’ contributions with other necessary resources, with special consideration given regarding member’s schedule and availability, and

3. ethical values – the set of behavioral filters that allows shareholders, stakeholders, and society to elect, allow, and trust members to hold the responsibility of their office in the audit committee and board of directors.

An individual audit committee combines these elements into a uniquely developing personality, while character is a more generalized version of this personality, applicable to all audit committees.

4.5.2 Qualifications of the Audit Committee

The detailed identification of member qualifications is particularly valuable to its character in three key ways. First all workgroups accrue benefits from identifying members’ capabilities, which would include those gained through education, training, certification, and experience. This combined inventory of human resources and skills provides a basis for allocating projects and other responsibilities. Such an inventory can be particularly beneficial in crisis, confidential and quick turn decision situations. Second, for boards of directors in particular, the promotion value of director’s backgrounds in company filings, prospectuses, and other public documents also adds to investors’ and other stakeholders perceptions of the strategic credibility of the whole
organization. This is the perceived board capital that directors can provide to furthering the strategies and goals, and therefore enhancing the performance, of the firm. Third, qualification has taken on a relatively new legal dimension. The SEC, in response to a provision of Sarbanes-Oxley, has for the first time established a specific background definition for a member of the board of directors, the audit committee financial expert.

The audit committee emerged originally because financial reporting disclosure requirements, with their increased complexity and critical influence on the financial health of the organization, needed to be reviewed first by a specialized and qualified group. The expectations have been raised even further for committee members to be able to review and analyze information and issues of higher strategic, operational, and risk complexity. The nature of the work itself sets a demand that committee members have the readiness and commitment, skills of understanding, and the extra time to devote to this complex function. Out of the financial scandals, a serious public impression developed that many audit committee members and, more generally, board directors, did not have proper backgrounds in accounting to ensure proper functioning oversight of management in financial matters.38

Firms must now disclose whether or not they have an audit committee financial expert and to identify any members so designated by name.39 The SEC’s final definition of who qualifies as an audit committee financial expert can be found in Appendix 5. This provision of Sarbanes-Oxley was contentious, especially when it came to this actual definition of a financial expert. Of course, the first issue is a libertarian one. Should the government be trusted to determine who is qualified to lead a private company? However, the number of publicized incidents of financial fraud, and the economic impact they have, had served to invite the legislature into the fray. In support of this initiative, research from DeZoort and Salterio, as cited and supported by Vafeas in his own article, showed that audit knowledge, not only independence, affects the position taken by committee directors in their relationship with management.40

38 Knowledge @ Wharton (2003).
40 Vafeas (2001–1).
The US public demanded and the government acted upon the perception that private industry and the securities exchanges were not adequately policing and preventing fraud and would not react quickly enough to the crisis. The resulting financial expert disclosure requirement, however, is not equivalent to the requirement that the audit committees in firms have financial experts, and the NYSE and the NASD chose not to require that firms have an audit committee member that meets the SEC’s definition. Instead, the exchanges require their listed firms to have one audit committee member who has finance-related experience such as that normally possessed by a CEO, CFO, controller, CPA, etc. Although this is not the SEC definition, it is at least a comparable standard of qualification for at least one committee member. In many cases, the person who meets the exchange requirements for a financial expert will also meet the SEC’s definition. Both exchanges also add the requirement that all committee members should be financially literate regarding the basic contents of financial statements.

The reasons for this discrepancy of approaches has to do with the desire of the exchanges not to disrupt the configuration of existing boards that they believe are functioning well just as they are, where the financial expertise of the committee members may have been acquired in board service, not through previous experience. There was also concern, especially by the NASD, that the boards of smaller firms would have serious recruiting issues with the specificity of the SEC definition. This fixed requirement could also restrict firms from going public simply for lack of finding a candidate who meets some particular aspect of the SEC definition, when an otherwise qualified person could be appointed.

There was a strong concern from many outside observers, as well, that by designating a particular individual as an audit committee financial expert it could increase their personal liability if something goes wrong financially in the firm. The term “expert” normally carries an elevated responsibility bound to the person in a legal setting. This could seriously limit the number of people who would be willing to serve in these positions, just at the same time that recognition of the critical importance of audit committee role has been elevated.

Sarbanes-Oxley also requires that audit committee’s have a minimum of three members, and all audit committee members must be independent. This also puts
pressure on boards’ recruitment and appointment of members from a more limited base of qualified and willing candidates. The SEC, therefore, addressed the liability issue specifically, by clearly stating that there was no intention from the legislation or regulations of an elevated liability for audit committee financial experts. It further protected the directors in this role not only by commenting on intent but also by specifically adding the following *safe harbor* provision to its regulations:

> “The designation or identification of a person as an audit committee financial expert pursuant to the new disclosure item does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification…”

Finally, the SEC also made it clear that the other members of the board and committee do not win any reduction in liability from their not being designated a financial expert.

### 4.5.3 Composition of the Audit Committee

Audit committee members, like all directors, are invariably highly qualified individuals through their uncommon experience, intelligence, and accomplishments. This makes influencing and administering the character of an audit committee a special case for application of the techniques of human dynamics. To be effective, a committee generally requires establishing and maintaining a uniquely collegial environment of respect and deference for each other’s backgrounds and schedule. The individual qualifications of the committee members must be composed into a productively functioning group with shared objectives and purpose. The complexity of this situation is made especially challenging because of the marked scarcity of time that directors are able and expected to allot to board activities.

Quantifiable factors in the composition of the audit committee include the number of members, meetings, and projects as well as the days and hours that can be applied to committee activities. The associated qualitative factors are commitment, motivation, diversity, interaction, leadership, and independence. How these factors are instituted and developed will greatly determine the personality of the committee and have a very significant impact on its performance. Most of these factors should best be regulated at the local level, through the specific planning and direction of each audit committee’s
chairperson working with the other committee members. However, two of these factors, the number of members in the committee and the independence of their relationship to the firm, are the subject of recent widespread analysis and discussion, and have been regulated at the national legal level.

4.5.4 Ethical Values of the Audit Committee

Finally, character cannot be discussed without incorporating ethics as a permeating factor of absolute necessity in the personalities of the members of the committee. The internal control system cannot function without an emphasis on ethics in the overall corporate operating environment. Accounting standards, if they are truly to embrace a principles-based rather than a rules-based system, require ethical behavior by accountants and auditors in the implementation, selection, and use of standards. Today’s highly dynamic corporations are highly dependent upon empowered employees who are expected to provide creative business solutions and situationally unique responses to internal and external demands. If they are to be expected to behave ethically in meeting the needs of their organization and society, then employees should have models of ethical behavior in their leaders, especially including the members of the audit committee.

4.5.5 Audit Committee and Board Size

In early 2003, a detailed search was conducted through the Multex investor web portal. This website provides a complex, but user-friendly interface to a database consisting of summarized quarterly and annual financial disclosures, financial ratios, indices, addresses, business descriptions, and many other statistics of public corporations whose shares are traded in the major US stock exchanges. A list of the Standard & Poor’s 500 index companies was searched in detail, and despite ongoing mergers, acquisitions and privatizations reducing the population reported, data could be collected on almost 90% of the target group.

The number of directors was tallied from individual webpages of each company, which listed all of the directors by name. The listings had been gleaned by Multex personnel from the most recently available company filings or reports published by the companies during 2002. As can be seen from the graph in Figure 4-3 below, the

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41 SEC (2003-3).
number of directors, as shown on the horizontal scale, ranged anywhere from a low of five to a high of 23, with the mean, median and mode falling on eleven members. Fully two thirds of the companies have between nine and thirteen members, inclusive. As a final observation, many of the S&P 500 corporations with a board size of 17 or 18 and all with 19 or greater were banks or insurance firms.

**Figure 4-3. Size of Board of Directors in the Standard & Poor’s 500**

![Histogram of Board Sizes](source: Own representation. Core data extracted from Multex website.)

The argument for a board size at the lower end of this scale primarily centers on factors of team effectiveness. On the one hand, business decisions have to be made under some acceptable level of uncertainty. When teams are below average in size, fewer splinter factions are allowed to develop around previous relationship commitments. In teams larger than average, it could be difficult to reach consensus, leaving management without board direction.

On the other hand, the board should have diversity of strong backgrounds at its disposal, so varied opinions and decision factors can enter discussions. Embracing diversity can assist in avoiding the serious problem of groupthink. Teams have been shown to make compromises that lead them to a complete agreement, but they agree to the completely wrong decision or solution. What teams attribute as positive cooperation is actually negative groupthink.
In still larger groups, the more difficult it is for especially part-time participants to develop any intimacy in their relationship with all of the other members. It becomes possible for a strong chairman, especially one who is also the chief executive, to dominate discussions and for debate to be stifled. This is, interestingly, similarly the case for boards that are well below average size, where small numbers reduce the opportunity for diversity in the overall make-up of the board.

Most audit committee charters require members to meet a mere four times per year, although they also allow for these directors to meet as often as they may see fit. A recent study based on survey input from over 1000 audit committee chairmen reports that those who attended committee meetings a total of 16-20 hours in a year were most satisfied with the committee’s performance. Those that met for fewer than 16 hours or for more than 20 hours did not rate their performance as highly. These results, as illustrated in Figure 4-4 below, also show that the great majority of members, over 71%, spent 20 or fewer hours per year participating in committee meetings.

**Figure 4-4. Audit Committee Member Availability**

Source: J.D. Power and Associates 2004 Audit Committee Best Practices Report

In addition, audit committee members must find additional time to allocate for reviewing reports to prepare for meetings, discussions with the external auditors and company accountants, as well as attendance at full board meetings and annual shareholder meetings.

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In the few years following the stock market correction, it has become generally well accepted that all directors will have to spend more time involved with board activities of the companies for which they serve. It is also expected that, as a result, directors will have to limit or reduce the number of boards in which they participate. This has resulted only in part because of the new requirements legislated by Sarbanes-Oxley in the US. To the credit of many researchers worldwide in the corporate governance sphere, this adjustment in the time and attention directors devote to individual organizations was repeatedly called for throughout the decade leading up to the stock market correction. The National Association of Corporate Directors had recommended in 1996 in its *Report of the NACD Blue Ribbon Commission on Director Professionalism* that boards should seek to limit the service of their directors on other boards. The limitation should be made depending on director’s professional situation and employment commitments. CEO’s and senior executives should only serve on one or two additional boards, non-executives with full time employment – only three or four boards, and others – five or six boards, maximum.\(^{43}\)

Even with the adjustment of schedules by directors, however, the amount of time that three or four audit committee members can dedicate to committee responsibilities is a very scarce resource. The few more hours they can offer should be applied to a deeper involvement and understanding in their core functional areas. It would be a rather big mistake to interpret this higher intensity of director involvement in the committee as leading to an addition to their functional responsibilities, or worse, as simply requiring their participation in many more new activities.

### 4.5.6 Audit Committee and Board Independence

In its 1996 report, the NACD had also recommended that a board should “have a substantial majority of independent directors”.\(^{44}\) In Chapter 3, two research studies, which preceded the NACD recommendation, were cited that uncovered bias, as may be expected, in the decisions of directors who have some other material relationship with the firm. In addition, Vafeas’ 2001 research article showed alarmingly:


\(^{44}\) Ibid.
“Director independence in terms of a fiduciary relationship is not, however, related to the likelihood of a committee appointment among Fortune [500] firms.”

Two years earlier in an appendix of its *Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors*, the following description for an independence standard was offered.

“A director will be considered independent if he or she.

- Has never been an employee of the corporation or any of its subsidiaries
- Is not a relative of any employee of the company
- Provides no services to the company
- Is not employed by any firm providing major services to the company
- Receives no compensation from the company, other than director fees.”

This type of standard is pursued as an objective in order to root out the negative influence of conflicts of interest that are perceived to plague the supervision of many of today’s corporations. For example, one group of authors contends that a board should have at least two-thirds of its members being independent to ensure conflicts of interest are removed.

Finding a fully inclusive standard is not easy because there are many indirect ways of affiliation with companies, other than through employment or contractual relationship. Close friendships can have many of the same interest dimensions as family relationships. The major US securities exchanges including the NYSE and NASDAQ have adopted very extensive definitions for independence that not only incorporate but also expand upon the NACD standard. The exchanges have also included the requirement for majority representation of indirect directors of listed companies in their rules. The expanded definitions are good attempts to close as many potential affiliation loopholes as possible.

Despite the NACD advisory, there is still no formal direct legal requirement in the US for a majority of directors in public corporations to be independent. However, The

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45 Vafeas (2001–1).
government has moved in the direction of the NACD reports because the SEC has accepted the exchange rules. Sarbanes-Oxley also added the requirement that all members of the audit committee must be independent, and the SEC and the exchanges have updated their regulations and rules to comply. The section of the legislation that addresses this provision reads:

“‘(3) INDEPENDENCE.—
‘‘(A) IN GENERAL.—Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.
‘‘(B) CRITERIA.—In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—
‘‘(i) accept any consulting, advisory, or other compensatory fee from the issuer; or
‘‘(ii) be an affiliated person of the issuer or any subsidiary thereof.
‘‘(C) EXEMPTION AUTHORITY.—The Commission may exempt from the requirements of subparagraph (B) a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.”48

Therefore, since an audit committee must consist of at least three members, this establishes a minimum of three independent directors in all public company boards, except in very rare cases approved by the SEC per paragraph (C), above. The SEC has moved further towards a policy of supporting independence with a new rule requiring companies to disclose whether or not the members of their board nominations committee are independent.49 The nominations committee is formed to source and recommend candidates for open director positions. Independent board members are more likely to recruit and accept additional new members who are also independent.

A requirement of complete independence of the board of directors would likely establish a system similar to the dual board structure in Germany. However, many argue against this extreme. There is no law against a board being formed entirely of independent members, if the board itself decides this is preferable. Company executives possess valuable insider knowledge and experience that is irreproducible by outsiders. There is also clearly plenty of evidence of highly ethical, credible, and

productive executive directors who make exemplary contributions in these parallel roles. In addition, as the agency assurance model shows, the board is almost fully dependent on management-supplied information. Having company executives participate on the board can reduce some limitations to access to MSI, assisting in lowering rather than raising the transparency barrier. Manager’s inside knowledge can make for a much more efficient and effective board meetings and decision processes, and provide an opportunity for bonding, as well.

The fact that audit committees now must include only independent and specially qualified members, although a positive development for monitoring, can be detrimental to bonding. The board must take care not to allow the specialized character of the committee to lead to a subtle or even blatant rift between the committee and the rest of the board. First, the remaining members could coalesce into an informal group. This group could become dominated by management, especially when there are a number of insiders in the group or when the CEO of the company is also the chairman of the board.

Second, the audit committee has heretofore often been used as a grooming ground for younger and newly appointed directors. There are a few advantages to the board from this approach. The audit committee benefits from a new outsider who has no history with the company and therefore can remain one step further removed from the decisions that generated the financial results. The committee may also be one of the best places for new directors to learn the ins and outs of the company quickly, bringing them up to speed on the company’s individual needs earlier than with other appointments. New directors may also be recruited because they simply have more time to devote to increased hours of audit committee activities. However, an audit committee appointment should not be seen as an unattractive and less influential position, a training ground with a stigma not unlike that of a fraternity pledge hazing ritual. The extra work hours of the audit committee meetings and reviews should also not be allowed to lead to its independent members becoming isolated from the rest of the board.

4.6 Strengthening the Audit Committee

Although it raises a difficult short-term recruiting issue, Sarbanes-Oxley’s requirement that audit committees must have a minimum of three members is helpful in the long
term. It directs more board resources to this critical function. The amount of hours that individual members will be asked to allocate to a corporation will also increase. However, the demands on the audit committee have grown significantly in number and complexity in the environment of the 21st century, even when compared to just a few years earlier. Calls for the audit committee to absorb the responsibility of the risk management committee, a logical consequence because return and risk are bound in any investment, and the associated strategy and control decisions, respectively, add to the committee’s workload. The overall combined result of a few more available director hours with increased demands will mean there is little to change the staggeringly high ratio of management activities when compared to board resources available for their supervision and for other board activities. This severely limits the time available as well for committee members to be involved in other corporate or non-profit boards or even in private pursuits.

It would be a mistake to blame, as some do, Sarbanes-Oxley legislation and related regulations for this resource and time pressure. The public lawmakers actually have stopped short of institutionalizing many of the recommendations made earlier by private commissions. The changes they have enacted are explained more by developments in the business world than by the legal system’s reaction. Therefore, solutions should be sought out from economics and business sources, and recommendations should be implemented by management, boards, shareholders, institutional investors, and all other relevant corporate governance disciplinary factors, including legislators and regulators.

In summary, serious losses in corporations that were apparently generated by fraud as well as by poor decisions have signalled a crisis of oversight. One initial remedy considered was a legal requirement for specifically qualified directors in independent audit committees. Standards for qualification were presented, then they were loosened in response to comments and pressures, and finally they were abandoned as a requirement. Arguments that defeated the proposal included wrong expectations being placed on just one person, risk of individual liability of the person, and the fear that not enough qualified members would be available to recruit. Unfortunately this also leaves the status quo in place. Therefore, there is no guarantee that the skill level identified by the SEC is met. However, the financial expert disclosure requirement

that was put in place does at least address the issue of firm credibility. Active investors can note and question why a company has not appointed a financial expert. In response to this potential loss of confidence, they can put pressure on the company board to add a genuine financial expert, or they can put pressure on the company’s stock price to generate a higher return in the face of a higher risk profile.
CHAPTER 5.

Constitution – The Rights of the Audit Committee

5.1 Expectations for the Audit Committee in the Corporate Governance System

The audit committee is an organizational entity that has earned widespread international acceptance for enhancing the performance of the boards of directors of the world’s corporations. Sarbanes-Oxley and other laws internationally have elevated the role of the audit committee as an important part of the goal of improving corporate governance and financial reporting in publicly traded corporations. This certainly places elevated expectations on audit committees from governments and the public for considerably improved results in the accounting integrity of large corporations, not only those traded publicly in the US. The SEC summarizes these expectations, as “duties and responsibilities”, as follows:

“Moreover, the NYSE and Nasdaq proposals explicitly require the audit committee to have the duties and responsibilities specified in Rule 10A-3, including direct responsibility for the appointment, compensation, retention and oversight of the company's outside auditor; the ability to engage outside advisors; the ability to obtain funding for the audit committee and its outside advisors; and the responsibility to establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission of employee complaints.”

The audit committee’s purpose and its character must be logically consistent with these expectations, or there will be continued confusion and disappointment. In Chapter 4, it was shown that the newly established audit committee purpose statements are not always consistent from one rule making authority, i.e. securities exchange, to another, even within the same national jurisdiction. In the US, an attempt was made to require a high standard of expertise for at least one member of the committee. Before it was finally enacted, however, the law was transformed into a disclosure requirement of a fairly relaxed definition of financial expert.

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1 SEC (2003-2).
It is therefore unfortunately distinctly probable that the audit committee suffers from an identity crisis stemming from unrealistic expectations. Especially in today’s environment, it is dysfunctional to attempt to develop an appropriate general character or individual personality to meet unrealistic or unrefined objectives. It is counterproductive for the audit committee to continue to accept an unclear purpose. Therefore, the constitution axis of the agency assurance model advises that the audit committee as an organizational entity must embody a set of rights that provide a proper balance to define, understand, and affirm its meaningful purpose. In this chapter, the presentation of the constitution axis is completed by reviewing the rights of the audit committee in light of its relationship to the actors of the corporate governance system reporting to the committee and involved in the preparation and verification of management-supplied information.

5.2 The Right of Best Efforts from the Agents of Corporate Governance

The key rights of the audit committee start with the members’ expectations of dedicated cooperation and performance orientation of transparent and ethics-oriented managers, active and informed shareholders, professional disciplinary actors in the corporate governance universe, and a shareholder interest-minded board of directors. The board of directors and its committees are knowledge transforming organizations. They use information as their input, and as their output, the vast majority of their actions are for making decisions. They are nearly fully reliant on the best efforts of others in the corporate governance universe in preparing, reviewing, and assessing the information upon which directors act. They must also, wherever possible, make sure to clear themselves of conflicts of interest when performing their supervisory responsibilities.

Corporate governance is the prescription for the ailment of misdirected agency control in modern corporations. When the span between control and ownership is not successfully bridged, residual losses can overwhelm a corporation, as the bankruptcies of Enron, WorldCom, Parmalat, and others have recently demonstrated. Whenever the interests of management crowd out those of shareholders, there are likely to be profits lost to the corporation greater than whatever management may have gained for themselves. Additionally, residual losses can be derived from conflicts of interest and
outright fraud. Some of the profits from good strategic decisions can be lost to the corporation because they are allotted to or skimmed off by management.

Monitoring and bonding, although they have substantial costs associated with them, are remedies that the corporate governance actors utilize to reduce what could be comparably larger residual losses. A key objective of these efforts is for the board to seek to lower the transparency barrier. If the board is successful in maintaining this improved condition, it will improve its visibility to alternatives of which managers may be reluctant, unable, or unaware to disclose. Intensive regulation as the alternative, however, is a blunt instrument that can substantially add to monitoring costs, but when misdirected, may not lead to substantial offsetting benefits.

Such regulation applied to all companies equally may not present a competitive disadvantage for individual firms, however, managers likely still have a valid complaint. Higher costs stemming from legislation such as Sarbanes-Oxley squeezes out some funds that could be used for investments in the future, especially for acquiring or developing critical intellectual capital. This results in perhaps another category of agency costs that could be called displaced profits.² The squeeze results because monitoring costs reduce short term profits, just as most costs of internally developed intangible assets are required by accounting standards to be period expenses, which also reduce short term profits. On one hand, whenever a choice is made between available alternatives, when one of the opportunities is shown later to have been a better choice for profits, the profit foregone is an opportunity cost. On the other hand, displaced profits, as well as residual losses for that matter, cannot be categorized as a true form of opportunity costs, because the choice between reasonable alternatives has not been presented to management.

The economic consequences of displaced profits and residual losses heighten the necessity of finding a place for balance in monitoring and bonding techniques in the supervisory oversight of today’s corporations. There is also a very real problem of misunderstanding of the role and value of both of these remedies in almost all of the key actors of the corporate governance system. First, many policy advisors who are also governance actors seek to discredit, in many identifiable situations, the role and

² Many regulations and other stakeholder influences, whether considered reasonable or not, have firm costs associated with them. Displaced profits are only related to higher than necessary monitoring or bonding costs.
value of monitoring as an instrument. Second, a significant exaggeration of its benefits creates false expectations and an over reliance on bonding as an instrument. Stemming from an apparently widespread anti-disciplinary bias, instead of seeking a proper, healthy balance between both categories, an extreme polarization has arisen between these two remedies, and an over reliant preference of collaboration over control.

5.3 Pressures Against Monitoring

5.3.1 Discipline is Lacking

Certainly, one of the biggest contributions of Sarbanes-Oxley, the German Corporate Governance Code, and comparable laws, is a reinstitution of the role and re-elevation of the value of monitoring. Many of the provisions of these laws institutionalize a wide variety of corporate governance recommendations of many expert commissions and panels. Unfortunately, the lawmakers often stop short of enacting many remedies that were initially suggested. Very often the financial press accuses the political lobbying efforts of the Business Roundtable, an association of top international business CEO’s and other high-ranking corporate executives, for allegedly using “enormous pressure” in influencing the legislators to ease off on reforms.  

Considering that the committees proposing reforms are almost exclusively conservative agents of industry, the specific issues that still have been taken off the regulatory agenda are often right to remain suspect in media coverage. Examples of loopholes that have not been closed in the US include allowing some questionable non-audit consulting activities of audit firms, not requiring expensing of stock options compensation in financial statements until 2006, and not allowing shareholders limited rights of nominating board members directly, among others. The problem lays not only in government, boards, and auditors allowing themselves to be influenced by managers but in managers who are unwilling to check their own conflicts of interest and who chafe at the disciplinary consequences of the proposed reforms.

5.3.2 Internal Finance Management as the Buddy, not the Bully

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Section 404 of the Sarbanes-Oxley Act explicitly requires that management must ensure that adequate internal control processes and reporting are established and maintained. Management must also now report formally on their assessment of internal controls and financial reporting. The external auditors must also perform an attestation of this assessment and report independently on their findings. This helps to re-establish the responsibility of the company’s internal accountants to be an instrument of professional oversight, not only a supporter or enabler of favorable financial results. However, even in recognizing the conflicts of interest in today’s business environment, Sarbanes-Oxley held back from requiring that the internal auditing function report directly to the audit committee or board of directors.

The internal accounting and controlling functions of corporations is the purview of the finance director or chief financial officer of the corporation. Often, the chief internal auditor has some authority to report findings and issues directly to the CEO or the board of directors, but just as often is responsible first to report to the CFO. In almost all corporations, the internal auditors’ future career opportunities lie within the accounting ranks.

The largest association of corporate financial officers is the Financial Executives International (FEI). Since the early 1990’s, the FEI has sponsored and promoted a series of articles which present two “opposing” polar views of the overall roles of financial managers in organizations. In one of these popular articles, financial executives were encouraged to redefine their role in the organization based on their operating managers’ view of their image as being modelled either as “Corporate Cops” or as “Business Advocates.” In a more recent study, the authors delved deeper into the “core values” of these two models, keeping the label of “Business Advocate” but changing “Corporate Cops” to the more polite “Corporate Policemen.”

The authors surveyed over 3000 business managers from various functional disciplines using a well developed diagnostic questionnaire. From the responses, they placed the activities of financial managers in the following three categories:

“Command and control orientation: This orientation to financial work stresses the vertical flow of financial information up and down the

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5 Jablonsky & Barsky (1998-2).
corporate hierarchy. The financial organization serves top management by providing an independent review, evaluation, and commentary on the operating and capital investment plans of the business units.

**Conformance orientation:** This orientation to financial work stresses the external flow of information prepared in accordance with externally imposed reporting requirements. The financial organization serves regulators, analysts, and other external parties by complying with the rules and regulations established for demonstrating external accountability.

**Competitive team orientation:** This orientation to financial work stresses the horizontal flow of information among all managers within the firm. The financial organization serves the business units by providing the sophisticated analytical and accounting support necessary for achieving the firm's strategic business objectives.”

The authors were careful to point out that “all three orientations to financial work existed to a greater or lesser degree in all firms.” However, they also noted that, on the one hand, when financial managers combine the command and control orientation with an emphasis on the conformance orientation, this produces the model for their organization of the corporate cop. They stated that the corporate cop stresses its oversight responsibilities and compliance to policies and regulations. On the other hand, the combination of the command and control orientation and primarily the competitive team orientation produces the model of the business advocate. The business advocate is said to pursue higher involvement with the operating managers in shared objectives and integration of business functions.

Further analysis of the questionnaire led the authors to identify the functional managers’ expectations for the finance function. These expectations were then grouped into five values categories of influence, involvement, operating philosophy, roles, and responsibilities. In preparing the grouping, the authors identified a strong contrast in the values consistent with either one of the two previously observed roles of corporate cop and business advocate, as summarized in Figure 5-1 below.

The article then displays a clear orientation in favor of the business advocate, or management bonding role, and against the corporate cop, or management monitoring role, from both the perspective of functional managers surveyed as well as the authors’ concluding recommendations to financial managers. It is important to understand that this binary orientation, favorable versus unfavorable, was clearly exhibited from the
data collected and analyzed. However, the data stems from polling the opinions of a group that is not without strong personal interest bias. The group surveyed consists of functional managers who most likely would prefer their decisions and activities being supported rather than them being audited.

**Figure 5-1. Business Advocate versus Corporate Policemen Models**

![Business Advocate versus Corporate Policemen Models](image)

Source: Jablonsky & Barsky (1998-2).

The bias that is illustrated permeates all of the five values categories. The business advocate is pictured very attractively and the corporate cop is displayed comparably unattractively, for example in the summary of the categories for roles and responsibilities in Figure 5-2 below. The authors determined that basically all financial organizations commonly exhibit the command and control orientation. They also praise the value of financial discipline as a key operating philosophy of the business advocate. These are consistent qualities of monitoring expected in a group responsible for internal financial and accounting controls. However, the article does not recommend blend of values that embrace key monitoring responsibilities that are
necessary to support the audit committee, the board of directors or corporate governance. Instead, the FEI appears to be mostly interested in molding the purpose of the financial function based on a goal of popularity in the organization and based on the opinions of non-financial managers, the same people that are expected to be monitored by finance.

**Figure 5-2. Internal Finance Organizations – Bonding vs. Monitoring**

<table>
<thead>
<tr>
<th>Roles</th>
<th>Responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business Advocates</strong></td>
<td><strong>Business Advocates</strong></td>
</tr>
<tr>
<td>Help Meet Financial Targets</td>
<td>Improve the Bottom Line</td>
</tr>
<tr>
<td>Develop Models for Business Operations</td>
<td>Cost/Profitability Reporting</td>
</tr>
<tr>
<td>Formulate/Implement Strategy</td>
<td>Achieve the Business Objectives</td>
</tr>
<tr>
<td><strong>Corporate Policemen</strong></td>
<td><strong>Corporate Policemen</strong></td>
</tr>
<tr>
<td>Focus on Periodic Reporting</td>
<td>Budget/Variance Reporting</td>
</tr>
<tr>
<td>Oversee Budget Processes</td>
<td>Concerned with Cost Control</td>
</tr>
<tr>
<td>Monitor Budget Allocations</td>
<td>Hold Management Accountable</td>
</tr>
</tbody>
</table>

Source: Jablonsky and Barsky (1998-2).

In practice, it is likely that the model of the corporate cop, the *bully* personality, is still derided and dismissed, while the business advocate, the *buddy* personality, continues to be praised and promoted. This position recommended to and taken by financial and accounting managers in firms is even more unfortunate in juxtaposition to the FEI’s position as one of the key founding organization members of the Treadway Commission, which has published the COSO *Internal Control – Integrated Framework* guidelines. The COSO Framework, basically unchanged from 1994, apparently remains as the most comprehensive reference for firms to follow in meeting the requirements of Section 404, and in planning and administering an internal control system overall. In an extreme measure, an unbalanced financial management culture could lead apparently to wide disregard for financial reporting standards and controls.

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Case Review 5-1  Financial Management and Fraud at Qwest Communications

In early 2005 the SEC announced that it had charged nine executives of Qwest Communications International with “massive financial disclosure fraud” and thirteen other top company managers in current and prior related legal actions. From 1999 to 2002, these executives were alleged to have inflated revenues by over $3 billion and hidden expenses of over $70 million. While many cases of actual or alleged fraud have involved a select few top corporate executives, this case spans a much wider group, particularly managers with financial reporting responsibilities.

The misrepresentations appear to have involved many operational managers colluding with their financial managers, and not only at the headquarters of the company, but in business units and functions as well. Along with the indictment of former top executives Joseph P. Nacchio, co-chairman and chief executive officer, Afshin Mohebbi, chief operating officer, and Robert S. Woodruf and Robin R. Szeliga, chief financial officers, four key business executives, eight financial managers, and six officers whose titles were not listed were named in charges. From the business side former executives named in all actions included an executive vice president of wholesale markets, a former Qwest executive vice president, a former Qwest senior vice president, and a former Qwest sales manager. Former finance and accounting managers charged included a senior vice president of pricing and offer management, a senior vice president of finance, a director of financial reporting, a senior manager of financial reporting, two controllers, a director of finance, and a CFO of Qwest's wireless division.

Some of the individuals had already negotiated personal settlements that totalled in the hundreds of thousands of dollars with the SEC. Representatives of the company had also settled a civil action by agreeing to have Qwest pay $250 million as a misconduct penalty. Although in their settlement agreements, they may have not agreed to admit any guilt in the charges, some of them are barred from employment as corporate officers for lengthy time periods, and all have to sustain the public embarrassment and consequences of being named in a financial scandal.

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8 Krell (2005).
Fortunately, many professional organizations do recognize their responsibilities in contributing clear and credible information to the board, in support of their corporate governance roles, in an effective balance between both collaboration and control. The publicity of the crisis and the legislation that followed has increased the visibility of these responsibilities. These organizations set recommended guidelines for their constituents to follow. A number of these organizations are internally placed in the financial management ranks as well. For example, the former chairman and one of the founders of the Irish Association of Corporate Treasurers and a current Fellow of the UK Association of Corporate Treasurers, Aengus Murphy, has recommended five key actions for corporate governance in treasury organizations. Company treasurers are reminded that they manage high-risk operations responsible for handling all of the cash transactions of the company’s receipts and disbursements. The fourth of the five key actions reads:

“A comprehensive treasury management report should be presented to corporate management and the board at least every quarter, in understandable presentation style, so that informed judgements can be formed and decisions can be made.”9

The FEI’s involvement in COSO is also a positive development. However, financial and accounting management must not only exhibit a superficial recognition of their corporate governance responsibility. They clearly must attain a much deeper acceptance of their role of reducing the constituent building blocks of the transparency barrier. Audit committees and their boards must set expectations of monitoring at a similar level for all professions in the organization to improve the transparency and serviceability value of management-supplied information.

5.3.3 Excessive Executive Compensation Elevates the Transparency Barrier

During the 1990’s an entrepreneurial culture was promoted among large corporations by their board members and their executives. Stock options were granted in larger numbers in hopes of fostering an ownership mentality. The well accepted idea conceived was that management will align itself more closely with investors if they have an equity stake in the organization themselves. This led to a significant emphasis among managers to concentrate on shareholder value. The value objective was most often narrowly translated simply as a higher market price of the firm’s stock, because
the gains for managers from higher stock prices often dwarfed all other forms of incentive compensation.

Before the last quarter of the 20th century, executive compensation was primarily made up of salary and benefits (health, disability and life insurance, vacation pay, retirement pension, etc.) expenses funded from normal business operations and from commissions and bonuses (also expenses) funded from achieving or exceeding target revenues and profits, respectively. Following the much publicized success of start-up companies with stock options granted to their founders and employees, options in larger numbers were added to executive compensation packages. Options were not required to be recorded as expenses by the start-up’s accountants; therefore, they were employed as a substitute for a measurable portion of the costly (i.e. expensed) standard compensation methods. As a start-up’s shares were not yet traded on any stock exchange, grantees of these options had consciously traded or risked a substantial portion of their salary and benefits compensation, for the very uncertain opportunity in the future of the stock’s placement on a recognized exchange, through an initial public offering (IPO) by the start-up at a price higher than the option’s exercise price.

Stock options in the hands of executives of established corporations, in contrast, have been granted without an equivalent trade-off of standard compensation and without the risk of an IPO hurdle. It was not until 2005 that options finally lost the advantage of non-recordability as an expense. Traditional cash bonuses and commissions, determined by sales and profits performance against objectives, have always been expensed. These significant compensation elements went undisturbed, and stock option bonuses simply added significantly to executive’s personal earnings. In addition, general improvements in economic conditions most often have lead to significantly higher stock market prices across the board, and therefore, higher compensation for executives exercising their options. As occurred throughout the 1990’s, economic improvements resulted to a measurable extent from a favorable business climate. This reflected society’s and its representative governments’ support for more liberal markets, more than superior performance of individual corporations.

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9 Murphy (2004).

10 In late 2002 and early 2003, a few major corporations announced that they would voluntarily expense stock option grants.
A highly significant portion of compensation for executive management is therefore now represented by stock options. Annual disclosures from many corporations show that top officers are accumulating significant wealth from these options alone, and in many cases the exercises of options provide much more financially to executives than all other standard compensation elements combined. In a 2003 interview, Princeton economist Paul Krugman pointed out that in 1970 the average US CEO pay was 40 times the pay of the average worker. By 2000, CEO pay had ballooned to over 1000 times. Krugman warned that corporate governance reform in the US was not ‘real’, and as evidence he said that since 2000 the gap in CEO pay versus the average worker had continued to widen.\footnote{Krugman (2003).} The evidence shows that in this era of globalization of business, this compensation issue has the capability of spreading like an infection over a larger area than just the American corporate environment.

The addition of stock options for executives is a major contribution to the imbalance in compensation of Krugman’s observation because they are not granted proportionally, or not granted at all, to rank and file employees. There have also been many items in the press noting large company loans to executives that were later forgiven, extravagant parties and vacations justified as company business but also serving to celebrate birthdays of executives’ family members and other personal events, exclusive memberships in social clubs and organizations, major donations to universities and charities by companies attributed to the executives personally, and innumerable additional creative company perks. All of these new items are given in addition to standard salaries, bonuses, and retirement plans that themselves continue to grow at a rate faster than the level of these items in the general working population. The overall issue of excessive compensation and apparently unreasonable executive contracts and payouts is being addressed in more boardrooms, as Case Review 5-2 below illustrates.

**Case Review 5-2  Executive Compensation Receives Public Attention**

In the mid to late 1990’s, Michael Eisner, Chairman and CEO of Disney, earned many hundreds of millions of dollars from his stock options. Even at that time critics were silenced by those who credited Eisner with increasing the market value of Disney for its shareholders. But since the decade ended, Disney stock performed miserably over
many years, not only as a result of the overall market crash, but in comparison with 
other blue chip companies as well. After a few years of the new century passed, it 
became the analytical opinion of a number of professional outsiders that Eisner had a 
flawed strategy for Disney’s new future. Eisner came under greater scrutiny in the 
press and from investment analysts, and the Disney board finally moved in 2004 to 
find a replacement for Eisner. In 2005, they named Disney insider Bob Iger, one of 
Eisner’s closest associates to take over. However, there was no requirement that 
Disney would be refunded any portion of the past inflated compensation received by 
Eisner and other Disney executives.

The excess compensation issue spilled over into a cross border debate at British-
American pharmaceutical developer GlaxoSmithKline (Glaxo). Glaxo was formed by 
the merger of a traditional British company, Glaxo Wellcome, and an American one, 
SmithKline Beecham, in 2000. Although Glaxo’s headquarters is officially in the UK, 
the French-born Chairman and CEO, Jean-Pierre Garnier, preferred to live in the US. 
When it became known that he was preparing to increase his pay and that of other top 
executives to be in line with American executive pay, quite a lot higher than is 
normally found in Europe, shareholders demanded a say in the decision. In mid-2003, 
the shareholders voted to defeat the proposed pay increases. Later that year, Garnier’s 
planned personal severance payout was cut in half by the board, from two years of 
salary to one year. Again, the decision was influenced by reasoning which called for 
severance to fall in line with general practice in the UK, rather than imitating higher 
US compensation terms.

The cross Atlantic pay debate surfaced as well in Germany, regarding former mobile 
telecommunications provider Mannesmann. The supervisory board of Mannesmann, 
granted the German executive managers over $50 million in bonuses following their 
capitulation to a full acquisition offer in 2000 by British headquartered Vodafone. In 
2003, a German government prosecutor indicted members of Mannesmann’s previous 
board, including Deutsche Bank chief, Josef Ackermann, claiming breach of duty for 
approving these apparently excessive compensation payments. The case was 
dismissed by the German court in 2004, but not without much embarrassment to the

directors involved. Moreover, prosecutors have appealed and the case was scheduled to be heard again in late 2005.\textsuperscript{14}

In 2002, almost two years after his retirement, Percy Barnevik, former Chairman of Swedish-Swiss conglomerate ABB, voluntarily agreed to cut his long-term pension compensation by about 60%, from an original $88 million (148 million Swiss Francs). His close associate and successor as CEO, Goran Lindahl, also agreed to pay back about 50% of the $51 million he had been granted. They made these gestures in the face of reported losses for 2002 of $691 million at ABB.\textsuperscript{15} The total amount they all together received for retirement, reported a few years later at a much higher $179 million, was so large in comparison with European standards that the Swiss government sought to prosecute both of them, but dropped the pursuit in late 2005.\textsuperscript{16}

In the US, Richard Grasso, former CEO of the not-for-profit NYSE originally agreed to reduce his 2003 $140 million compensation (some newspapers reported up to $187.5 million), but only after then chairman of the SEC, William Donaldson, himself former CEO of the NYSE, subpoenaed records for an investigation into Grasso’s pay package. Unfortunately, after he resigned his position at the NYSE, Grasso apparently changed his mind and sued to recapture the full compensation amounts from the NYSE. In mid-2005, the state of New York had sued Grasso for $100 million or more of excessive compensation and Grasso had sued the NYSE for $57 million he claimed was still owed to him, and neither case had been decided or settled.\textsuperscript{17}

Donald Carty of AMR Corp., parent of American Airlines, resigned his position in 2003 after it was finally disclosed publicly that special cash contributions were made to bolster executive retirement plans, unbeknownst to company union officials. At virtually the same time, employees had agreed to major cuts in their salaries, benefits, and pension plans to help save their jobs. Carty and his executives had used looming large losses at the airline to convince the workers that the company was nearing bankruptcy, and they had also promised that AMR managers were contributing to help the company out of it’s financial distress with cuts in their own compensation.

\textsuperscript{14} Scally (2005).
\textsuperscript{15} Europe Review World of Information (2003).
\textsuperscript{16} Mijuk (2005).
\textsuperscript{17} Gustin (2005).
Jack Welch, the much heralded leader of US General Electric (GE), agreed to reductions in previously undisclosed elements of his 2001 retirement agreement, which had him receiving many compensation and benefit elements he had held as a full-time chairman and CEO of the company. He also agreed to pay the company back for some of the items he had received. However, this only occurred after details of his private contract became issue of public debate from open legal filings of his divorce proceedings. In addition, soon after Welch’s departure, GE started to show evidence that it was not as strong a company as many had believed. The newly revealed GE situation was described in the following manner:

“Waking from the dreamy 1990s, investors discovered that GE was not, after all, a smooth earnings machine that pumped out profit growth of 16-18% a year, but a collection of mature industrial assets bolted to a fast-growing, opaque and highly-leveraged finance business…. the firm’s best days now looked to be behind it.”18

GE agreed in a settlement with the SEC in September of 2004 that in future disclosures it would not withhold details of retirement agreements like those that Welch was granted, but the company admitted no wrongdoing nor paid any fine.19

When excess pay becomes a public issue, should some substantial form of refund or post-grant reassessment be expected? There is no legal basis for reimbursement in most cases of poor performance by executives, only in cases of proven fraud or severe mismanagement and neglect. Most often shareholders must bring suit against the company itself, as well as its board, which does not penalize the executives themselves. Also, as the above examples illustrated, public opinion has not attained much measurable impact on voluntary agreements reducing long-term compensation.

The sharing of equity investment and risk by managers is a method for aligning the interests of managers and owners. It is expected to increase the benefits of bonding and reduce the effects of residual losses. Because managers may not have the wealth initially to make a direct investment, stock options have been argued to be an appropriate substitute for stock purchases. Therefore, stock options are only a derivative form of equity that is not fully comparable to employee stock purchase plans, where stock can be purchased by employees at a modest discount, or any other

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19 Stein (2004).
form of direct investment with a company matching benefit attached. Options are unique in granting the holder with upside profit potential, without downside risk of loss. Because of the normal volatility of stock prices and the general tendency of stocks to rise with inflation, holders of costless options can benefit through a pure profit in both the short-term and long-term without having to produce any corresponding favorable performance in company results.

Stock options pay off risklessly. The grantees (receivers) pay nothing for option rights. Instead, they can choose to exercise the options only after the stock price of their employer corporation has risen, providing a sure profit. If the stock price remains stable or even falls, managers do nothing and allow their options simply to expire. They often also choose to leave the under-performing company they managed to find a better stock option compensation deal where the company is already better positioned for appreciation of the stock price. Many executives who still oppose options expensing do so with the argument that there is no outlay of cash that the company must make in granting the options. However, this argument ignores that the owners are foregoing significant future rights to cash of a material value from dividends or capital gains. The company cannot sell the shares that are exercised at the higher future market price because the option holders hold a contract for the lower exercise price, which had been established at the option grant date, leaving less cash in the company for dividends to shareholders. Also, if there had been no options granted, then the owners would not face dilution of ownership that occurs from options being exercised. Their own shares would have a higher market value and potential for capital gains at sale of the shares.

In addition, riskless option compensation has not been enough for many executives. Leaving the company to find a better opportunity has also been too uncomfortable for them, despite their willingness to use firing, lay-offs, and early retirement plans to reduce employment numbers in their companies. Therefore creative stock option practices called reloading and repricing have been developed. Reloaded occurs simply once executives have exercised their options. Exercising involves simultaneously purchase of shares from the company at the exercise price and sale of the same shares in a stock exchange at market price, often at a great profit. Executives are actually not equity owners of these company shares, and they no longer hold any
options for future compensation. To keep these executives further incentivized, they *reload* by being granted a whole new set of options.

When the stock price of the company remains *under water*, i.e. below the exercise price of the options, for an extended period, executives present a case to the board of directors to allow for *repricing* of options. The corporation then “offers” to grant to the executives, for example, two of the new option shares at an exercise price reflecting the current market situation, in return for each set of three of the older options at the much higher original exercise price. The two for three trade is a legal requirement that allows the government to look the other way, allowing the transaction to slide through without a personal taxable event being recognized. Supposedly, by giving up every third option, the grantee has provided the grantor with valuable consideration in return for the consideration represented by the lower exercise price on the two-thirds of options replaced. Besides the tax issue, in most commercial legal systems, in general, no contract is considered valid without a reasonable and proper exchange of consideration between negotiating parties. Even when the price of the company’s shares has been dropping and owners have been losing a significant portion of their investment, repricing provides executives with a chance of exercising shares at a deep bottom discount and selling them for a large profit even when the price of the shares never returns to the value that the owners paid outright for their shares.

The FASB, under significant pressure from the management lobby, more than once decided against updating accounting standards to require the expensing of stock options. Options have had no impact on company profits, and managers continued to see them as costless to the organization. Therefore, their personal conflicts of interest were potentially indulged further by the significant additional wealth they could gain with a personally riskless instrument. Moreover, they received this benefit without any countering monitoring influence that this personal wealth is derived at a substantial cost to their businesses. In late 2004, the FASB finally realized that its solution to have the estimated financial impact of options included in annual disclosures was only a weak partial remedy. These disclosures rarely entered into the many disclosures and discussions from quarter to quarter of earnings forecasts and estimates, reported results, and analysis of differences. Starting finally with 2005, direct expensing of the value of options granted in US corporations will help resolve the lack of transparency of this compensation element, and help to balance the cost of
options issued to management against the benefits they produce for shareholders and other stakeholders.

Interestingly, Sundaramurthy and Lewis cited an article by Stulz that showed management’s “extensive stock ownership widens the risk differential” between them and their shareholders. The higher their personal investment stakes are the more managers are conservative.20 This would be especially true where managers have a much higher percentage of potential for their own personal wealth tied up in the company than the typical shareholder does. In comparison to options that could provide managers with more wealth than any other income source, the majority of shares in public corporations are held by institutions that, as a rule, remain as minority investors in companies and investing only a small percentage of their total available funds in any one corporation. They avoid concentrating high percentages of fund capital in single investments.

Portfolio theory, distributing financial capital fairly widely over a diversified selection of investments, is a well-documented and accepted risk-reduction strategy for institutions and individuals alike. It appears from Stulz’ research, therefore, that a high percentage of an individual manager’s wealth being tied up in minority interest of the firm where they are employed, may misalign interests of managers and shareholders. A high personal investment of management’s wealth does not necessarily bring about the same benefits for governance as majority ownership of a firm by management, such as in a family owned business.

Executive stock options are the right to profit from the increase in the stock price without any investment outlay by the option holder. In fact, because incentive options shield executives from any downside losses from a lower stock price, they can actually widen the risk differential between management and shareholders. Options are not ownership, so they do not provide any of the prescriptive control benefits of executive stock ownership found in the research literature and outlined by Sundaramurthy and Lewis. Options can also only provide imperfect prescriptive collaboration benefits, those that accrue from participating only in the up-side of stock price movement. True executive stock ownership aligns the parties through the ups, downs, and sideways performance of the company and of the financial markets. Options form a separate

equity class, which in its key aspects of risk and return are not aligned with other investor classes. In this way options can contribute further to widening the separation issue of agency theory, which does not promote bonding between managers and shareholders.

There is finally now more discussion about whether or not stock options are a very good vehicle for aligning management interests with those of the shareholders. Some companies, such as Microsoft, have announced a reduction in the number of shares and the number of employees that will be receiving options as part of their compensation. Many companies are looking more closely at how many option shares they are granting to their CEO’s and other executives. However, perhaps the best indication remaining of a detrimental preoccupation with stock price as the key indicator of management performance is evidenced by its institutionalization in SEC reporting requirements. An example from Pfizer, Inc.’s Notice of Annual Meeting of Shareholders and Proxy Statement March 14, 2002 of this type of disclosure is shown in Figure 5-3 below.

Financial results are most valuable when placed against benchmarks. The key financial statements provide comparisons to prior periods of the company’s results, not to any industry or competitive averages. But during the stock market run-up of the 1990’s, this new manner of disclosure standard for the company’s share price was added in the US. The performance of the company’s shares had to be reported in comparison to the overall market index, often the S&P 500, and to another index chosen by the company as indicative of its industry segment. Curiously, there is no similar requirement for competitive benchmark reporting for any standard financial statement accounts prepared based on US GAAP, nor even for other financial market indices such as company bond ratings or interest rates.

Excessive total compensation granted to top executives, one very small segment of the population, is economically unsound. A skewed wealth distribution prejudices the market economy’s allocation of investments for the future, which hurts business prospects and performance. It also is similarly detrimental to corporate governance, because it bolsters and justifies executive conflicts of interest. It induces managers’ tendency to erect the transparency barrier by strengthening the underlying foundation that conflicts of interest represent.
5.3.4 External Auditors and the Recurring Expectations Gap

In the 1970’s, in response to US Congressional inquiries into the accounting profession following bankruptcy-related scandals, awareness of a serious credibility problem was elevated within the community of auditing professionals. The Commission on Auditors’ Responsibilities led by then SEC Commissioner Manual F. Cohen was formed in 1974 to investigate potential causes. The Cohen Commission’s
1978 report identified the problem of an “Expectations Gap” between external auditors and the users of financial statements.\(^{21}\)

Investors and the general public had come to believe that an audit opinion was a final say about the quality of investment, and a confirmation that the financial statements were correct. While auditors understood that they could be misled in their audits by unethical, fraudulent, or error-prone activities of management, they also firmly held their opinion that they were not giving any investment advice by issuing their opinions. Therefore, the audit opinion letters they wrote made it clear that management prepares the financial statements, and that although they do a thorough job and follow audit standards, auditors are not reproducing the financial statement preparation process. In other words, even though they may give their best efforts, auditors can still be misled by management, and they can still make errors in their audits.

In the 2002 U.S. Senate hearings on Enron and WorldCom, it was very clear from the line of questioning of the senators to the audit firm partners called before them that the expectations gap still existed, even in such prominent places. The senators were incredulous and dismayed by the answers of the partners of the firm, Arthur Andersen, who had audited both Enron and WorldCom. The partners simply stated what they thought everyone should understand, that auditors are not responsible for the financial statements of the companies they audit.

The senators, as well, seemed to not have been aware of the content of the annual reports of US public corporations. The audit opinion letter from the external accountants was always accompanied by a formal letter signed by the CEO and CFO of the company. In the latter letter, management alone clearly accepts responsibility for the content of the financial statements. Unfortunately, for Arthur Andersen, which had been the world’s largest as well as one of the oldest and most respected audit firms, the bad publicity resulting from these two disastrous client situations led to the firm’s demise. As illustrated by the following Case Review 5-3, Andersen’s partners also appear not to have understood the risk and potential ramifications of the expectations gap.

Case Review 5-3  Andersen’s and Enron’s Intransparence

Enron’s auditors, Arthur Andersen, appear to have fully understood that they were hired by management, and that management’s interests trumped those of the board of directors. Andersen partners were able to show through meeting memorandums that they had clearly presented to audit committee members that many of the questionable accounting practices were “high risk”, “pushing the limits”, and “at the edge” of acceptability. Disagreeing strongly with this conclusion, the members of the audit committee claimed that the high risk practices were consistently presented by Andersen as highly “complex”, “innovative”, and “leading edge”, and that the auditors confirmed that Andersen was in agreement with management’s accounting practices.

Worldwide engagement partner David Duncan’s own handwritten notes from a February 7, 1999 Enron Audit Committee meeting discussing the 1998 financial statements stated that Andersen was “obviously … on board with all of these” accounting practices.

Additionally, even though Andersen claimed no fault in the matter in 2002 because they had serious misgivings about Enron’s practices, in a marketing oriented 2001 white paper it had high praises for Enron. It presented Enron prominently as the leading benchmark for other firms interested in creating value in the new economy. On the lead page of the white paper, the authors, four Andersen partners, stated:

“In a business world battered by ever-greater competitive pressures and economic uncertainties, savvy managers today know all too well that they must squeeze advantage from every asset within their grasp.

A prime example of a company that has successfully followed that path is Enron Corp., a $52-billion energy and communications company based in Houston, Texas. Over the last decade, Enron has continually changed the proportions and combinations of the assets in which it is invested. In the process, it has reaped rich rewards and high praise. Indeed, Fortune magazine describes Enron as the most innovative large company in the United States.”

In the end, although the board must carry much of the responsibility for what happened, the board members rightly felt severely let down by the auditors. Instead of

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making clearly transparent warnings that they were not in favor of management’s questionable accounting practices, the auditors seemingly used their meetings with Enron’s audit committee to extract the committee’s official approval in order to protect Andersen from liability. This type of behavior from auditors cannot be simply explained away by the expectations gap. Rather, it could be explained by the high fees for consulting services, which in 1999 were $27 million and exceeded their audit fees of $25 million for the year. At least $7 million was even earned by Andersen for helping Enron’s chief financial officer, Andrew Fastow, set up highly irregular special purpose entities that were later used to hide significant company liabilities.

In response to these and other apparent audit failures, Sarbanes-Oxley has established new registration, inspection, and investigation requirements for external accounting firms and a new bureaucratic authority appointed by and reporting to the SEC, the Public Company Accounting Oversight Board, over these processes. The PCAOB is also directed “to establish, or adopt, by rule, ‘auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for issuers.’” Sarbanes-Oxley sets new requirements for auditor independence that, fairly extensively, limit the non-audit consulting work that accounting firms are allowed to do when they are already engaged for audit work. Most importantly, the auditors must now be engaged directly by the audit committee, and they must report first and foremost to the audit committee, not to management. These actions are directed at reforming the auditing community to root out conflicts of interest that have crept into the system.

Accountants let their own conflicts of interest interfere with their central recognized purpose – the audit function. The American Institute of Certified Public Accountants and Canadian Institute of Chartered Accountants (CICA), which greatly influence all of the major accounting firms’ practices globally, clearly supported information supplied to their members in the 1990’s that “auditing is no longer a growth industry.” The three main identified conditions, or “causes”, emerged from a focus only on the 30 largest US and Canadian corporations as potential audit clients:

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1. whose demand for audit services had flattened,
2. who lent themselves to efficiencies in standard audit practices from development and implementation of new ICT, and
3. who pressured audit firms to lower fees.

The institutes also confirmed that firms had reacted to these developments by competing more strongly on price with each other in this market segment.\(^{28}\)

The reaction of the accounting firms to these conditions appears to be the most logical cause for the commoditization of the audit. The top 30 corporations is, after all, a rather limited market segment. There is great economic evidence that the number of venture backed companies at that time were expanding greatly.\(^{29}\) Their ultimate goal of achieving a successful IPO provides a new captive source of demand for legally required audit services as an SEC qualification for the offering. Small, medium, and even large sized enterprises, as a rule, experience faster growth rates than the, on average, more mature group of *extra large* companies that makes up the top 30. Mature businesses naturally direct their attention to cost savings, i.e. lower negotiated audit fees, for bottom-line impact when the top-line, revenues, flattens out.

The AICPA Special Committee on Assurance Services did “make suggestions to maintain and strengthen the audit” and observed that accounting firms’ credibility rested, above all else, on the quality of the audits performed. However, again, the strengthening of the audit was not presented as a pursuable end in itself, whose purpose was to reclaim audit as a profitable, value-add service. Instead, the purpose for bolstering the audit was for accounting firms to enjoy “market permissions” which would provide entry and access to a broader offering of lucrative assurance services. The tone coming from the AICPA and CICA was clear that accounting industry faced a rather severe financial future if the profession did not modernize itself as a provider of these broader information-oriented services.\(^{30}\)

As is illustrated in more detail in Chapter 12, auditors are still allowed to provide consulting services consisting of alternative reporting methods, often called Value Based Reporting. There is nothing apparently wrong with this on the surface. The

\(^{28}\) Elliott (1998).

\(^{29}\) Gompers & Lerner (1999).

field of management accounting, consisting of a higher detail understanding of the internal workings of the organization, provides very valuable tools for management decision making. However, these new proprietary methods are all too often presented by the outside auditors as alternatives to the official accounting reports disclosed by law to external investors and the general public. In addition, to sell these alternative methods, the audit firms have not withheld serious criticism of the adequacy and relevance of the official financial statements in their clients’ annual reports. The fact is that they have allowed their conflicts of interest created by seeking more consulting fees, to drive them to belittle the financial statements that they audit and approve as well as the underlying accounting standards that they themselves establish.

5.4 Leading and Supporting Monitoring and Bonding Activities

The actors in the corporate governance system on which the audit committee must rely appear to be suffering from a condition that can be termed as anti-disciplinary bias. Monitoring can be a difficult, unpopular, and uncomfortable role to fill for anyone, including directors, executives, external accountants, and internal accountants and auditors. Monitoring often, but not always, involves criticism in situations where a counterbalancing solution to the problem may not be immediately evident. When identifying such problems, in many business cultures, unfortunately, a person may be unfairly negatively identified with the causes of the problem. Worse, the person can be branded as disloyal to the organization for raising a critical voice. This is especially curious when considering that the key activity that identifies someone as a manager is decision making, and the first step in any decision making process is the proper identification of the problem. All governance roles carry monitoring responsibilities, but if their warning signs are suppressed, they provide a falsely positive sense of control.

The internal finance and accounting area, which encompasses the internal auditors, first must reassess its responsibilities. The characterization of the CFO as partner or policeman is not a fair representation of the multidimensional personality of this key role in the organization. There is no need to polarize the required functions by popularizing strategic partnership, while belittling disciplinary monitoring. A true environment of control secures a stable platform for strategy implementation. Poor strategy is rarely blamed for faulty control systems, but bad controls can sink
companies whose strategies would normally succeed. Early detection of problems, variances, and exceptions can be the first step leading to significant value in efficiency and effectiveness of the internal operational functions of the company.

Company executives and external auditors also must face their own conflicts of interests, which distort their independent viewpoints. The board, generally, and audit committee, specifically, must root out and redirect the misplaced compensation and incentive systems that reward counterproductive behavior from these groups. It is not the prerogative of the disciplinary factors to seek a favorable impression from management. Rather they are expected to provide a management oversight function that underscores the responsibility of monitoring.

Bonding is an activity where management seeks to earn the trust of its shareholders through a transparent and proactive program of communication efforts directed at the board of directors, the shareholders’ directly elected supervisory representatives. Bonding activities may be initiated from management, but bonding should be motivated and controlled by the board of directors. Bonding has the advantage over monitoring in that it can proactively establish an overall organizational environment that fosters internal controls. Bonding cannot replace monitoring, however, just as the motivation of strategic vision and goals must be accompanied by measurement of results against those objectives for the organization. The concept of bonding is greatly misconstrued when it involves board members, internal finance and accounting staff, internal auditors, and external accountants pursuing the favor and attention of corporate management. The audit committee can actively use the MSI process to promote and maintain the proper attitudes towards and balance of monitoring and bonding activities.

5.5 Audit Committee Performance Evaluation

The greatest right that the audit committee possesses is to an appraisal of its members’ performance that is fair and constructive, providing committee directors with personal benefits of both motivation and growth, and serving as an objective basis for their financial compensation. Where special qualifications are required which limit the pool of talent capable of fulfilling expectations for the director’s position, special considerations for compensation can be reasonably expected. These rewards are very important intrinsic factors for developing loyalty and renewing commitment to their
office. Although it is important for their administrative effectiveness, it is unreasonable and nearly irrelevant to evaluate directors’ performance by applying any simple measures such as tracking the number of projects assigned and completed or the hours of labor scheduled and served. After all, the board is responsible for the overall performance of the corporation. The actual results achieved by the organization will need to be measured against the reasonable expectations for that performance. In normal situations, this is determined primarily by the corporation generating profitable results and maintaining solvency. In extreme cases, good performance can involve minimizing losses in an unprofitable period for the firm and industry or can even require leading the orderly dissolution of the firm.

Audit committee members cannot reasonably and effectively fulfill their constitutional responsibility unless they are granted and favored with additional constitutional rights that squarely and clearly subject management to the committee’s direct requests and recommendations. As the Treadway Commission points out, “Audit Committees should have adequate resources and authority to discharge their responsibilities.”31 Just as importantly, as the OECD defines it, the committee also has an overriding right to disclosure from management of accurate and adequate sources of information regarding important events and environmental changes of a material impact to the firm’s performance now and into the future, whether or not that information has been directly requested.32 In addition, as mentioned earlier in Chapter 4, the 1998 Blue Ribbon Committee ranks the audit committee as the first among equals, when compared to the external accountants and the internal auditors, in the process of oversight over the preparation and presentation of the company’s financial results to the public.

The Treadway Commission originally claimed,

“All Audit Committees should be informed, vigilant, and effective overseers of the financial reporting process and the company’s internal controls.”33

But a few years later its own “Internal Control — Integrated Framework Executive Summary”, which remains as one of the most accepted advisory guidelines for internal

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auditors and accountants, fails to even mention the audit committee. Is it correct that the audit committee is treated as an afterthought? To the contrary, agency assurance seeks to establish rights for the audit committee, which puts it in the center of the critical process of verifying, validating, and vetting crucial management-supplied information.

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34 COSO (1994-2).
CHAPTER 6.

Constitution – The Imperfect Authority of Institutional Investors

6.1 Institutional Ownership and Majority Control

6.1.1 Investor Anonymity in Agency Theory

In the wake of the 1929 stock market crash, Berle and Means warned of the continued risk of expropriation of assets and other resources by managers of corporations. Ownership in shares had become so diffuse as to be anonymous. Oversight of management actions was often neglected by distant minority shareholders. As defined earlier, these ideas have been termed *agency theory* to identify the separation of ownership from control, which is inherent and inseparable from the modern corporate form. The US securities laws enacted soon thereafter formalized the duties and responsibilities of directors, managers, auditors, and the government in protecting the rights of shareholders.¹

The separation of ownership from control identified by agency theory places the board of directors in the center of the corporate governance system. The management team holds internal authority over all human, physical, and intangible firm resources. The investors are widely dispersed geographically, often without relation to the location of the firm’s facilities, without knowledge of the firm’s day-to-day decisions and activities, and without access to the firm’s employees and financial assets. The board is expected to bridge the distance between these managers and their apparently anonymous shareholders.

6.1.2 Institutional Fund Managers – an Apparent Agency Remedy

A number of researchers have observed that the growth of ownership levels of institutional investors may have created an opportunity for investors themselves to reassert direct supervision over management.² Institutions that pool funds for investment from individuals, businesses, and not-for-profit organizations, include stock and bond mutual funds (also known as unit trusts in the UK), insurance

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² Bricker & Chandar (2000); Firstenberg & Malkiel (1994), p. 29; and Johnson, et al. (1996), pp. 414-416. All three sources discuss this concept and cite the work of many other researchers in this area.
companies, and private and public pension funds. Institutions now own about half of all shares in US public corporations. This has led to some hopes and predictions that institutions will cooperate to use their combined majority or near majority ownership influence to initiate collective action among themselves and other individual shareholders to bridge the gap between ownership and control.

In this chapter, high profile examples are presented which show that some of the institutions have, to this end, taken the lead and asserted their relatively large ownership positions, to not only influence the company’s strategic financial decisions for shareholders, but also its social and environmental consciousness. The free rider dilemma, however, can reduce the incentive for involvement, which mitigates to some extent the effectiveness of institutions to cooperate. Of course, rational differences and disagreements in key areas of investor interest between any single institution and other investors can also preclude many cooperative efforts. Such non-converging interests include differing perspectives for short-term vs. long-term investment potential, varied choices and values in strategic direction, and differences in leadership philosophy, among others.

6.1.3 Involved and Informed (Active) Investors

John Pound uses the term “managed corporation”\(^3\) to describe the organization form that has come to dominate the scene since Berle and Means time. Pound shows that despite the securities laws, senior managers still are making most strategic and key operational decisions while delegating responsibility for implementation down through rigid hierarchical management layers. The board is not involved in choices other than to evaluate the performance of management retrospectively, and in extreme cases, replace the CEO once confidence is lost irrevocably. In this setting, shareholders are so widely diffused, that their involvement is severely limited in practice, to confirming board members to new terms of office, and only in extremely rare situations, removing ineffective directors. This describes the typical corporation, especially large multinationals, in operation throughout most of the 20th century.\(^4\)

In contrast, Pound outlines his vision of the balanced approach of the “governed corporation” where managers and directors act collaboratively. The focus of this

\(^3\) Pound (1995).
model is joint responsibility for decision-making. The board is actively engaged in making suggestions and reviewing all critical proposals with a forward-looking view. As pointed out in the previous chapters, this certainly puts more pressure on board members, requiring a higher level of commitment in time and higher expectations of expertise. In return, they should expect to receive access to free flow of information, not only from management, but also directly from customers and employees. They should also expect to benefit from a richer package of performance-oriented compensation incentives.

The managers and directors are spurred on by active shareholders, represented in form by large institutions more generally interested in becoming involved and lobbying for substantive changes with longer-term impact on firm value. Pension funds, the prime examples being the California Public Employees Retirement System (CalPERS) and the State of Wisconsin Investment Board (SWIB), mutual funds, and insurance firms have embraced investment in shares over the same time period. Over the past two to three decades, that they have accumulated a significant portion of savings for individuals. These savings result from the wealth generated by corporations during a sustained period of economic expansion and are, in turn, being reinvested in this sector. By 1998, these institutional “New Owners” had amassed over 60% of the shares of the largest public corporations in the US and the UK. This was an increase of about 10% over the level measured just six years earlier in the US.

The yellow line in Figure 6-1 below shows that among the S&P 500, combined ownership of all investing institutionsCombine to form a simple majority of common shareholders, greater than 50% ownership, in almost all of the firms. This implies, as Pound and others may be correct, that purposeful cooperation between institutional investors has the potential to lead to controlling interest among them. Interestingly, where institutional ownership is particularly low appears to be in high risk firms. Among the population represented in Figure 6.1, two particularly unpopular firms, Enron and WorldCom, had zero or near zero percentage ownership from institutional investors.

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This new structure with a higher concentration of ownership in percentage terms controlled by institutions is defined by Bricker and Chandar as a two-tier agency structure. In contrast to the agency theory of Berle and Means, the investment manager with his own responsibilities as an agent is inserted between the investors and firm managers. Fortunately, in support of Pound’s concept of the governed corporation, the new research also highlights that:

“Today funds are increasingly forced into being ‘proprietors’ rather than ‘punters’. ”

In addition, the US Securities and Exchange Commission also recognized the development of influence by institutions in financial markets. The commission was concerned about asymmetry of information – especially the privileged access to firm managers that investment managers and their analysts were receiving in private conferences. The SEC enacted regulation FD, for “fair disclosure”, in October of 2000, which required firms to follow public disclosure rules simultaneous to any private disclosure of material information.

6.1.4 Individual Shareholder and Institution Separation

The development over the years of higher institutional ownership concentration in the financial markets should not be confused with a reversal of dispersion in ownership. In fact, dispersion has increased as more and more individuals have almost

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8 Weber (2000).
continuously entered into the equity markets, both directly as individual shareholders and indirectly as holders of shares in pension plans, mutual funds, and life insurance policies. And the number of these investment vehicles as well as the number of institutions offering them to the public has also increased significantly. Diffusion, the grammatical opposite of concentration, implies a greater overall volume with elements spread evenly over the larger space. For example, planets in a galaxy are generally disperse, but because they tend towards clustering in solar systems, they are not diffuse. In a similar manner, dispersion among investors does not guarantee diffusion. Although dispersion coincides with a larger volume, as in the total number of shareholders, it still allows for areas of concentration of elements, as in majority ownership clustering among institutional investors.

Figure 6.1 showed that because ownership is disperse, no single institution or individual owns a measurably influential block of equity. Dispersion contributes to the “free-rider” dilemma for the individual and institutional shareholders. Although institutions in total dominate the investment scene, it takes many of them to create a controlling interest. The red line shows that even when the shares of the top ten investing institutions are added together, they still do not add up to more than half of the common shares outstanding in the vast majority of S&P 500 firms. In addition, the black line shows that in almost all firms, no single institution owns as much as 15%, while Figure 6-2 below shows that most institutions own less than 10% of any one firm’s shares.

**Figure 6-2. Top 1 Institution - % Ownership**

Source: Own representation. Core data extracted from Multex website.

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It is very costly to become involved directly in company governance. Dispersion does not allow for a fair allocation of these costs across a wide percentage of the shareholders, which acts a competitive disincentive to investment managers who might bear these costs. Bonding requires proximity in physical, intellectual, and emotional dimensions. The personal time associated with these activities is not only a straight cost calculation of the days spent, they also present clear opportunity costs for institutions. Investors fear they could become distracted away from opportunistic chances of investments only available if the keep their focus on trading in the financial markets. Direct monitoring employs expensive analyst resources, subjects the investor to insider information trading blackout periods, and increases risks if information is improperly acted upon or leaked to outsiders. This recognition is further “proof” of the problem that asymmetry of information poses for disclosure fairness. The resulting loss of liquidity could restrict the investor’s freedom to buy or sell the company’s securities at opportune times in the general market as well as to line up cash quickly to make moves in the market to purchase other companies’ securities.

In addition, active monitoring could be equated with a concept that Albert O. Hirschman defined as “voice” while simply selling shares could be called “exit”\textsuperscript{10}. Hirschman convincingly theorized on the impact that “loyalty” plays in combination as follows:

> “... the presence of the exit option can sharply reduce the probability that the voice option will be taken up widely and effectively. Exit was shown to drive out voice.... Clearly the presence of loyalty makes exit less likely.... the likelihood of voice increases with the degree of loyalty.”\textsuperscript{11}

Further, because stocks that trade in markets that are more liquid than others are tend to earn higher returns through higher valuations, institutions are also incentivized to trade-off control for liquidity.\textsuperscript{12} Finally, investment professionals are most comfortable with the concept of portfolio theory, which shows that the overall risk of a basket of investments is lower than the sum of weighted risks from each of the investments. In commenting on this theory, Eugene Fama stated:

\textsuperscript{11} Hirschman (1970), pp. 76-77.
\textsuperscript{12} Becht (1999).
“efficient allocation of risk bearing seems to imply a large degree of separation of security ownership from control of a firm.”\textsuperscript{13}

This investment management approach is an anonymous and costless method for risk management in comparison to high cost direct monitoring.

Due to these recognized structural issues in the separation framework, investors can easily become free riders who avoid the costs of active supervision, and who expect other investors to bear the costs and do the work. If no investors pick up these responsibilities, then all shareholders still can hope for the governance mechanisms that Jensen outlined, including capital (financial) markets, legal systems, commercial markets, and the board of directors. This is why securities markets, institutional investor and financial advisor associations, lawmakers and regulators like the SEC, as well as voluntary principles of corporate governance increasingly direct fund managers, the leaders in institutions, to exert oversight on invested companies on behalf of the fund investors they represent. This contemporary structure of the equity markets has therefore the potential to meet the three requirements according to Marco Becht for the “ideal situation” for corporate governance:

1. concentrated voting power which coincides with more active monitoring,

2. concentration which does not come at the expense of liquidity (dispersion), and

3. concentrated voters (institutions) with incentives to exert governance influence.\textsuperscript{14}

Unfortunately, because of structural issues, actual situations in the corporate governance system have rarely approached the ideal, and in the case of institutional investors, it is no exception.

6.1.5 Conflicts of Interest and Activism

On deeper investigation of the governance system structure, a number of conflicts of interest issues arise that may mitigate the influence effectiveness of institutional investors in the internal control system. Many of the financial institutions are to some extent dependent on commercial relationships with the companies as investment

\textsuperscript{13} Fama (1980), p. 291.
\textsuperscript{14} Becht (1999), p. 1072.
advisors or service providers and vendors, therefore they hold conflicts of interest that tie them to management. Investment funds are often formed by banks and finance companies that, in parallel, have investment banking divisions advising the corporations in which they invest. They offer services in support of mergers and acquisitions and stock and bond offering placements in the financial markets. Insurance companies also depend on corporate clients as a major source of revenue from all types of life, property, and casualty policies. Even most private pension fund companies are selected by the benefits managers of corporations with approval from their bosses, the company executives.

Institutional supervision as a concept is also less acceptable when fund managers are granted a potentially unfair advantage in control and authority over the interests of other shareholders. In many countries, complicated equity structures are employed by corporations that grant extra weighted voting power to minority classes of shares. Instead of a one-share/one-vote allocation to all shareholders, privileged investor classes are granted special voting rights, which allow them to form blockholdings that are not proportionally representative of share ownership. Figure 6-3 below presents measurements of this phenomenon in a sampling of European countries.

**Figure 6–3. Institutional Influence in Europe**


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The chart shows compellingly that corporations in many of the most developed nations in Europe still embrace equity ownership systems that distribute voting rights in an unequal manner.

Public pension funds should be in the singular position to maintain their independence from management pressures by avoiding the trap of conflicts of interest that too often snare the managers of other classes of funds. These funds have virtually no other constituency to serve than the state and local government employees whose retirement funds they manage. Some very large funds have emerged in the last decade as leading activists for change in corporate missions and objectives. For example, the pension funds for the New York City Teachers and the New York City Employees have been leaders in sponsoring proposals for shareholder vote at annual meetings and proxies.17

Perhaps even more influential than these two New York City pension funds has been CalPERS, the California state public employees retirement system. CalPERS has not only sought to influence the specific corporations in which its managers have invested, it also lobbies and educates other fund managers as well as all other classes of financial market investors, corporate directors, and key executives to show greater interest in corporate governance. But while CalPERS management is a sector highlight in its pursuits on behalf of its investors, the city of Philadelphia’s pension fund may be providing a quite opposite lowlight example in the sector (see Case Review 6-1 below for a comparative view). Philadelphia’s pension fund is being probed in early 2004 by the U.S. Federal Bureau of Investigation (FBI) for allegedly letting local political conflicts of interest influence the selection of fund management companies as service providers to the city.

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**Case Review 6-1. The Good and Bad of Public Pension Fund Management**

CalPERS manages approximately $175 billion in retirement investments for the current and former employees of the state of California. The President of its Board of Administrators, Bill Crist, has been quoted as saying “’At CalPERS we believe very strongly that we do have a responsibility as a shareholder. And that to be a responsible owner we have to participate, and that to participate we need to be informed.’”18

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one indicator of its commitment to this philosophy, CalPERS helped to found the International Corporate Governance Network in 1995.

The ICGN brings together some of the world’s largest and most active institutional investors and investment industry advisory groups as a common force of influence to the behavior of corporate management, board of directors, and other stakeholders. At its annual meeting in Frankfurt in 1999, held just a few months after the OECD published its Principles of Corporate Governance, the ICGN released complementary criteria, distilled into the ten main points listed in Appendix 1, to motivate and guide the world’s corporations in adopting the OECD principles. CalPERS motivation for cooperating with other investors in raising business accountability levels was captured in another statement from Bill Crist. “We believe that corporate governance adds value. It’s difficult to measure precisely in terms of the bottom line, but we think it makes a significant difference to our return in the long run, so we are committed to engaging in this effort to improve corporate governance at companies in our portfolios around the world.”

In contrast to CalPERS approach, as reported in The Philadelphia Inquirer, the $4.1 billion Philadelphia Pension Fund employs fund management companies with some motivations which appear to stray far from good corporate governance practices. At the center of an FBI investigation in 2004 was an election campaign fund-raiser and close friend of Philadelphia’s mayor who also lobbied on behalf of fund management firms. Some of those firms made donations and were allocated funds to invest despite apparently unfavorable prior performance backgrounds. One firm, Keystone Venture Capital, gave donations to the mayor’s campaign and received $5 million more to invest in 1999 even though it was being investigated for corruption in another state. Also, two firms that were managing $101 million for the Philadelphia Pension Fund, were at least partly owned by a partner to White in third investment firm (though this firm did not invest any money for the city). An attorney to one of these lead advisors argued against the administrative burden of proposed disclosure requirements in a letter stating, “It is not illegal – and in fact it is common – for …[fund management]

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firms to be solicited for political contributions, sponsorships and donations by city employees, board members and others with connections to the system.”20

The root cause of their political conflicts of interest most likely lies in the fact that U.S. pension fund companies acting as paid managers of public fund investments and advisors to government officials are not barred by law from making political donations. The decisions and activities of the board of trustees (or board of administration) of a pension fund, which has a similar role to that of the board of directors of corporations, are subject to the U.S. Employee Retirement Income Security Act (ERISA). Still, the influence from politicians and their cronies and patrons on trustees is a conflict of interest that is fairly widespread, and even known as “pay to play”. The financial industry has not itself closed this loophole through self-regulation of this activity. On the contrary, the financial sector successfully discouraged a 1999 SEC regulatory initiative directed at halting this practice. The U.S. Congress, politicians all, also joined in supporting the fund managers position defeating this initiative, despite the existence of a similar legal ban on contributions to politicians by investment banks who underwrite and advise state and local governments on offering and issuing of bonds.21

While institutional investors account for about half of the equity of corporations, they are responsible for a substantially higher majority of trading activity, that is the buying and selling of shares. This may imply a tendency of fund managers to have a short or medium term outlook for most of their share investments, rather than the long-term involvement that is more desirable from a corporate governance perspective. Even public pension fund managers must be prepared to sell shares when a company turnaround is expected to require a long-term commitment because it has been generally interpreted that these sales are legally required of them as a fiduciary responsibility under ERISA.22

Fund managers have been severely criticized and reprimanded for their poor record in failing to take advantage of their right to vote at shareholder proposals. New regulations and industry association rules have been enacted to require them to report when they have voted and, in addition, to explain why, when they did not vote. Most

recently in 2003, the SEC adopted a rule requiring mutual funds to disclose how they voted share proxies when such information is requested by their fund investors.\textsuperscript{23}

Although these initiatives may appear to force fund managers into a more active supervisory position, it simply holds them to a low minimum standard of accountability. The passive activity of voting on proposals placed before all shareholders is not taxing and is rarely the center of controversy. The new requirement simply serves as a reminder to them to avoid the embarrassment that arose when their disinterest in the operations of the firms whose equity they held in their funds was exposed. Taking initiative by actively raising issues of substance, drafting new proposals for debate, recruiting other shareholders in lobbying management, etc. remain voluntary legally.

In addition, in 2003 and 2004 mutual fund managers achieved undesired limelight through a widespread multi-billion dollar scandal of their own. Although at times illegal and always unfair, the practice of “market timing” (see Case Review 6-2 below) has been employed by many fund managers at firms of all sizes. The beneficiaries of this practice were their largest customers – usually fund managers from other segments of the financial services and investment industry. Although the majority of mutual fund investments can be found in the US, the scandal has encompassed some of the world’s largest and most respected firms. Putnam Investments, Strong Financial, and Janus Capital, to name just a few, experienced the resignation of their leading executives within months after the scandal was exposed publicly, while CalPERS had removed Putnam as one of its fund managers.\textsuperscript{24}

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**Case Review 6-2. Conflicts of Interest for Mutual Fund Managers**

Mutual funds are made up of a portfolio of investments, most often publicly traded stocks and bonds. Prices of these individual securities are changing almost constantly as they are traded in exchanges. If a stock is listed, for example, on the New York Stock Exchange, trading stops at 4:00PM in the afternoon on a weekday and starts up again at 9:00AM on the following weekday, excluding certain national holidays. Mutual funds use the final posted price of the day, which is the same price published

\textsuperscript{22} Firstenberg & Malkiel (1994), p. 29.
\textsuperscript{23} The Philadelphia Inquirer (2003).
\textsuperscript{24} The Economist (2003-10).
in newspaper stock listings the world over, in calculating and reporting the overall value of their funds for that day. Corporations regularly wait until trading has halted for the day, once the market closes, to make material announcements affecting their business operations and financial results.

When mutual fund managers allow favored customers to buy or sell at the end of the day price after 4:00PM when the exchange has closed, a practice called “market timing”, these customers are able to act upon the material information disclosed by the companies before fund prices adjust to that information when the markets open the following day. In fact, because after hours trading now occurs outside of the exchanges and prices of these trades are posted real-time in public places like the internet and other proprietary financial news services, these favored customers can trade the mutual funds with a fairly accurate idea of the impact of newly released information on prices of the funds underlying investments.

The relatively small changes in prices of thousands of individual stocks and bonds when accounted for on a daily basis have already been documented to add up to billions of dollars of additional profits for these favored large investors and many hundreds of millions of additional fees and bonuses for their investment managers. Mutual fund managers themselves benefited from this arrangement because they earned substantial additional commissions and administrative fees on the transactions. All of these gains come at the expense of the average individual investor in the mutual funds who is never allowed to trade their fund shares after hours.

The largely favored customers of mutual fund managers have most often been their counterpart hedge fund managers. Hedge funds are highly specialized investment vehicles established to attempt to increase fund portfolio returns by reducing market volatility risk. They openly promoted their proprietary development of highly technical, mathematical predictive models that match select securities in their portfolios to complementary derivatives of these securities. The derivatives they purchase are mostly options to sell the same individual securities in the future at preset prices. Hedge fund managers can also purchase options to buy specific securities in the future while simultaneously short selling these securities, agreeing to sell them at a preset price in the future.
While direct purchases and short sales of securities will almost definitely lead to profits or losses, options are only exercised if the results are favorable. When options have been purchased that are able to be exercised, they can add to profits or reduce losses from related direct purchases and short sales on securities they previously made. This group of funds gets its name from this “hedge” element.

Needless to say, the selection of the correct underlying securities and derivatives is not an uncomplicated nor a riskless task. Options themselves have their own prices which must be paid by the hedge funds, and these costs cannot be recovered by the managers whether or not options are not exercised which cannot be recovered or reduce losses on those transactions. These advertised activities are far more speculative for managers of hedge funds than the silent “sure thing” market timing transactions they were so often allowed to make by their allies at mutual funds. These additional profits not only inflated the performance of hedge funds but also created a false impression of the effectiveness of the technical hedging models in the industry.

New industry regulations are expected to be adopted to address market timing and other related abuses in 2004. Eliot Spitzer, the attorney general of New York state, as well as officials from other U.S. states and other nations in Europe and Asia have been prosecuting a large number of mutual fund firms and some of their managers criminally for laws that are alleged to have been broken (see Case Review 6-3 below for one transnational example). Spitzer was already the leader in prosecuting the largest widespread scandal in the investment banking segment of the industry for their public stock recommendations being bullish while their private trading practices were bearish during the 1990’s stock market bubble. A global settlement with regulators including Spitzer and SEC Chairman William Donaldson made by ten Wall Street investment bankers in April, 2003 has already cost the financial services industry $1.4 billion, with Citigroup, Credit Suisse First Boston, and Merrill Lynch paying well over half.25 To gauge the potential magnitude of the mutual fund scandal, William Goetzmann of Yale University has estimated that market timing for the period of 17 months leading to June, 1998 alone reduced overall returns to investors by $1.5 billion.26

26 *The Economist* (2003-8).
Case Review 6-3. Allianz Dresdner in the International Mutual Fund Scandal

The U.S. asset management subsidiary of Allianz Dresdner, Germany’s largest integrated insurance and banking group, was sued in February of 2004 by the state of New Jersey for market timing fraud. Within hours of learning of the suit, its trustees decided to return $1.6 million in fees it earned from 2001 to 2003 to the mutual funds it manages through its Pimco group. Canary Capital Partners L.L.C., a hedge fund company, was Pimco’s main client in the transactions. Canary had already settled its own lawsuit with the state of New York, led by Attorney General Spitzer, for $40 million in September, 2003 for its alleged role in market timing trades.27

6.1.6 Supervision Effectiveness

Financial services and financial institutions are among the most highly regulated industries internationally. This is in part because of the critical role in economic activity that this industry plays, but it is also due to the history of abuse and scandal that plagues the industry and its managers. Therefore, it cannot be expected that members of an industry who are supposed to direct significant attention to compliance to complex regulations and standards governing their own activities, could be prepared to supplant the board of directors role in governance of corporations of all of the thousands of types and segments of industries all over the world.

Just as Jensen has issues with boards’ inability to protect shareholders and other stakeholders in the current corporate governance system environment, fund managers are not at all satisfied with the performance of boards. An article by researchers at the University of Southern California states that institutional investors are seeking more opportunities to provide input to board performance appraisals and also cites a 1997 survey by Russell Reynolds Associates that shows that institutions consider the quality of the board as an important factor in their investment decisions. The researchers analyzed interviews and survey data that they collected from board members at 12 corporations over two years. They found that very little external input is being sought for board evaluations, despite their additional analysis of a 1996 Korn/Ferry survey

finding that directors value feedback from outside stakeholders because such input significantly improves the board evaluation process.\textsuperscript{28}

Institutional fund managers, therefore, have good reasons for having misgivings with the effectiveness of board supervision, but they do not measurably embrace the opportunity to fill the supervisory role themselves. They most often choose to align themselves with the board of directors as the preferred mechanism of influence for achieving better corporate governance. Public pension fund activism has predominately been directed at reforms of the board of directors themselves (see Case Review 6-4 below for an example influencing audit committees directly).\textsuperscript{29}

\textbf{Case Review 6-4. UK Fund Managers Address Auditor Independence}

Fourteen top fund managers operating in the UK financial community devised 40 point reform “benchmark for audit committees” in late 2002 and submitted it to the Financial Reporting Council for regulatory consideration. The institutions “including Schroders, Morley Fund Managers, Deutsche Asset Management, Henderson Global Investors, Gartmore and the Universities Superannuation Scheme” primary contention was the dominance of consulting fees that accounting firms were earning alongside their audit fees, an average ratio of more than 2.5:1 of non-audit to audit work at the United Kingdom’s largest public corporations. The group recommended that the audit committee of the board of directors address this apparent conflict of interest issue by taking on the responsibility of reviewing and approving all of the accountants’ work and fees.\textsuperscript{30}

\textbf{6.1.7 Agency Cost Effectiveness and Efficiency}

This preference for reliance on the board of directors has a rational economic basis. The separation of ownership from control results in agency costs, which similar to any transaction costs faced by a business, market forces would be expected to manage downward and to attempt to minimize. As was shown earlier in the chapter, individual as well as institutional investors are far too dispersed for their monitoring or bonding efforts to be effective in many of today’s public corporations. 

\textsuperscript{29} Johnson, et al. (1996).
\textsuperscript{30} Targett (2002).
managers, as well, generally do not possess the necessary skills nor the time for overseeing management to reduce agency costs efficiently, whereas, directors can be recruited more specifically for their applicable qualifications of “knowledge and experience” in leading a corporation.\textsuperscript{31} Robert Monks has noted more specifically that:

“Public plans are staffed by civil servants without experience and, therefore, credibility in the business sector…. They can raise consciousness of problems, but their internal political dynamics makes it virtually impossible … for success in a confrontational context.”\textsuperscript{32}

Directors can be recruited and selected for other desirable personality factors such as their propensity to exhibit healthy authority and ethical behaviors and to foster constructive interpersonal communications and relations, capabilities they have acquired and exhibited in their prior professional lives. Martin Hilb categorizes the demands on directors at a very high qualification level that includes four key categories:

1. personality (inward) competence,
2. social (interaction) competence,
3. leadership (vision, advisory) competence, and
4. specialty (professional, technical) competence.\textsuperscript{33}

A board position, as well, is offered with specific expectations for availability, attendance, planning and preparation of members, in return, most often, for material compensation of directors’ time and effort required for performing these activities. Researchers at The Corporate Library have calculated that large US corporations have an average group of eight outside board members and the total compensation for this group averages about $800,000 per year.\textsuperscript{34} The board therefore apparently offers a comparably efficient mechanism for managing agency costs.

Institutional investors like Paul Crist at CalPERS can be reasonably confident that their activism directed at improving the general corporate governance environment as well as specific firm governance provisions will pay-off. A major study by Gompers,

\textsuperscript{31} Firstenberg & Malkiel (1994), p. 29.
\textsuperscript{32} Monks (1999), pp. 25-26.
\textsuperscript{33} Hilb (1999).
Ishii, and Metrick first points out that researchers have been able to determine that corporate governance laws positively affect the value of corporations.\textsuperscript{35} They then describe how they observed 24 governance characteristics or “rules” as applied to 1500 corporations. The rules included various rights and responsibilities that can be granted to shareholders and the board of directors. The team created a single overall governance index from their measurements of the 24 rules, and the firms were segregated into ten index categories spanning from the “dictatorship portfolio” of least shareholder orientation and highest agency costs to the “democracy portfolio” of highest shareholder orientation and lowest agency costs. They then measured the return on investment in the shares of the subject corporations and found that the democracy portfolio had an average return impressively higher than the dictatorship profile by 8.4\% per year over the 1990’s decade. The corporate governance index they created was strongly correlated to performance, i.e. return to investors (although they did also add the caution that they had not necessarily proven a causal relationship).\textsuperscript{36}

6.2 Institutions – A Factor, But Not The Factor

It should not be forgotten, however, that fund managers, somewhat like the board of directors, are positioned in between investors and management. They are not owners themselves, they represent the investors who have entrusted them, and their financial skills specifically, with their money. In summary, institutional investors have not stepped up to fill the role of agency theory’s “missing link” of ownership and control in the evolution of corporate governance due to their:

1. commercial conflicts of interest,
2. political conflicts of interest,
3. persistent scandals in the financial services sector, and
4. avoidance of agency costs related to supervision.

In other words, although it plays an important economic role in disciplining corporations by adjusting the prices of their stocks and bonds and adding to efficiency in the financial markets, fund managers’ active trading should not be equated with active supervision. The financial sector has not progressed to provide “the unique

\textsuperscript{34} The Economist (2006).
\textsuperscript{35} Gompers, et al. (2003), p. 125.
element in a constructive activist program" 37 but does remain an important external factor in the corporate governance system. At best, therefore, fund managers activities in governance could be labelled as “the monitors of the firms’ appointed monitors—the board of directors.” 38

The board of directors is able to bridge the distance between shareholders and management physically and conceptually. In fact, the board concept, is also favored for its capabilities by medium to large size family owned firms, not-for-profit organizations, including charities, religious groups, and universities, and various non-governmental organizations (NGO’s). In these cases, the board may be made up of individuals called trustees, councillors, overseers, governors, or simply members. Their duties and responsibilities of management supervision remain similar to those of directors of publicly traded corporations, nonetheless. Even though there are no owners’ investments to look after, society in general, or groups thereof involved in and impacted by the workings of these organizations, depend on the board to look after their interests.

The bylaws of many organizations of these various categories have been updated in recent years to adopt the audit committee as a requirement in their boards. The constitution axis of agency assurance including its purpose, character, and rights for the audit committee would apply as well for these organizations whether they are publicly traded corporations or some other form of business or non-profit. The Blue Ribbon Committee recommends:

“A significant body of literature concerning corporate governance has evolved over the past two decades guiding boards in their composition, structure, and responsibilities, as referenced in the Bibliography to this Report. The Committee believes that the same progressive governance standards applicable to the full board should be used to decide how the audit committee should carry out its job, and who should serve on the audit committee.” 39

Institutional and individual investors, members of non-profit organizations and NGO’s, and other constituencies among the general public, lend great credence to the

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board of directors concept, and the audit committee thereof, as the key central factor in the corporate governance system.
CHAPTER 7.

Classification in the Knowledge Economy

7.1 Measures of Quality and Quantity for Management-Supplied Information

7.1.1 Evaluating Management-Supplied Information

Whether the detailed responsibilities of the board of directors fall under the category of strategic guidance or of monitoring, as presented in the Chapter 3, the audit committee must be actively engaged with the evaluation of management-supplied information necessary to support the board’s officially accepted responsibilities. Both because of its small size as well as its separation from business activity, the board is dependent on management for most of the information that is employed in fulfillment of its office. The audit committee, with the agency assurance model as its guide, should be the chief evaluator of MSI, keeping as its main concern the interests of the board, shareholders, and all other legitimate stakeholders at the forefront of this validation. As with many business areas, the measures of management’s performance in the preparation and presentation of MSI to the board are both qualitative and quantitative.

7.1.2 Questions for Board and Audit Committee Consideration

Quality of information, on one hand, is a subjective measure, where the intended sender’s delivery and multiple receivers’ interpretations can hold subtle to extreme differences of meaning. MSI quality can be defined as follows:

**MSI disclosures should strive to be presented accurately, understandably, and as objectively as reasonably possible.**

This reasonableness can be tested through management’s answers to the following questions, which must be repeatedly posed by the audit committee. Is financial statement information prepared consistently according to GAAP standards, whether its nature is:

1. accounting – a survey of current and past historical events,
2. forecasting – a focus on short- and mid-term tactical actions, or

3. planning – a scan of strategic and long-term directional decisions?

In addition, are economic and statistical methods and associated presentation formats used in projections generally accepted techniques in the financial community, or is it possible they are proprietary, firm-specific innovations or even management’s subjective estimates? If they are proprietary, then here, as is often the case with quality metrics, measurement is soft. More definitive measures are only possible in hindsight, with the nearly complete transparency that inevitably comes with the full completion of events, and more often than not, with the change of responsible personnel.

Quantity, on the other hand, is usually an absolute and objective measure in business. However, in this situation, MSI quantity, like quality, is more of a delicate measure. The quantity of MSI must be selectively condensed and summarized for the part-time board members to ingest and digest under critical time pressures. This must be balanced simultaneously by the requirement that MSI is materially complete and comprehensive to assure a true and fair presentation to investors and other stakeholders. MSI quantity can, therefore, be defined as follows:

There should be no critical gaps of information between what management knows and what management shares for board decision making and performance reporting.

The audit committee’s questions for evaluating quantity should address the concerns, below:

- Are investment and resource requirements materially determined?
- Is there a relative range of outcomes to expect?
- Are risks reasonably identified and assessed?
- Are alternatives also considered and presented?

The audit committee must seek full disclosure from management, in advance of company strategic commitments, to optimize the board’s critical decision-making role. Management must seek to spare the board from a flood of detail that will only compromise directors’ performance.
This is why auditors are asked to state their opinion of the financial statements and internal control system with the materiality concept as their standard. It is not possible to review every transaction, nor even the majority of transactions, and it is not possible, nor even reasonable, to expect to eliminate all errors. Instead, the International Federation of Accountants (IFAC) offers the following definitional guidance:

“Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cutoff point rather than being a primary qualitative characteristic which information must have if it is to be useful.”¹

This definition must not only be applied to financial statement disclosure. It can serve as an audit committee standard for broad disclosure of MSI.

Although attention to these typical measures of quality and quantity will generally, or at least in part, assist in lowering the transparency barrier identified in Chapter 1, the board must hold management accountable to an even higher standard of performance. Agency assurance is concerned with this fuller measure of accountability. The key question management must always be prepared to answer for the audit committee is:

“Does the MSI provided adequately support the board of directors in its intended purpose, both in the specific decision situation as well as in the board’s much broader responsibility of governance?”

Directors must look after both board functions of monitoring and strategic resource allocation in fulfillment of their responsibilities. Management supplied information must support these functions directly and specifically.

7.2 Differentiation Costs for Monitoring and Strategy

Strategic management theory provides a particularly effective way of looking at the issue of MSI relevance. In his 1980 seminal book *Competitive Strategy* and a number of subsequent articles, Michael Porter of the Harvard Business School has encouraged business executives to position their companies competitively within an industry by choosing between the elements of two primary options: cost leadership and

¹ IFAC (2004).
As Figure 7-1 below illustrates, Porter recommends that a firm makes its strategic choices between costs and values along a logical “productivity frontier”. Generally, it could be said that a firm can concentrate on low price, i.e. cost leadership for the customer, as a competitive advantage or on differentiation, i.e. higher utility of product and service content for the customer.

Figure 7-1. Differentiation Costs Invested at Porter’s Productivity Frontier

Operational Effectiveness versus Strategic Positioning

High

Nonprice buyer value delivered

Low

Productivity frontier (state of best practice)

Relative cost position


Cost leadership dominated companies provide their customers with generic products or solutions at the best price to value in directly comparable competitive situations. Economies of scale, efficiency of operations, and proactive management of price levels in the marketplace are required for a successful cost leadership strategy. These characteristics are embodied by Wal-Mart in the discount retail section, Hyundai and Kia in the automotive sedan segment, and Hexall in the generic pharmaceutical sector.

Porter’s other identified choice for strategic direction, differentiation, requires firms to make comparably higher investments on a regular basis in factors that distinguish their

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products and services from competitors’ offerings. These unavoidable additional structural costs logically require a company to charge higher customer prices and to earn higher profit margins to remain competitive in their consumer and financial markets, respectively. Differentiation is apparent at Nordstrom’s in the premium retail sector, Mercedes-Benz in the automotive sedan segment, and Unilever in the consumer goods sector. All of these types of companies have internal policies requiring adherence to higher than competitive standards of operating activities. These policies, when successfully implemented, tend to support a public image of market leadership that transcends any direct competitive comparison of price to value for the products and services these companies offer.

All firms must also make strategic investments in production and distribution capabilities as well as in quality of their products, services, and processes to meet minimum expectations of competitiveness. When a firm adds value for its customers or clients through differentiation of the content of its product or service offerings, then it will incur internal costs, of both a tangible and intangible nature, to develop these criteria. A different set of investments is needed, but many costs must be avoided as well, for a firm to be identified as a cost leadership provider in the marketplace. In the classification axis of the agency assurance model, all of these types of investments are termed **differentiation costs** within the agency assurance model.

The management-supplied information disclosed by publicly traded corporations must be prepared with questions of quality and quantity, especially regarding strategic investments in differentiation costs at the forefront. MSI must identify for the board of directors all influences of a material nature to the company’s performance. These objectives cannot be accomplished unless MSI can foremost frame and reflect the business’ activities and results within today’s ultramodern industry and economic environment.

In the following sections of this chapter, the key factors influencing this new environment are identified. Following this explanation, the classification axis of the agency assurance model is presented to introduce recommendations for the adoption of a differentiation cost emphasis within MSI. These changes are long overdue in recognition of the dependence of the board on MSI for the effective balance between monitoring and strategic guidance of the corporation. The differentiation costs focus
accomplishes this because it helps to describe the firm in balance between cost leadership and differentiation, respectively.

7.3 Five Factors of Change in Business and Industry

7.3.1 Keeping Pace With Change

Almost all major corporations operating today have come a long way from when economist David Ricardo in the early 19th century defined the products of trade as items consisting of four main hard (i.e. tangible) input factors - land, labor, natural resources and capital. Subsequently, economics researchers have respectfully come to identify the physical products of trade through the designation “Ricardian goods”. The Industrial Revolution both fuelled and was fuelled by the burgeoning volume of trade of hard goods. For over 150 years following Ricardo’s publication of *On the Principles of Political Economy and Taxation* in 1817, therefore, trade was dominantly identified with physical goods. The value of trade measures was calculated by economists almost exclusively from the contribution of the four Ricardian factors of production.

Through exploration and the establishment of trade routes, the products of widely diverse cultures were introduced to one another. The interests of European citizens in agricultural and mineral-based commodities of abundance found in the Americas and Asia were soon matched by the demands of colonists and native peoples, respectively, for manufactured goods from Europe. New shipbuilding and navigation innovations allowed tremendous logistical distances to be bridged. This unleashed the comparative and absolute advantages in factors of natural resources and production between nations and helped to fuel their economic and social development. Trade and colonization also introduced long distance legal ownership issues of communication and control, which, as noted in an earlier chapter, had been predicted by Adam Smith. However, the opportunities gained were perceived to outweigh by far the risks encountered, and industry and governments combined to expand and protect foreign direct investments and cross border transactions by business owners. Admittedly, not all would agree that this progress, especially in the social context, has been a positive development.

The historical progression that followed Ricardo’s generation has unquestionably led to the contemporary situation of globalization. MSI disclosure practices, which are
influenced by accounting standards, can and should be adapted to keep pace with the business environment as it changes. However, accounting standards, which apply themselves fairly well to the four hard factors of production of Ricardian goods, have not kept pace with a great many economic and business practice developments which produce differentiation costs as a reality of the 21st century corporation. It is possible to understand better what the challenges to today’s complex information environment are by reviewing the following five factors of change that greatly influence contemporary business and industry. Following this review, the current relevance of MSI disclosure practices is analyzed and critiqued. Finally, in subsequent chapters, factors of quality and quantity in the production and review of MSI, along with recommendations for their improvement, are addressed.

7.3.2 Factor #1 - Intellectual Capital Content in Physical Goods

Today economists and business managers alike recognize the very real, but seemingly difficult to measure, added value in manufactured goods from the strategic contribution of intangible content, often referred to as intellectual capital. Intangibles combine with the four traditional physical factors in the transformation processes of today’s factories and laboratories in the creation of new consumer products at a frenetic pace. In today’s Intangibles Age, the added value of three additional soft (i.e. intangible) input factors, the three I’s, can be identified as follows:

1. Invention improvements to the technological functionality, quality, efficiency or other performance factor housed within or programmed into the product
2. Innovation efficiencies in the administrative, operational, or creative processes of design, production, transportation, distribution, or support of the product
3. Image elevation of the product’s visual and intellectual memory and psychological positioning that the customer holds

Another way to view these factors is to consider the association that invention (i.e. technology) has with the core physical product characteristics, innovation with the business processes surrounding the product, and image with the product identity formed in the minds of the consuming public. In many situations, these three factors are clearly interrelated or overlapping in some manner or form with one other. This
segregated categorization, though somewhat artificial, is meant as a helpful instructional simplification. Case Review 7-1 below is presented as well to assist in understanding these concepts.

**Case Review 7-1. Intangible Factors in Production of Automobiles**

Statistics on the relative size of the automotive industry in the world economy clearly have ranked it for decades as the world’s largest durable goods producing industry. It is an industry that is, in comparison to others, relatively mature. Its history spans over more than 110 years, since its establishment in the late 19th century. Today, automobiles maintain a worldwide following and reputation for highly modern and technologically advanced features. The industry, therefore, is a testimony to the significant role that intangibles play in the transformation processes of the 21st century. Just a few of the many relevant examples of intangibles as vital input factors arising out of the automobile industry are presented below:

<table>
<thead>
<tr>
<th>Land</th>
<th>Process innovations such as just-in-time delivery of raw materials by suppliers and of finished products to customers has significantly reduced the acreage required for factories and warehouses.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor</td>
<td>Automation innovations of most assembly and test operations throughout the shop floor have made workers extremely efficient, reducing dramatically the direct labor hours required in each vehicle.</td>
</tr>
<tr>
<td>Natural Resources</td>
<td>New technologies are present in every component such as those that can make car bodies stronger while also more scratch, dent and rust resistant and give auto engines more power and higher acceleration with greater fuel efficiency and lower exhaust emissions even while the metals required in both applications were being rolled, pressed, molded and stamped more thinly and lighter in weight.</td>
</tr>
<tr>
<td>Capital</td>
<td>Laboratories have been equipped with computer aided design (CAD) systems that virtually simulate and test form, fit, and function of new products while slashing development time and prototype material requirements. Customer relationship management (CRM) information systems have transformed sales and service processes allowing manufacturers to have more direct points of</td>
</tr>
</tbody>
</table>

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contact with consumers and providing nearly instantaneous feedback to manufacturers and their dealers.

Image

Mercedes-Benz of DaimlerChrysler AG provides a classic example of a truly globally recognized brand that supports higher prices and profit margins relative to its competitors. This success helps to sustain its competitive advantage through affording further investments in image improving activities like advertising, new performance, higher feature content, and best-of-class customer service. Toyota has achieved great success, particularly in the US and Japan, positioning its Lexus brand as a viable high-end, luxury automotive competitor by regularly benchmarking its products against those of Mercedes-Benz.

Not only mature industries and companies but also completely new industries and companies provide evidence of the burgeoning role of soft inputs factors in today’s products. In *The Venture Capital Cycle*, Gompers and Lerner comprehensively review the dramatic development of the venture capital market since its “infancy” in the late 1970’s. They present many studies containing much evidence that point to the critical role that smaller technology and innovation oriented start-up firms financed by independent venture capital funds play in the modern economy. As an example, over the last decade of the 20th century, US patent applications surged to over 120,000 per year. This is a level 50% to 300% greater than the range measured for the entire first 85 years of the century, and start-ups are responsible for much of this growth.\(^4\) Information and Communications Technology patents alone grew at a 20% compound annual rate from 1992 to 1999, which contributed to 31% of the growth in overall patents in the US over the same period.\(^5\) The OECD 2000 study, *A New Economy?*, recognizes that there are many very visible corporations from the ICT sector, such as Microsoft, Intel, Netscape, Compaq (recently acquired by Hewlett-Packard), and others whose performances illustrate that venture backed firms have a major influence on both innovation and economic activity.\(^6\)

The scale of the level of independent venture investment surged to over $11.5 billion in 1997, 25 times the activity measured 20 years before.\(^7\) Over 50% of US venture

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\(^4\) Gompers (1999), pp. 326-327  
\(^5\) OECD (2000), p. 29  
\(^6\) OECD (2000), p. 34.  
\(^7\) Gompers (1999), pp. 8-9.
capital in 1999 was supplied to internet-related businesses. In most OECD countries investment in intangibles has reached a level equivalent to that of fixed equipment. Another recent study also shows that small businesses are greatly increasing their participation in the trade of intellectual property (i.e. intangibles) in the US, and this activity had grown from a level of $15 billion in 1990 to $100 billion in 1998. Gompers and Lerner refer to this phenomenon as a “‘virtuous circle’” where venture investment drives innovation, which leads to economic growth and the formation of even more capital for further investment.

7.3.3 Factor #2 - Intellectual Capital Content in Services

The dominance of intangibles-related activities is not only measured in production of hard goods. Also contributing to this situation, are the ever-increasing creation and consumption of an array of new forms of innovative services. These services include tele- and data- communications, financial planning and investments, attorney and agent representation, advertising and promotions, education and training, insurance, travel and transportation, entertainment, health and fitness, news and information, among many others. They have come to be offered by modern businesses and consumed by the public ubiquitously in the 21st century. In the following Table 7-1, the statistical measures of gross domestic product value-add components in 2002 clearly show that services have come to dominate broadly the economic output of developed and developing nations, in comparison to agriculture and industry. Since the OECD published The New Economy in 2000, the great successes of newly publicly traded firms such as eBay and Google, among others, provide relevant examples of the great value that can be captured in new services.

As an additional factor, the provision of services, similar to the delivery of goods, is a logistical service solution. Logistics processes are composed primarily of the same hard factors of land, labor, and capital, and, to a lesser extent, of natural resources, as utilized in goods production. Services normally require some point of direct contact for the consumer, with either a live person or an automated system using telephone recordings, interactive television, or a website. Space and facilities are required to house direct service workers, indirect administrative support personnel, and their

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9 OECD (2000), p. 10 and p. 28, respectively.
9 The Economist (1999-3).
supervisors, as well as any machinery and equipment, especially ICT-related devices, vehicles, and storage systems, required in services fulfillment. Natural resources, normally associated with the raw materials needed in goods production, are also required for services, as in the form of printed informational materials provided to consumers for promotion or instruction purposes, in the spare parts required under warranty or support contracts, or in the material component of the capital equipment employed in distributing or delivering the service.

Table 7-1. Gross Domestic Product and % Value Added by Category in 2002\(^{10}\)

<table>
<thead>
<tr>
<th>Country</th>
<th>Total US$ (Billions)</th>
<th>Agriculture</th>
<th>Industry</th>
<th>Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>951.9</td>
<td>2.3</td>
<td>33.3</td>
<td>64.4</td>
</tr>
<tr>
<td>Mexico</td>
<td>925.5</td>
<td>4.1</td>
<td>26.7</td>
<td>69.3</td>
</tr>
<tr>
<td>USA</td>
<td>10383.1</td>
<td>1.6</td>
<td>22.8</td>
<td>75.6</td>
</tr>
<tr>
<td>Australia</td>
<td>554.8</td>
<td>2.9</td>
<td>25.9</td>
<td>71.2</td>
</tr>
<tr>
<td>Japan</td>
<td>3421.9</td>
<td>1.3</td>
<td>29.1</td>
<td>69.6</td>
</tr>
<tr>
<td>Korea</td>
<td>810.6</td>
<td>3.9</td>
<td>40.3</td>
<td>55.8</td>
</tr>
<tr>
<td>New Zealand</td>
<td>86.6</td>
<td>6.7</td>
<td>24.4</td>
<td>68.8</td>
</tr>
<tr>
<td>Austria</td>
<td>232.5</td>
<td>2.3</td>
<td>30.4</td>
<td>67.3</td>
</tr>
<tr>
<td>Belgium</td>
<td>286.3</td>
<td>1.2</td>
<td>26.1</td>
<td>72.6</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>154.1</td>
<td>3.7</td>
<td>38.4</td>
<td>57.9</td>
</tr>
<tr>
<td>Denmark</td>
<td>157.1</td>
<td>2.4</td>
<td>25.5</td>
<td>72.2</td>
</tr>
<tr>
<td>Finland</td>
<td>137.8</td>
<td>3.5</td>
<td>31.1</td>
<td>65.4</td>
</tr>
<tr>
<td>France</td>
<td>1666.5</td>
<td>2.6</td>
<td>24.2</td>
<td>73.2</td>
</tr>
<tr>
<td>Germany</td>
<td>2137.7</td>
<td>1.1</td>
<td>28.8</td>
<td>70.1</td>
</tr>
<tr>
<td>Greece</td>
<td>201.9</td>
<td>7.0</td>
<td>22.3</td>
<td>70.6</td>
</tr>
<tr>
<td>Hungary</td>
<td>141.1</td>
<td>3.7</td>
<td>30.2</td>
<td>66.1</td>
</tr>
<tr>
<td>Iceland</td>
<td>8.2</td>
<td>8.6</td>
<td>25.7</td>
<td>65.7</td>
</tr>
<tr>
<td>Italy</td>
<td>1486.1</td>
<td>2.6</td>
<td>27.1</td>
<td>70.3</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>21.9</td>
<td>0.6</td>
<td>16.7</td>
<td>82.7</td>
</tr>
<tr>
<td>Netherlands</td>
<td>468.4</td>
<td>2.5</td>
<td>24.9</td>
<td>72.7</td>
</tr>
<tr>
<td>Norway</td>
<td>161.2</td>
<td>1.6</td>
<td>36.8</td>
<td>61.5</td>
</tr>
<tr>
<td>Poland</td>
<td>414.5</td>
<td>3.1</td>
<td>30.0</td>
<td>66.9</td>
</tr>
<tr>
<td>Slovak Rep.</td>
<td>65.9</td>
<td>4.4</td>
<td>31.1</td>
<td>64.5</td>
</tr>
<tr>
<td>Spain</td>
<td>908.5</td>
<td>3.2</td>
<td>28.5</td>
<td>68.2</td>
</tr>
<tr>
<td>Sweden</td>
<td>243.3</td>
<td>1.8</td>
<td>27.5</td>
<td>70.6</td>
</tr>
<tr>
<td>Switzerland</td>
<td>223.8</td>
<td>1.2</td>
<td>25.6</td>
<td>73.2</td>
</tr>
<tr>
<td>Turkey</td>
<td>448.9</td>
<td>11.7</td>
<td>29.6</td>
<td>58.7</td>
</tr>
<tr>
<td>U.K.</td>
<td>1654.7</td>
<td>0.9</td>
<td>25.9</td>
<td>73.2</td>
</tr>
</tbody>
</table>

Source: Data from OECD (2004-2).

\(^{10}\) Current prices and purchasing price parities.
It is customers’ experiences that markedly differentiate today’s innovative yet commonplace services from traditional Ricardian goods. The customer’s recognition of the service experience is almost completely dependent on the three soft factors of invention, innovation, and image. The actual services provided and the consumption thereof are purely experiential. Services are tactically uninventoriable by the provider, and nothing physically tangible is carried away by the consumer. Arguably, as well, products in the 21st century are not so fully segregable from services, as illustrated by Figure 7-2 below.

**Figure 7-2. Marketing Dimensions of a Product.**

![Marketing Dimensions of a Product](image)


Products formerly were defined in design engineering terms by their *form*, *fit* and *function*. Today this utilitarian definition basically describes only one dimension of the marketer’s view of a product, its *physical core*, as illustrated in the center of Figure 7-2. Directly surrounding the physical core dimension, the *product package* is recognized for its promotional and identification value along with its traditional protective function. Products also increasingly consist of an embedded *auxiliary services* component, shown as the outside layer in the figure. Consumer satisfaction
with products is increasingly measured from the physical as well as emotional utility received when the product is used as intended.\textsuperscript{11}

### 7.3.4 Factor #3 – Internationalization of Markets for Goods and Services

While services have come to dominate domestic economies, the providers of services, and those of physical goods alike, are facing higher levels of competitive pressure from offers originating from foreign producers in broader international markets. Table 7-2 below, from the World Trade Organization’s 2004 press release for its annual analysis of international trade, shows that combined world exports of merchandise (goods) and commercial services surpassed US$ 9 trillion in 2003. This is a level approaching the annual GDP of either the entire EU or the US in value. Moreover, the average growth in services exports has generally been higher than growth in merchandise trade. This indicates that the world economy is sustainingly increasing its production and consumption of intangible content.

#### Table 7-2.

<table>
<thead>
<tr>
<th>World exports of merchandise and commercial services, 1990-2003</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Value</strong></td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td>Merchandise</td>
</tr>
<tr>
<td>Commercial services</td>
</tr>
</tbody>
</table>


Continuing a pattern of many decades, growth rates of exports over the most recent nine-year period have most often outpaced the growth rates of world GDP. The following Figure 7-3, from the same WTO analysis as referenced above, illustrates compellingly the importance that international (i.e. non-domestic) markets have become to the world’s producers. Therefore, the chart also hints at corporations’ greater dependence on reaching foreign customers and the added competitive pressures and complexity of operations that is associated with doing business internationally.

\textsuperscript{11} Albaum, et al. (2005), pp. 374-419.
Figure 7-3. Real GDP and Merchandise Exports, 1995 – 2003.
(Annual percentage change)


The gross value of trade in Table 7-2 and the relative rates of growth of trade in both Table 7-2 and Figure 7-3 point to a critical mass and positive momentum, respectively, in the economic integration of international markets.

7.3.5 Factor #4 – Trade in Property Rights of Intellectual and Financial Capital

7.3.5.1 Direct Property Rights

While trade is normally associated with goods and services, world markets have also developed for contracting in all kinds of existing and new direct ownership and productive property rights, including intangible assets and financial assets. Intangible assets in contracts are designs, patents, brands, methods, trademarks, copyrights, and other like ownership rights. They are not only developed for proprietary use inside a single corporation. They are often also marketed as standalone items for broad unrelated applications, or even for use by direct competitors, with increasing frequency. Financial assets are individual stocks and bonds, portfolio and mutual fund investments, currencies, and structured debts. They have relatively widespread recognition and their ownership has become relatively commonplace. Agency assurance is applied to these intangible assets and financial assets, which are direct
ownership rights that are quite commonplace and both highly costly and highly valuable in businesses today.

7.3.5.2 Indirect Property Rights

Less commonplace than intangible and financial assets, but often associated with them, are indirect ownership rights labelled as financial derivatives. Derivatives are contractually dependent on the value of these direct assets, usually with an opportunity for substantial gains, and often carry some inordinately heavy risks and obligations. Because of their serious exposure potential, it is important for board members to be fully aware of these contracts. Agency assurance does not specifically address the risks of derivatives other than to recommend that the audit committee should be alert to them and prepared to call in independent experts, as necessary, to inventory and review all of these contracts. The experts should be employed to isolate, identify, and record any and all expenditures and exposures to the company from these contracts. The following few paragraphs are provided as an introduction to derivatives, to allow for base of understanding of their complex intangible nature and as further evidence of how the business environment, which directors oversee, has dramatically progressed.

Agricultural commodities have long been traded in special futures markets. In these physical trading floors or electronic exchanges forward contracts are negotiated by a buyer and a seller for the delivery at a preset price of specific agricultural products, like corn, wheat, soybeans, coffee, and even pork bellies. Oil, natural gas, coal, gold, silver, and other precious and non-precious minerals are also traded in similar futures markets. These markets originally developed so that farmers and other producers of commodities could lock in advance sales contracts for their goods. This allowed them to concentrate then on the difficult job of producing those items, knowing they already had a buyer and fixed price for their harvests and production.

Speculators, primarily, have created similar futures markets for corporate equity shares, which can also be traded under forward contracts, most often as stock options. A call option allows the holder who bought the option to purchase a certain number of shares at a predetermined price from the option seller. There is normally a limited period of time into the future, such as 30, 60, 90, or 180 days, where the holder can choose to exercise their option. The call option holder will logically exercise the contract only when the market price, or spot price, of the shares rises above the
contract purchase price, or *strike price*, embedded in the option contract. A purchased *put option* allows the holder to sell a certain number of shares at a preset price to the option seller. If the share price goes down in the market during the option period, the option holder would normally choose to exercise his option rights and sell shares to the option seller when the contract price is higher than market price.

Most of the derivatives in question for boards to concern themselves about are relatively new forms of tradeable contracts, which have been invented mainly by financial markets experts influenced by the speculative futures and options contracts described above. When they are utilized by businesses, they are often financial in nature, related to the company’s transactions in foreign currencies or in interest payments on debts. They carry names such as *foreign currency forward contracts*, *interest rate swaps*, and *market index contracts*, which hint at their complexity. Such contracts are most often entered into by the corporate treasurer.

The purpose of entering into derivatives contracts is to attempt to shield the corporation from the extra costs of currencies and interest rates when they move to a level that is higher than expected or to provide some benefit to the company when they move lower than expected. If the company has a lot of cash to invest in corporate equities and debts (i.e. stocks and bonds), derivatives may also be used to attempt to offset unfavorable short-term fluctuations in the values of these securities. But it is also precisely this tendency for fluctuation in values of currencies, interest rates, and securities that can make entering into derivatives a very risky practice. Understanding these risks completely usually involves very complex mathematical formulas and statistical models.

Investors in Dell Computer were surprised in the late 1990’s by a derivatives contract loss of a few hundred million dollars at the company. Apparently, top executives and board members of one of the personal computer leaders with conservatively run internal business operations were fully unaware of the external financial risks that had been taken by corporate treasury. Around this same time period, the Orange County, California treasurer announced a loss of well over one billion dollars from derivatives contracts. The county treasurer himself may not have understood the highly speculative nature and potential for losses of these items and faulted the county’s investment banking advisors for not disclosing these risks. Enron lost billions of
dollars in trading derivatives on electricity, oil, and gas contracts, when many investors had believed that the company was primarily involved in physically producing and distributing energy. It also appears that Enron used its involvement in these derivatives markets to manipulate prices illegally, contributing to the highly publicized California energy cost crisis in the years following 2000.

Accounting standards now have been updated for calculation of potential liabilities and fuller disclosure of derivatives-based risks. FASB 139 and IAS 39 call for derivatives to be valued in the financial statements at fair value (e.g. market value), unless cost of amortized cost are determined to be more relevant. The Canadian standards board, in proposing its own standard to be closely aligned with the US and international standards, describes these directives as a means of “closing the gap in GAAP.”\(^{12}\) Despite the significant publicity given to this issue, surprise losses of material value related to derivatives continue to be announced each quarter by a handful of public companies.

7.3.6 Factor #5 – Innovation in Statutory Ownership of Capital

A fifth order of complexity in today’s business environment stems from the normally positive development of national and supranational legal systems and associated regulations that protect owners’ property and personal rights. The basic functioning of the corporation, for example, is dependent on governments that support the concept of limited liability. Respect from the society in general for personal property provides for an environment with incentives to individuals for efficient production and reinvestment of profits. Organizations including the WTO, OECD, World Bank, United Nations, universities, and individual government agencies and officials have succeeded in winning broad international recognition of intangible assets as deserving of protection similar to those for tangible personal property. As an example, The Walt Disney Company won the first major intellectual property protection lawsuit by a foreign firm before a court in the Peoples Republic of China, which was seen internationally as an important test case. The Chinese court officially recognized Disney’s legal rights to its intellectual property, such as cartoon and animated images of Disney characters, and to control the copying and distributing activities of this property.

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\(^{12}\) CICA (2003).
Property rights usually must be registered to a person or recognized legal entity to provide full protection, especially in an increasingly international competitive environment. Registration then also more clearly determines who is liable for:

1. income, property, excise, value added, and other taxes;
2. registration, licensing, filing and other fees;
3. warranties, guarantees, and legally mandated insurance coverage;
4. statistical surveys, sales and use reports, and all other government imposed information disclosures. and
5. employment, social security, environment (pollution controls), health and safety, and other regulatory provisions.

All of these extraneous requirements have led managers to seek mechanisms to shield their companies from part or all of these additional burdens to operations. In many cases, simply by comparing existing differences in local conditions and legal systems, companies choose to relocate their operations for lower costs and lax standards. Serious humanitarian issues that have arisen for Royal Dutch Shell in Nigeria, Unocal in Myanmar, Union Carbide in Bhopal, India, and Nike in Indonesia have, of course, served as warnings to boards of the hidden risks of these choices.

Governments have participated actively also, in a manner that is expected to yield direct economic and social benefits for their citizenry, by helping to create special categories of legal entities for businesses to exploit. Limited Liability Companies (LLC’s) are registered today by law and accounting firms who ten years ago were all strictly partnerships. Tax shelter benefit organizations include Foreign Sales Corporations (FSC’s) employed by Boeing, among many other US firms. FSC’s have been criticized by Airbus and the EU for skirting WTO restrictions that outlaw export subsidies by national governments. Local governments implement location incentive programs for businesses, such as grants and tax breaks in the hundreds of millions of dollars to Mercedes-Benz, Honda, General Motors, and other auto manufacturers to build factories in southeastern US. Income tax rate reductions and holidays, i.e. a 0% tax rate for a three, five or ten year period, are granted for new subsidiary companies, for example, by the Economic Development Board in Singapore to electronics and bio-medical high-technology firms, and, in its pre-EU past, by Ireland to software companies.
Although there are many benefits in which to take advantage by erecting a strategic legal entity structure, the risks are just as numerous. The many incentives available domestically and internationally can lead to placement of entities in many foreign locations. By foreign, two definitions are intended, international and inexperienced.

First, business operations could be established physically in international locations that are not ordinary choices and much less familiar to management and the board. Special transaction-only legal entities can also be registered in physically and psychologically distant foreign countries. These international entities can carry any of the typical ever-present threats associated with foreign government reach and jurisdiction as well as the day-to-day complexity of foreign culture and custom.

Second, many legal entities can be registered domestically but which contain a highly specialized and complex transactional purpose. Management and the board are likely to lack significant experience to react appropriately when faced with business situations and challenges that are foreign to them. They could incur unrecognized liabilities and losses with potential material impact if transactions are posted improperly or simply mistakenly omitted. For example, it is estimated that Enron was able to hide about US$30 billion of liabilities in all of its hundreds of Special Purpose Entities (SPE’s). These liabilities were not consolidated into the overall debts reported in Enron’s audited financial statements. Parmalat similarly claimed to have billions of Euros in cash held at an offshore bank account that simply did not exist.

The incentive benefits of location and registration must be fully balanced against any operational inefficiencies and organizational risks. The organization, rather than protecting its property interests could become victimized by its statutory structure. Placing assets in non-obvious locations can make it quite difficult to trace ownership rights, transactions, and even the items themselves. Lernout and Hauspie, a software company headquartered in Belgium, had an estimated $100 million simply disappear in a Southeast Asia subsidiary. FlowTex, a German heavy machinery company, fraudulently duplicated and even triplicated ownership values of well over one billion Euros for both existing and fictitious boring machines, by placing values for the machines in creative leasing and trading subsidiaries in Germany and France. Andrew Fastow, the CFO of US energy concern Enron, led the establishment of a maze of hundreds of overlapping and intertwined subsidiaries, in some of which he was
appointed as chairman, where he allegedly hid material liabilities, manufactured fictitious profits in the billions of dollars, and paid himself and his cronies very real multi-million dollar bonuses.

Auditors and audit committee members should not be embarrassed to admit they do not understand the complexity of the entity structure and transactions occurring therein. They certainly should never tolerate a patronizing attitude from the CFO or other company executives for the questions they pose about these situations. On the contrary, the onus should be placed directly on management to document and explain the corporate entity structure and purpose, as well as the consolidation process, in a logical and transparent manner. After all, management has most often received their own instruction regarding how to create and maintain these intricate structures, incurring costly fees for outside advice from attorneys, economists, strategists, accountants, and other consultants.

7.4 The Need for Accounting Recognition of Identifiable Complexity

The full extent of complexity of today’s business and economic environment may not be explained fully by the five factors presented here. There may be more identifiable underlying factors, and there may be some factors that avoid detection and defy description. What is clear is that these five identified factors, exogenous to individual firms, have changed the business landscape dramatically. However, accounting reporting systems and other standard forms of MSI have fallen short in their descriptions of the endogenous impact to many public corporations of this changed environment, and, therefore, corporate governance has greatly suffered. How firms, especially the successful ones, behave internally in this new environment must be analyzed to uncover further clues to the potential MSI related causes of these governance shortfalls.

What appears to be consistent about these exogenous economy and endogenous firm factors is a trend toward the increasing contribution and concentration of value from intangible content. While business managers and economists identify this content clearly as intellectual capital, its value most often goes unrecognized and unreported in the accounting standards classification system. In addition, according to creative destruction, the value of most intellectual assets does not have an indefinite life.
Reinvestment and new investments will have to be made in order for an organization to attempt to remain competitively viable.

In the board of directors, monitoring is required in companies regardless of their positioning as a cost leader or differentiator. Current accounting standards and financial reporting are fairly adequate in monitoring of those companies that make standard investments. However, the internal development of new products and processes and exploration of new markets and methods are not required to be traced in any detail conducive to monitoring. These activities are generally expensed as incurred, which means they are not treated as investments in most accounting regimes. This treatment of differentiation costs not only makes monitoring of them virtually unnecessary, it also neuters any direct opportunity of standard regulated financial reporting of playing a vibrant role in strategic resource allocation and identification.

The board of directors and the shareholders they represent have the right to a detailed understanding of the investment in this collective knowledge. The reporting of these intellectual assets over their useful life to the organization reduces intransparency from the expectations gap and the reporting gap. This new reporting requirement would be made available to them only through a properly composed and presented accounting information system for classification (cost-based valuation) that supports the overall requirements of MSI for monitoring and strategic guidance in the 21st century business economic environment.

The reaction of the accounting standards community to decades of monumental changes and innovation in the economic and business environment surrounding it was to hold fast to tradition in preparing financial statements. In a world dominated by consumption of services and other intangibles, it is clear, however, customers and clients place high monetary value on acquiring these items in today’s markets. Accountants, however, continue to hold the primary position that transactions involving most such internally developed firm resources should not be valued as company financial assets. Figure 7.4 below illustrates that the great majority of the world’s intangible assets are not allowed by national accounting standards to be capitalized as assets.
In addition, the second column from the left side shows that the IAS standards are generally more conservative than many of the countries of the EU listed in the third and fourth columns. This could indicate that after 2005, when adherence to these standards is required of almost all EU public firms, even fewer intangibles will be carried as assets.

Standards govern accounting as an information system. They should first and foremost reflect the existing, modern, and primarily knowledge-based business environment. If standards are not kept up-to-date, they quickly lose their relevance, which is their ability as a tool to provide illumination to the users of financial statements, therefore, to reduce the transparency barrier.
7.5 Agency Assurance Addresses the Reporting and Expectations Gaps

7.5.1 Accounting Standards Neglect Knowledge Assets

Accounting is popularly referred to as the language of business. The financial statements are designed, supposedly, to provide a true and fair view, in monetary terms, of business organizations. These statements are central to MSI and therefore arguably to all of the critical review processes of the internal and external discipline factors of the corporate governance system. They are so important that the accounting standards developed for their preparation, if not explicitly legislated, are adopted in whole from accounting boards by government regulation. The accounting system and the financial statements they produce are a universal necessity that no one, of course, sensibly would suggest to do away with. However, it is only slightly less dangerous for these statements to lose their economic reliability and relevance because of their apparent disregard for the role of discrimination costs in corporate governance.

The accountants’ arguments against recognition of many knowledge asset transactions have been the same for decades. The accounting profession generally believes that many research and development (R&D) activities of scientists and engineers are too risky to be capitalized as accounting assets due to their indeterminable future outcomes. There are some exceptions allowed for in-process R&D projects in special cases, but standard setters still prefer expensing as the more conservative choice. In an important study commissioned by the FASB in 2001 to examine the significant challenges in place that make it difficult to adapt standards to the new environment, Wayne Upton described how FASB Statement No. 2 *Accounting for Research and Development Costs* justifies the expensing of almost all internal R&D expenditures:

“Statement 2’s basis for conclusion cites several reasons for that decision, including:

- Uncertainty of future benefits—Even after the R&D stage, the failure rate for new products is high.
- Lack of causal relationship—Paragraph 41 of the basis cites studies that “generally failed to find a significant correlation between research and development expenditures and increased future benefits as measured by subsequent sales, earnings, or share of industry sales” (footnote references omitted).
• Inability to measure future benefits—The basis explores *measurability* as a recognition concept, and paragraph 44 describes a notion similar to that found in the IASC Framework:

The criterion of measurability would require that a resource not be recognized as an asset for accounting purposes unless at the time it is acquired or developed its future economic benefits can be identified and objectively measured.

• Lack of usefulness—Paragraph 50 of the basis cites the views of financial statement users that capitalization of R&D costs ‘is not useful in assessing the earnings potential of the enterprise.’”¹³

However, Upton was not ambivalent when stating:

“Those four conclusions have been challenged extensively in the years since Statement 2 was issued.”¹⁴

He points out that considerable uncertainty of future benefits exists not only for internally developed intangible items, but for many other items that are regularly recorded as assets, while it is “absolutely certain” that a firm will be lacking in valuable resources without these investments.¹⁵ A causal relationship, therefore, is clearly established. He also outlines academic research which also has shown, in general, that the financial markets, who represent a significant contingent of financial statement users of public corporations, lend more relevance to full cost up-front capitalization and capitalization after determination of successful efforts, than to full period expensing of internal R&D expenditures.¹⁶

The markets for both existing and new products and services are considered by accountants to be similarly uncertain as markets for technology generated by R&D, as they are subject to uncontrollable economic and competitive forces. Therefore, market development expenditures are required to be expensed in the period (month, quarter, or year) incurred. This is also why most R&D and marketing expenditures are classified as period expenses along with direct sales and indirect general and administrative (G&A) expenditures.

¹⁴ Ibid.
¹⁶ Upton (2001), pp. 84-86.
Transactions for acquiring or producing inventories, machinery and equipment, buildings and land, and other physical property, although they are of declining influence in overall firm value, appear to have been absorbing a continually increasing proportional share of accountants’ attention. Accountants have developed and regularly redevelop methods of cost-based valuation for physical assets. They monitor these transactions and collect the associated expenditures in construction in progress accounts, in pre-production pools, in overhead allocations for materials and labor inputs, and other such devices in order that the actual cost of physical assets can be capitalized, i.e. placed and carried in the financial statements.

The accountants then must continually protect these assets to ensure they are secured, maintained, and preserved from stealing, spoilage, or mishandling. They must also stay on watch to expense these assets in full or in part as they are sold, consumed, and used in the course of business sales and operations. They must take care that any remaining value is fully carried over from period to period in the books of account. Deliberate systems and methods are developed and put in place to assure that the recategorization of assets to expenses is properly matched to specific product revenues and time periods. First-in-first-out (FIFO) inventory valuation and machinery double declining balance depreciation are respective examples of these expense recategorization methods. The accountants must also monitor physical assets for any possible impairment, an indication that their actual value in the market may have deteriorated in comparison to their internal carrying value in the financial statements.

In comparison to all of this administrative activity for physical assets, accountants’ treatment of company internal development transactions for intangible resources such as designs, brands, and customer relationships is most often to expense them as incurred. Even the costs of tangible output such as prototypes, models, and demonstrations are generally expensed. Expensing is also done often without any specific program category recognition or product revenue matching, other than a department or cost center being charged for the expense. Once expensed, visibility to residual value over the resource’s useful life is virtually lost, and, therefore, monitoring becomes technically unnecessary.

Period expense of these activities continues even in the face of major advancements in technology, methods and practices for automated pre-testing of design and
development concepts for products, services and markets. Companies and their investors do not enter into very many ventures that are so absolutely filled with risk that a common, reasonable outcome cannot be expected. There is also no reason to believe that expensing versus capitalizing would make managers any more or any less inclined to irresponsibility. Proper expensing passively eliminates risk of any and all negative consequences from failure or manipulation. However, this has not stopped some accountants from capitalizing against rules and practice standards, as WorldCom’s management did for line maintenance costs of billions of dollars, nor from hiding expenses and risks of losses by delaying their recognition to an indefinite future period, as Enron’s financial officers did with unique majority owned SPE’s.

Capitalization, however, provides an extended period of visibility to differentiation costs through accountability to company strategic projects, making them more likely to be proactively reviewed for measures of success. When impairment does occur, the write down actually provides another valuable signal to owners for monitoring purposes. Unfortunately, in the current accounting system, when expectations are not met for these projects, there is no definite indicator that arises in the financial reports. Most of the investment in differentiation costs has previously been expensed, sometimes many periods earlier. Further, financial theorists often instruct management that sunk costs, because they are a thing of the past that can never be changed, should not enter into present decisions on how to proceed into the future. The accounting system, however, is particularly equipped to accurately measure, categorize, and dispense historical cost based transactions. Measurements of the ability of management to make investments that earn an appropriate return are certainly relevant for setting future expectations of the performance of the leadership team in the organization.

The accountants holding to traditional practices that were successful in the past echoes the problem of successfully innovative firms, who later fail once they become entrenched in their past positions. Competitors arise and erode these firms’ market leadership position, and consumers have more choices and receive more utility. However, with national accounting standards, there is a monopoly environment, not a competitive situation. If standards become outdated or less relevant, they can remain in place for all companies reporting regardless of their usefulness. The “consumers”
of financial statements are left worse off, and have nowhere officially to turn for alternative audited reports.

Most national governments, nevertheless, add their blessing to these outdated standards by officially recognizing them and requiring their use in audited financial statements of their registered corporations. They have up to now chosen politically to restrict their choice to the single output of a national standards committee, except for the recent choice of most EU countries to drop national standards and exchange them for the even greater centralized standards of the IASB. Management in corporations, with their strong emphasis on lowering costs, have little economic incentive to lobby strongly for change that would add to disclosure requirements or increases transparency. The large accounting firms also suffer under serious competitive pressure with audit fees having been rationalized by corporate clients. The firms themselves have allowed their audit services and pricing to become commoditized and marginalized in the market. Therefore, time taken by highly qualified experts in accounting firms to input to standards development of benefit to the general public is seen as a loss of resources that could instead be placed in revenue generating activities, which are in the interest solely of the accounting firm. This has come to include comparably more lucrative consulting in proprietary financial reporting and measurement systems.

Financial analysts also have little reason to lobby for improvements in the accounting standards, because in the current situation, they are granted the opportunity to differentiate their equity advisory services by developing their own financial models and publishing their own reports. Credit rating agencies, which make up another outside group of governance agents, are invited into and paid by the firms to make their examinations. They are provided with whatever details they need to rate the lending volume and credit risk levels of the firms. However, they do not see the need for the financial statements standards regarding intangible assets to be modernized, because the information they need is made available privately. In fact, their greatest concern is for the creditors of the firm, in order that they can feel assured that they will be repaid for the money advanced to debtor corporations. Shareholders are the last in line at insolvency, and the ratings agencies have no responsibility to approximate or comment on the value of the firm for investors’ purposes.
7.5.2 The Reporting Gap and The Expectations Gap Compounded

As firms all over the world continue to adjust to modern consumer requirements for innovation, technology and image in products and services, the *reporting gap* between the equity value reported in the balance sheet of the financial statements and the investment value of the company’s shares will continue to widen. This is not just a serious issue in traditional western developed economies, but the transition economies of Eastern Europe, Asia, and Latin America, among others, are comparably quickly advancing into their own development of innovative services and other intangibles.

In the current environment of uncertainty caused by the frequent reporting surprises and financial crises, the issue of the *expectations gap*, as identified in Chapter 5, for the accounting industry and profession has also worsened. Pressure is on the accounting standards setters of the FASB and the IASB to make financial statements more relevant. Moreover, the general public continues to place their trust in financial statements audited by independent, certified accountants with the strong belief, and seriously rational expectation, that the accountants and auditors deliver what they advertise by the descriptive titles of the statements, including:

1.) the central Statement of Financial Position (a.k.a. Balance Sheet) which should carry the full investment basis determined by actual measured cost rather than expected market value, of the company’s internally developed and externally procured resources, i.e. assets, and match, or balance, these resources to all claims against them from creditors, owners, and all other contractual vehicles, entities and individuals, i.e. liabilities and equity;

2.) the Statement of Operations (a.k.a. Income Statement) which should report the firm’s earned revenues at market value and match them to the expenses required to create, produce, sell, and deliver, at cost, those goods and services to customers and clients, with the difference expressing the true profit margin generated by the firm’s internal transformation processes;

3.) the Statement of Shareholders’ Equity which should provide a cost basis of the owners’ investment, not a basis that undervalues total assets and equity by excluding internally developed resources, but also not a market value basis that is filled with assumptions and guesses about future activities which have not been performed and future profits that have not been earned; and finally
4.) the Statement of Cash Flows which should reclassify expenditures for internally developed resources as investing cash flows rather than as operating cash flows in the current system.

As long as the accounting standards reject the recognition of many secure internally developed products and services as well as market factors, only because they are not physical assets or not purchased from external sources, none of the key financial statements above can be considered fully relevant. Resources will be grossly understated, which in-turn appears also to lead to a higher likelihood of the non-disclosure, as in off-balance sheet obligations, or misclassification of many liabilities. Profits will always be somewhat distorted because the expenses arising from investments in intangible factors of production are never matched to the revenues produced in the proper time period. The book value of equity will not reflect the cost incurred value of the investment in many internally developed intangibles. This has unfortunately steered management, boards, and governance agents to look to the very fickle stock market price as the key indicator of firm value. Even though bottom-line cash flow cannot change in reclassification of intangibles as assets, cash flow reporting can be improved by reclassifying operating expenses flows as investments in assets. Financing cash flows will also provide better indicators because it will be easier to identify financing activities, borrowing or raising equity, with the long-term investing requirements for funds.

The combination of the reporting gap and the expectations gap adds dramatically to the transparency barrier problem for management-supplied information. This combination therefore intensifies the agency problem for today’s firms. The solution that audit committees the world over must pursue lies in the recognition by accounting principles setters of the criticality of recognition of differentiation costs not only as economic assets but also as reportable assets. That knowledge must be managed in firms is a well-accepted responsibility, but what must be managed, must also be measured. In 2003, an important study contracted by the EU to investigate and review reporting practices of intangible assets determined:

“Reliable measurement is the regulators’ stumbling block to a systematic reporting framework.”17

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In the following two chapters, agency assurance offers a knowledge management basis for a reporting classification system, which provides an auditable basis for setting general accounting standards and recognizing specific business transactions in today’s complex business environment.
CHAPTER 8.

Classification for Intellectual Capital Recognition

8.1 The Impact of Creative Destruction on Firm Performance

In the first half of the 20th century, economist Joseph Schumpeter presented his theory of “creative destruction”, where he sought to show that entrepreneurial technological innovation was the main cause of significant economic growth. Innovation, he observed, creates discrete periods of disruption to the status quo of industries and economies.\(^1\) While this is often detrimental and even fatal for many of the entrenched firms, it seems to concurrently create an opportunity of equal or even greater potential for new competitive entrants and substitutes.

Paul Geroski of the London School of Economics more currently postulates that corporate growth occurs erratically, even randomly (as measured in many independent studies), because it is a function of innovation. Once a firm innovates, it succumbs to a strong tendency to shift its attention from creative development to protecting its hard-fought established position. Management of the firm is reluctant to innovate again for fear of cannibalizing its proprietary business or weakening its hard fought competitive position or both. This shift to an inward view therefore serves as a distraction to value creation that the firm might be able to attain if it continued to use innovation to seek further differentiation in newer inventions and applications. A few firms, however, are able to react and overcome this tendency when they have focused their vision to see that the latest innovation will protect them from new competition and reemphasize their creative leadership position.\(^2\)

Schumpeter’s and Geroski’s statements generally expose a significant weakness in the capability of large, entrenched organizations for cultivating and nurturing an endogenous environment of change and innovation. Michael Tushman and Charles O’Reilly have also observed this weakness and found that the most successful organizations are able to recognize the development of new strategic innovation streams. When such patterns appear, they are associated with a dominant design, architectural innovation, or product substitution. They appear during a period of

\(^1\) The Economist (1999-2), p. 7-8 article subtitled “Catch the Wave”.\(^2\)
accelerated discontinuous change in the industry. Between these crucial periods of discontinuous changes, there are normally relatively longer periods of incremental change, where the organization’s culture should embrace continuous improvements. What the authors identify as “ambidextrous organizations” apparently succeed in building cultures that adapt to and operate well throughout both of these main cyclical phases of the innovation stream – discontinuous change followed by incremental change.

On the other hand, most ordinary organizations suffer from what Tushman and O’Reilly term “the tyranny of success”, which keeps these firms stuck living in the past. Without realizing it, their own past success lures management into defending the status quo. They should rather be looking for the key new product or service either from within their own firm’s development organization or outside the firm from a potential competitor, that will inevitably make their current offer less attractive or even obsolete. Porter identifies these threats as either “new entrants”, whose similar offerings can steal away market share from existing providers in the industry or as “substitutes”, whose very different offerings can replace the products and services in an entire industry. Managers in these less successful firms often also fail to see the compelling need for divesting operations or cutting staff and overhead that will no longer add value in the new innovation environment.

Researchers at the Ernst & Young Center for Business Innovation similarly claim to describe contemporary, widespread activities that resemble this phenomenon of innovation induced disruption. They have also observed successful companies and from their findings predict that the development of business activities, now and into the future, is being driven by three key factors:

1. Connectivity – the geometric growth of interconnected communications points of telecommunications and the internet,

2. Speed – technological developments in processing power and communications bandwidth, and

3. Intangibles – the intellectual capital and innovation that carry value beyond any apparent tangible, physical worth.

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2 *The Economist* (1999-1).
3 Porter (1979).
Because the authors consider these factors to be both inevitable and irrevocable, businesses are expected to embrace these key factors rather than rejecting or ignoring them. The prescription suggested for management is to “blur” their business by defining new strategies and instituting methods that allow their suppliers, employees, and customers alike to participate in defining everything about the business – from design and production to pricing, distributing, and marketing.5

Critically relevant for the board’s agency assurance responsibilities, in response to these change factors, management is advised to reject traditional command and control processes. Although not a central theme of the book, the authors, nonetheless, clearly portray these generally accepted processes as barriers to be broken down by management. They claim that the command and control approach was only appropriate when tangible goods made up the main value being produced, and they deem that this approach has become outdated. Today’s managers must accept modern, fluidly adaptable organizational structures where decisions are made by empowered employees who are guided by an enterprise-wide cultural understanding of what is right and wrong. Finally, the authors recommend that the company should measure itself by stock price, i.e. market capitalization, and not by revenues earned from customers.

Is it possible that with the rejection of “the tyranny of success”, that management could be unwittingly led to substitute it with another unwanted form of tyranny? It is perfectly acceptable to direct specific criticism at outdated management practices, but it can be very harmful to level a broadly unspecific indictment against basic reporting and disciplinary controls. As shown earlier, a balance between collaboration and control, and their respective bonding costs and monitoring costs, is advisable. Revenues, although not the only measure, certainly show that the company is able to find its accepted place in society, satisfying its customers, and transacting competitively in the industry and overall economy. Moreover, it is hardly insignificant that the authors of the latter study are employed by, and publishing openly under the direction of, one of the world’s largest and most prestigious audit firms, Ernst & Young. It is difficult to advise management credibly to respect the audited financial statements, when, simultaneously, auditors and their firms advise management to question whether they have much value at all.

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5 Meyer & Davis (1998).
Whether or not managers have been successful in the call to *blur* their business in order to adapt competitively to the contemporary knowledge based environment, is not of central interest to agency assurance. The fact that many have achieved to *blur* their business in respect to corporate governance *transparency*, however, is of primary concern. The previous chapter showed how the business environment complexity has changed in at least five different dimensions. The challenge for investors to gain a true and fair view of a business’ performance and prospects is already severely increased by this complexity. When the transparency barrier is raised simultaneously, this task is made all the more insurmountable.

### 8.2 Agency Assurance in the Knowledge Management Context

When knowledge based transactions are ignored by accounting principles, quality of the entire accounting system suffers. This misplaced conservatism, in turn, contributes to raising rather than to lowering the transparency barrier. In 2001, Thomas A. Stewart strongly warned:

> “we’re not talking about fraud, except in a few cases – we’re talking irrelevancy, with the result that investors are kept in the dark and managers are operating by guess and by gosh.”

6

In direct contrast to current standards, the classification axis of the agency assurance model, as illustrated in Figure 8-1 below, recommends a framework for the accounting recognition of the great array of knowledge based assets produced in the modern business environment presented in the prior chapter.

This classification framework utilizes foremost a knowledge basis for governing accounting standards in their critical contribution to MSI. This knowledge approach addresses the principles, which govern the reporting output, as well as the transactions, which provide the categorized inputs, of the accounting system. Before looking more specifically at MSI and making recommendations for change, gaining a better understanding of the general business economic environment in which MSI is currently placed, and which shows that such changes are overdue, is advisable. The relatively new field of *knowledge management*, therefore, should be able to provide insight into the potential for recognition of the value of these intangible assets.

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8.3 Classification: A Knowledge Management Basis

“In an economy where the only certainty is uncertainty, the one sure source of lasting competitive advantage is knowledge. When markets shift, technologies proliferate, competitors multiply, and products become obsolete almost overnight, successful companies are those that consistently create new knowledge, disseminate it widely throughout the organization, and quickly embody it in new technologies and products.”

Ikujiro Nonaka in “The Knowledge-Creating Company”

8.3.1 Knowledge and Differentiation Costs

As the above quotation points out, the contribution of knowledge in businesses today is not fleeting, while the value of many assets that have been categorized as long-term in nature, may be not as long lasting as has been traditionally thought. It appears, as well, that due to the five new factors of modern business activity described earlier, the center of balance for business activity, in the contemporary setting, has moved away from the exploitation of traditional physical capital and toward the contribution of modern intangible knowledge. A great portion of public corporation investments is related to differentiation costs. Firm capital is directed at acquiring externally or developing internally intellectual capabilities that support the newer emphasis of these five factors over traditional factors. Consistent with this observation, in its 1996 study The Knowledge-Based Economy, the OECD reported that the economies of its larger

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members had grown to be over 50% knowledge based.\textsuperscript{8}

There is also apparently a very substantial untapped reserve of knowledge readily at hand that management has yet to exploit. The Dutch Knowledge Management Network has estimated that businesses only employ about 20% of their potential for knowledge as a resource.\textsuperscript{9} The OECD report also concluded that the shift to human (intellectual) capital and technology is continuing to increase in importance throughout all of the OECD member nations.\textsuperscript{10}

In consideration, then of how highly recognized the modern dominance of intellectual content in the many forms illustrated above, it should be expected that the financial reporting system would have adjusted commensurately to the new business and industry environment. While many forms of MSI have been developed or adapted to this modern environment, and the many role players in the corporate governance system have also adjusted their analysis to include more intangible factors, the accounting standards setters have not managed to define a consistent system for recognition of knowledge-based assets. Therefore, a better understanding and recognition of what knowledge is must first be established, as presented below. After this, a system for valuation of knowledge’s contribution to business, i.e. an intellectual capital basis, is proposed.

\textbf{8.3.2 Knowledge and its Forms Defined}

Management theorists have recently come to define knowledge concisely as \textit{justified true belief}. It is a product and possession of the mind and psyche but is somehow more than just random or fleeting thoughts, perceptions, ideas, hopes, emotions, or imaginations. Knowledge evidences some elements of organization, even if unsystematic, and of endurance, even if brief.

Knowledge is generally manifested in two basic, distinct forms – explicit and tacit. The key factor of differentiation of these forms is that explicit knowledge can be communicated in a recognized written, spoken, or gestured language. It is, therefore, the easier to comprehend of the two forms. The more obscure concept to grasp is tacitness. This has been described simply as, “We can know more than we can tell” by

\textsuperscript{8} OECD (1996).
\textsuperscript{9} uit Beijerse (1999).
Michael Polanyi in his seminal work *The Tacit Dimension*. Individuals and groups embody tacitness in the “insights, intuitions, and hunches” and “collective sense of identity”, respectively, that they tend to form intrinsically. Tacit knowledge is differentiated from explicit knowledge also in that it is possessed more personally by an individual or organization. Therefore, the transfer of tacit knowledge is generally more expensive, time-consuming, and difficult than the sharing of explicit knowledge.

Knowledge, i.e. *know-how* in management jargon, has been an important contributor to business entity value creation throughout commercial history, even if it has predominately gone unmeasured. “Accumulating and applying knowledge” by individuals and firms has also always been an important strategic commercial objective. With the realization and acceptance of knowledge’s contribution in economic science and business studies, the requirement of measurement and accounting of its contribution to firm value has naturally arisen. Perhaps understandably, it is the tacit dimension of knowledge that, by its invisible and transient nature, conflicts with necessarily strict measurement and control standards of generally accepted accounting principles. However, there is a great reluctance by the accounting standards setters to recognize even the clearly enduring value of intangible assets of the explicit dimension.

### 8.3.3 The Contribution from the Maturing Field of Knowledge Management

The growing general understanding and acceptance of knowledge theory in research and business today is accompanied by the emergence and growth of the field of knowledge management (KM). Many streams of research are being pursued to describe business practices that recognize and build on the value of knowledge in modern firms. In a literature review of the great breadth of the KM research landscape, Derek Binney has produced a helpfully condensed framework called the *knowledge management spectrum*. The various published research emphases have been grouped into six descriptively named categories on the spectrum as shown in the

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As one scans from left to right on the KM spectrum, the emphasis moves from management of highly codified, repeatable explicit knowledge to highly personal, original tacit knowledge. Transactional KM includes experiential history and results that can be accessed, retrieved, and referenced from storage, physically or virtually, as from a database. The person requesting the information can use it to formulate a response, behavior, or other plan of action that best fits a current transactional situation. Analytical KM takes data and information stored in the organization as input to organizationally relevant algorithms for assembling patterns, segmenting groups, determining statistical relationships, etc. The results from these analyses usually provide more specific direction for implementation of projects.

Asset Management KM is a system of identifying, inventorying, and issuing explicit knowledge-based organizational assets. For example, traditional intellectual property including designs, brands, formulas, etc. can be more easily accessed and utilized by various departments and divisions. Rather than becoming dormant and obsolete, these
assets have the potential to be exploited in broader applications and situations and longer time periods than without this KM approach. Process-based KM is a structured approach to the organization’s internal procedures and methods. One important goal of this approach is to develop day-to-day habits and activities into documented best practices.

Developmental KM is concerned with introducing, enhancing, and renewing human resource capabilities on a personal level. Typical developmental initiatives include continuing education and training focused on building up individuals in their professional, technical, interpersonal, and collaborative skills. Innovation and Creation KM recognizes the burgeoning contribution of teams working in concert towards shared project objectives. Organizations need to find a motivational balance between leadership and loyalty in their group dynamics to foster an environment that recognizes and exploits its creative contributors.

The completed KM spectrum also identifies a significant number of knowledge management applications as well as enabling technologies that have been instituted in business practice today. Knowledge management applications are business functions, activities, and systems, while enabling technologies are primarily information, communications, and workflow oriented tools. In the lower half of Figure 8-2, below, Binney presents a fairly exhaustive list of examples of these applications and technologies. Each of the examples is associated with one of the six KM spectrum categories.

The classification axis of agency assurance calls for the positive recognition of such an inventory of choices across the entire KM spectrum. The FASB Exposure Draft Business Combinations and Intangible Assets offered just such a categorized inventory list of the types of intangible assets which can be identified for valuation, employment and monitoring. Some items are separable from the firm, as there is no legal restriction on their sale, however others are bound to the firm simply due to internal legal contracts or declared property rights. Upton presented a revised list of these assets as found in the following Table 8-2.16

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Table 8-2. List of Intangible Assets for Recognition by Firms

<table>
<thead>
<tr>
<th>Item</th>
<th>Separable</th>
<th>Based on contractual/legal rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agreements and contracts (for example: advertising, airport gates, construction, consulting, customer, easements, employment, insurance, licensing, maintenance, management, manufacturing, marketing, mortgage, noncompete covenants, royalty, standstill, and supply)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Rights (for example: broadcasting, concessions, development, gas allocation, landing, lease, mineral, mortgage servicing, property, reacquired franchise, servicing, timber cutting, use, water)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Favorable executory contracts (for example: leases )</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Permits (for example: construction and environmental)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Patents</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Copyrights (for example: manuscripts, literary works, musical compositions)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Franchises (for example: cable, radio, television)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Trademarks, trade names (for example: brand names, newspaper mastheads)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Computer software and licenses, computer programs, information systems, program formats, internet domain names and portals</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Unpatented technology (for example: secret formulas and processes, recipes, manufacturing processes and procedures)</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Value of insurance-in-force, insurance expirations</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Technical drawings, technical and procedural manuals, blueprints</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Databases, title plants</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Research and development</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Lists (for example: advertising, customer, dealer, mailing, subscription)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Files and records (for example: credit, medical)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Financial institution depositor or borrower relationships (for example: core deposits)</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Savings value of escrow fund</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Customer routes or territories</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>


These explicitly identifiable intellectual assets in today’s economic environment pass the recognition tests identified in IAS 38 *Intangible Assets*, which call that such assets:

- should be identifiable
- should have future utility
- can be transferred separately, and
- can be controlled.”\textsuperscript{17}

Management should be able to direct their considerable investments and expenditures to the specific categories of knowledge management they are trying to influence strategically in creating these types of new intangible firm resources (i.e. assets).

Among the approaches of the KM spectrum, the Innovation and Creation category, especially, is receiving significant attention. Similar to Porter’s differentiation strategy choices for firms, contemporary KM researchers are searching to define what truly distinguishes one firm from another, contributes to strategic competitive advantage and underlies what may be the most important, but at the same time most tacit and least tangibly measurable category of intellectual capital. According to J. Barney’s article “Firm resources and sustained competitive advantage” in California Management Review (1991), organizational resources add to strategic competitive advantage, and hence value, when they are:

1. themselves valuable,
2. not easily substitutable,
3. difficult to imitate, and
4. rare among competitors.\textsuperscript{18}

Echoing Schumpeter’s warnings, competitors, therefore, are motivated to seek to create resources that are different from each other as well as to build barriers to entry from this differentiation, and to protect and limit features of imitability and substitutability of their products and services, which are called “barriers to imitation”. The most valuable, non-substitutable, least imitable, and rarest of these resources are individual and organizational “competences”. In summary, “the potential for competitive advantage is greatest in industries where firms need large investments in specialized activities, skills and assets – a form of organizational commitment.”\textsuperscript{19} This highlights again the critical role of knowledge, both explicit and tacit, in organizational

\textsuperscript{17} European Union (2003), p. 152-153 .
\textsuperscript{18} von Krogh and Roos (1995); Sanchez, et al. (2000); and Bollinger & Smith (2001).
KM today, as well as the importance of identifying differentiation costs to modern MSI.

8.4 Intellectual Capital Basis for Accounting Recognition of Intangibles

8.4.1 The Distraction of Market Value Approaches

Knowledge management in firms is linked to the development and production of intellectual capital (IC) as a resource for creating firm value. In the FASB Special Report: Business and Financial Reporting, Challenges from the New Economy, IC has been identified as the missing link needed to bridge the valuation gap spanning from the book value of the audited financial statements to the market value of the firm.20 This report represents the capstone to three other studies commissioned by the FASB under the Business Reporting Research Project in 2000 and 2001. Its sentiment echoes throughout nearly all intellectual capital literature. The following studies show that this issue is an international concern, identified by researchers from many countries on various continents.

In the introduction to his study “Measuring intangible corporate assets”, Luiz Antonio Joia from Brazil states:

“Knowledge may be intangible, but that does not mean that it cannot be measured. As we know, markets do it when they value the stock of some very knowledge-intensive companies way above their book value.”21

Joia adopts definitions from the Skandia Value Scheme, as found in Intellectual Capital (1997) by L. Edvinsson and M. S. Malone and presented as a chart in Appendix 6, and refers to the Intangible Asset Monitor from The New Organizational Wealth (1997) by K. E. Sveiby, in developing his own scheme for categorization intangible value in the firm. He calls his model the Intellectual Capital Taxonomy as presented in Figure 8-2 below.

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Figure 8-2. Intellectual Capital Taxonomy

As originally proposed in the Skandia Value Scheme, Market Value is composed of both Book Value, as calculated and reported in the audited financial statements, and Intellectual Capital, which is all residual value not embodied in book value. Joia’s model, as shown in the figure, breaks down these major categories further, with some additions and changes from the Skandia Value Scheme that Joia has measured in his research.

It therefore appears or it could be inferred that a simple additive relationship among these various forms of capital exists, and that, when given the value of each element, a sum can be produced. However, the study goes on to analyze only a single firm in the relatively mature and stable magnesium industry. The results of specific business strategy action programs are measured and then priority weighted and associated to these various intellectual capital forms. Joia utilizes “some computer calculations, using a specially developed software”. He claims he could produce a very high correlation of ratings (i.e. indices) for intellectual capital with the market to book (M/B) ratio for the firm from 1995 to 1998, on a primarily retrospective financial basis. In his conclusion, it seems Joia cannot resist pointing out that “accountants are unable to measure the intellectual capital of a company”, but he also admits that for this area of contribution to IC research “a long and arduous road still needs to be
negotiated before we have reliable measurements for this intangible capital.”

A second research study from Spain reviewing the IC literature also adopts the Skandia Value Scheme to classify types of intellectual capital. They suggest that a complete review of intangible assets within these types would involve three steps – identification, measurement, and monitoring. The measurement method chosen involves financial or non-financial indicators using different scales or units for each identified asset. This would not allow for a summation of monetary value, but would support a system of management of strategic intangible assets. They also encourage the regular development of new indicators to ensure the organization is responding to changes in the business environment and firm objectives. While the voluntary disclosure of these indicators by firms appears to be an accepted practice, the methods for development of the indicators are withheld for competitive reasons.

A third study from a team from the Asia-Pacific region (Hong Kong and Australia) “attempted to conduct a meta-analysis of the field of intellectual capital.” They conclude that the research just has not progressed far enough or deeply enough to understand the issues of measurement and management of intangible assets. In addition, after reviewing the many reporting models for intellectual capital that are offered by research teams they suggest that the qualitative systems, especially Sveiby’s Intangible Asset Monitor and Kaplan and Norton’s Balanced Scorecard are the most useful strategically.

A fourth article from an Irish team reviewed the indicators and measures in most every accepted intellectual capital research model and found fairly similar approaches, which have nevertheless been arrived at from independent perspectives. From these studies the various financial and non-financial indicators are recommended to be classified using categories equivalent to the Skandia Value Scheme. But similar to all of the other studies, it is concluded reporting methods of intellectual capital, especially when applied to the accounting field, are only just forming, without any apparent standard yet being adopted. From a review of the current conservative accounting standards for intangible assets in the UK/Ireland, US, and International (i.e. IAS), they also do not

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22 Joia (2000), p. 82.
23 Sanchez, et.al. (2000).
expect any accounting standard setting board to take the lead in this field.

Not unexpectedly, a fifth article from a research pair from the US and Canada adds its voice to the unanimous global opinion by calling for more creative, directly relevant, and deeper discerning value measurements for KM and IC than are today available.\textsuperscript{26} The authors identified five studies of KM metrics and provide a simple list (without definitions or critique) from a 1998 study by the ICM Group; a 1998 book by G. Roos, J. Roos, Dragonetti, and Edvinsson; a 1999 draft report by the Canadian Management Accountants motivated also by the lack of depth of research in this area; and the “Universal Intellectual Capital Report” by Edvinsson and Malone.

As referenced earlier, the OECD examined the knowledge economy in its 1996 report. Wayne Upton led the analysis of the impact of intellectual capital on financial reporting for the US FASB in a 2001 study. The EU also enlisted a research team to review how intangible assets can better be recognized as published in its report in 2003. Thomas A. Stewart refers strongly to research by key influential experts, Robert A. Howell, Baruch Lev, and C.K. Prahalad, all proponents of intangible asset recognition in accounting standards, and in a 2001 article he stated:

“Look at the evidence: R&D (which produces structural capital), high performance work systems (which produce human capital), and brand equity (a measure of customer capital) all produce significant gains in the value of companies.”\textsuperscript{27}

The KM and IC studies reviewed in this chapter are offered to assist in recognizing that internally developed intangible assets can be identified systematically. However, despite the clear urgency of the issue, the major world accounting standards boards still have not adopted any new form of principle and methodology.

\subsection*{8.4.2 The Justification for Historical Cost Capitalization versus Expensing of Intangible Assets}

Influenced heavily by the uninterrupted growth of the stock market and economy in the US throughout the 1990’s, researchers in the field of IC, which is an important complement to or offshoot from the field of study of knowledge management, fault historical cost accounting methods and principles for their failure to measure fully

\textsuperscript{26} Liebowitz & Suen (2000).
\textsuperscript{27} Stewart (2001), p. 272.
many market value components. They claim that by identifying IC strategic value in its various forms, categorizing intangible assets developed through investing this capital, and then valuing IC in monetary terms using financial market models dependent on predictions into the future, the perceived reporting gap of accounting could theoretically be closed.

However, there is a benefit of recent financial market experience available here in the early 21st century that we should not be overlooked. We are clearly in the post “irrational exuberance” period of the high technology, particularly internet related, equity valuations. Stock markets worldwide now reflect clearly lower share prices across the board for internet start-ups, with the possible exception of Google, as well as communications infrastructure equipment companies. The following graph in Figure 8-3, covering a ten-year trading period, illustrates the extreme peak on March 10, 2000 and the subsequent dramatic fall, of the technology weighted NASDAQ index, in percentage terms, compared to the broader S&P 500 and the Dow Jones Industrial Average (DJIA) indices.

**Figure 8-3. The Rise and Fall of the Shareholder Value Emphasis**

Source: BigCharts.com on March 10, 2005.

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This large market correction shows that previous specific and compelling market valuation measures appear far less deterministic today. For example, the estimates that each mobile phone client is worth over 10,000 Euros in telecommunications industry mergers and acquisitions pricing scenario or that the internet as a primary sales channel provides a value to a firm far greater than the combined value of all other major firms in the industry (i.e. Amazon.com) are no longer acceptable metrics. Perhaps this dot-com meltdown is why the latest FASB Report recognizes, if only too cursorily, that market value is influenced by “puffery, pessimism, and market psychology”.30

Yet the stock market meltdown has not yet wilted the criticism of accounting, despite the closing of much of the reporting gap due to the share price decline in most of the high profile firms. Instead the evidence of a real “new economy” remains.31 This supports the need for new methods in economic, financial, and accounting measures. As evidence of a new environment, despite the correction in market value shown in the top section of the above stock market index graph, the bottom section displays clearly that NYSE market activity, i.e. buy/sell volume, jumped greatly just prior to the turn of the century and has remained at these much higher levels for many years.

Therefore, the review presented earlier of the theoretical basis in KM and the respective IC models for measurement of intangibles, provides a relevant basis for reporting. It is no longer appropriate simply to overlay one of the equity share valuation templates that were derived prior to the stock market meltdown. The results of the review show that the relatively new study of KM has now developed far enough to provide a theoretical basis for presenting a specific deterministic application in the mature field of accounting. The models developed for identification and measurement of IC are not yet devised with the intent of application in audited financial statements. However, the combination of these research fields, KM and IC, do appear to support, at least indirectly, the necessity and capability for implementation of a new accounting standard for differentiation costs that incorporates measurement of historical cost for valuation of intangible assets in firms.

On one hand, it has been an enlightening incentive for the field of accounting,

31 OECD (2000).
especially *management* accounting, that over the preceding few years criticism was
directed at traditional financial reports for their failure to account for these market
values. On the other hand, with the sudden disappearance of billions of dollars
worldwide in market value, *financial* accountants would be today dealing with
significant impairment issues, if these market valuations had been translated somehow
into inventoried assets on company balance sheets.\(^{32}\) This is why the accounting
profession must exercise the conservatism principle in its interpretation and adoption
of knowledge management and intellectual capital research. Intangible assets are
identifiable and controllable, and therefore, capitalizable. However, a measured actual
cost based approach should provide an upper limit to valuation of these assets.
Accounting policy makers also should not fall into the dangerous trap of applying this
research to the preparation of financial statements where the researcher’s own
intentions and findings were not directed toward accounting.

The monetary values enclosed in accounting statements have arguably never been a
perfect indicator of firm economic value. Market based valuations are a function of
interoperable variables of book value, human capital, structural capital, and market
psychology, whose relation to each other is theoretically sound but not yet accurately
measurable. The most well accepted investment valuation models incorporate
forecasted cash flows that are discounted by a rate of return appropriately factored for
firm (or project) risk. Accountants have long understood this concept and debated its
application in asset representation on balance sheets. They have concluded that this
method is appropriate almost exclusively only for valuing fixed income securities and
other fixed payment contracts. With these financial assets, the firm has no significant
contingencies left to perform in recognition of revenue and in earning the cash that
underlies the asset value.

One recent study also underlies this principle of contingencies by warning of the trap
to consider intellectual capital as simply the sum of the firm’s intangible or intellectual
assets (IA) values without also devising methods of identifying and recognizing
intellectual liabilities (IL), i.e. “IC = IA − IL”.\(^{33}\) An important aspect of investment
valuation models is the use of a discount rate to *reduce* the sum of the payment

\(^{32}\) Caddy (2000).

streams to a net present value (NPV) for these assets.\textsuperscript{34} Conservatism again plays an important limiting role in valuation, but not in blocking asset recognition.

The greatest argument that accountants pose in requiring the immediate expensing of activities related to producing internally developed intangible assets while allowing the same categories of externally acquired intangible assets to be capitalized relies on the conservatism concept. Accounting rules setters are concerned that the asset carrying value may be impaired without reliable projections of the future income that can be generated from these assets. Of course, the same argument can be made regarding any acquired intangible assets, but they are allowed to be capitalized anyway. The assumption is that purchased assets are likely to have established markets, whereas internally developed ones are not. However, there appears to be little empirical evidence to back these conservative hunches (i.e. opinions). As the following Case Review 8-1 presents, actually, acquired intangibles are capitalized at all stages of their life cycle.

\textbf{Case Review 8-1. Acquisition versus Development of Intangibles at Cisco}

All throughout the past decade, Cisco Systems (Cisco), the world leader in networking equipment, has been acquiring smaller networking hardware and software companies, most prior to or soon after these companies going public. Cisco used its own inflated stock price during the stock market run-up of the 1990’s, to acquire new technologies by taking over smaller potential competitors and suppliers. Often by simply issuing more stock, Cisco was able to consummate deals totalling in the billions of dollars. Most often Cisco succeeded in absorbing the technological innovations of the acquired companies into Cisco’s product lines before these companies had established markets for their own products and encamped in those segments.

In August of 1999, Cisco acquired all of Cerent Corporation in exchange for 100 million Cisco common shares that had a stock market value of US$6.9 billion at the time of the transaction. Cerent had been established in January 1997, had less than 300 employees, was not profitable, and had few customers and minimal sales; but it had developed its own promising technology.\textsuperscript{35} Even if Cerent had hired all 300 employees on its founding day, and all of them had been employed for three years as

\textsuperscript{34} Sanchez, et.al. (2000) and Caddy (2000).
engineers at an average cost of $110,000 per person for all salaries and expenses each year, the total costs incurred would still not total $100 million. In other words, this investment of $0.1 billion in actual costs may not even show up in rounding calculations in comparison to the $6.9 billion valuation at acquisition.

Under current US GAAP rules, Cerent was required to expense all of its development costs. Accounting standard setters consider it too risky to capitalize these costs. However, because the acquisition is a “market” transaction, even with no cash being involved, the same set of accounting standards generally requires Cisco to capitalize the entire acquisition value. Cisco had to split the $6.9 billion between an estimate of the value of the technology, which must be amortized, and another asset called goodwill. Goodwill is the premium paid over the value of all recognizable assets, less any debts, of the acquired company. It appears that at a cost of $100 million, the risk is too high for Cerent to recognize its internal intellectual capital, while at an estimated $6.9 billion acquisition value, the risk is virtually ignored for Cisco to recognize these same assets.

In addition to Cisco, innumerable other examples are available of acquisition of intangibles that are capitalized in all stages of product and service life cycle, seemingly regardless of risk or outlook. In addition, these purchased technologies and innovations which are carried as assets are often intermingled with and become inseparable from internally developed products, services, and processes whose efforts are expensed. The press reports daily of these acquisition transactions across all industries such as pharmaceuticals, semiconductors, automotive, chemicals, telecommunications, financial institutions, etc.

In June of 2001, however, FASB issued its Statement 142 Goodwill and Other Intangibles. This new accounting standard no longer allows goodwill from acquired companies of US firms to be amortized. Instead, after valuation and capitalization at acquisition, goodwill must be analyzed at least annually for impairment and revalued lower, as necessary. This means that the standard setters accept that goodwill, an unidentifiable, lump-sum premium paid at acquisition, is more appropriately capitalized versus identifiable actual costs incurred in development. Somehow, FASB appears to possess great trust in acquiring companies bid price methodology and

negotiation ability, despite significant evidence of overpayments for many acquired businesses. Goodwill is not even subject to an amortization schedule, which would ratably reduce the asset value carried in the financial statements, and help to match expenses to revenues. Alternatively, since the standard setters do expect that goodwill does normally lose value, then they prefer to delay recognition of these costs until impairment is documented, which would almost certainly occur in a period after the assets’ value has been exploited.

8.4.3 The Conservatism Concept and Disclosure Principle in Reliable Balance

As noted earlier, an important guiding principle in the accounting system is the conservatism concept. Conservatism is an environmental factor which should permeate the personality of the accounting function. However, this should not become a factor which management uses to distance itself from its own internal accountants nor should it be misrepresented as being an inaccurate view of results. The disclosure principle also carries much weight in the overall balance of standards in the accounting system. Disclosure can be defined as follows:

“… a company’s financial statements should report enough information for outsiders to make knowledgeable decisions about the company. In short, the company should report relevant, reliable, and comparable information about its economic affairs.”

Management has an almost innate tendency to present an inaccurately optimistic view of its own activities, a view that often suffers under a cloud of management’s conflict of interest. Accounting’s conservatism, rather than achieving an oppositely inaccurate pessimistic view, is necessary to reduce management’s contribution to information asymmetry. Conservatism, when properly applied, moderates the effects of conflict of interest on the information presented to the public, providing a fairer view of the firm’s financial condition. Disclosure presents the proper information at the proper time, with information users in mind.

Principles such as conservatism and disclosure, rather than dictating rules explicitly, govern accounting practice as it develops. This is a concept similar to the British and American common law system which developed from historical practice and judicial precedence. Conservatism is not defined as presenting the worst case scenario, rather

it sets the expectation that accepted practice and precedence will be followed first and foremost. In their absence, conservatism then would call for an adaptation of the closest existing accounting practice that provides a best fit to the situation. Disclosure requirements would also have influence, for example, in not allowing expensing of assets simply because management has unexpectedly high firm profits to realize. Finally, in the extremely rare event of a choice between two apparent “best fits”, the one that presents results through a more accurate, stable, and consistent method should be adopted. Conservatism’s objective, therefore, is not the result from accelerating incurrence of all costs and expenses while delaying recognition of all incomes and revenues.

What other reason, in light of a correct view of conservatism and disclosure, do accountants have for capitalizing only acquired intangible assets? The reason given is one loosely based on trust in economic theory, i.e. that the capitalizable cost of this asset has been determined by the market mechanism. A fair price, and therefore appropriate capitalizable value, for the asset is set at the point of sale through arms-length negotiation in a competitive market. This reasoning is given in full view of the fact that there actually are few, if any, active markets for intangibles that approach what economists would consider fair or competitive. These nascent markets cannot begin to be compared to those that are well established for hard commodities, products, or services. Most of the time, in these intangible markets, negotiations are held in secret between only two parties, the ultimate buyer and seller, with the buyer having no knowledge of any previous interest or bids for the items. In addition, a significant number of intangibles are acquired in package deals of more than one asset, or even through vast M&A transactions. No specific prices for the individually identifiable assets have been negotiated. Applying principles of conservatism and disclosure in this light, the accountants of the buyer should have no more confidence in the value capitalized at acquisition than the accumulated, traceable, measured cost of internally developed intangibles.

These knowledge assets cannot be differentiated for usage by the firm from one another by whether they are internally developed or acquired. In either case, they meet the respective standard in the US FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises:
“Definitions”—The item meets the definition of an element of financial statements.

Measurability—It has a relevant attribute measurable with sufficient reliability.

Relevance—The information about it is capable of making a difference in user decisions.

Reliability—The information is representationally faithful, verifiable, and neutral.”

The last major argument against capitalization appears to be related to value chain management theory and the Skandia Value Scheme. Thomas A. Stewart refers to the earlier work of Paul A. Strassmann, Margaret M. Blair, and C. K. Prahalad, who describe the contribution of human, organizational, and customer capital to firm value. Stewart expresses concern with mixing the value of these items with traditional assets in financial statements. Customers and suppliers are involved along with the firm in the creation of intangible value, and the determination of the ownership split or legal claims to each organization’s specific value can be cloudy. Capital is also created in efforts of employees and contractors who are not permanently bound to the firm and can take their knowledge with them wherever they go. A great problem with the logic of this argument is that the same cloudiness is present with acquired intangibles, as they were created at firms with their own customers, suppliers, employees, and contractors. The acquired costs are nonetheless capitalized as a rule.

Human, organizational, and customer capital are excellent descriptive terms to categorize how firms create market value in excess of the accounting book value. However, portions of the capital in these categories cannot be as easily separated from the existing book value of the firm itself. In current accounting standards, manufacturing labor and overhead, which contains human resources and other organizational costs, are already included in the value of manufacturers’ inventory. The long-term costs of constructing and installing production and service delivery systems and outfitting facilities for these purposes are also capitalized. These items are often developed with the direct input of customers’ requirements and specifications. The costs of R&D laboratories and benches are capitalized in a similar manner. All of these physical assets include costs derived from intangible knowledge,

and, in the accounting system, the value of assets is, in parallel, included in the equity, i.e. book value, of the firm.

A major roadblock to capitalization often arises because of the misguided desire to value intangible assets using mathematical models based on estimates of future revenue streams. The fault lies in the fixation on the stock market as a model for accounting valuation. Financial models including Real Options, Black-Scholes, Discounted Cash Flows, and similar Net Present Value methods, and even the newly popular Fair Value method include components influenced by stock and bond market prices. These prices are set by all of the investors in the market incorporating their outlooks and estimates of future operational profits not yet earned and cash flows not yet realized. Any model using a discount rate based on cost of capital includes an element of stock and bond pricing which is set predictively by market expectations.

These valuation techniques fly in the face of the long accepted cost principle, which calls for maintaining inputs to the accounting system utilizing actual incurred cost. Clearly, the actual costs within a single firm that have been incurred to develop an intangible asset are comparatively far easier for accountants to measure and to determine accurately, as well as to verify and monitor. These differentiation costs also represent absolutely the actual stake of the monetary investment associated with the firm itself, not the stake of its customers, suppliers, employees, or contractors. Although the determination of market value and future benefits to the firm is strategically directive, it is not accurate for standards of accounting application and economic measurement.

All of the above predictive models used by securities market analysts are helpful to the strategic decision process of a firm. They also should be given consideration, albeit in a supporting and not a deterministic role, in the evaluation of asset impairment. This would help to keep the conservatism concept in mind. However, there is no consistently reliable evidence for a place in accounting principles for future estimates as an accurate and conservative valuation technique. The appropriate solution is to follow long-standing accounting principles related to the capitalization of virtually all other assets – an actual historical cost basis.

Anyone who has actually led a business is not surprised at all by a reporting gap between the total sales revenue attained from customers and the total expenses incurred from employees and suppliers. This is called profit. Firms exist because the whole is greater than the sum of its parts. In capitalist and socialist economics alike, the production function of any properly functioning business entity results in value being added. Managers expect this result to show up in their profit measurements, whether value-add is produced by trade secrets, intelligence, or just plain hard work and extra efforts. This is hardly a revolutionary concept in business or economics. Why is it, therefore, such a conundrum for accountants to defend that audited financial statements should normally have a reporting gap when compared to market value?

Physical assets are generally maintained at historical cost. Inventories are carried at lower of (historical) cost or market. They therefore are neither allowed to contain any portion of margin nor of profit, which would be earned in the future. Their potential value is only given consideration in situations of potential impairment, in order to determine how far the value is required to be reduced. Although property, plant, and equipment items are supposed to be depreciated only to the extent of their residual value, buildings are commonly depreciated even in climbing markets for commercial real estate. But by classifying IC consistently at cost, whether acquired or developed, as amortizable assets, rather than expensing them directly up-front, a proper balance of the conservatism and disclosure principles can be achieved. The financial statements can provide users with important IC indicators of:

1. value - accumulated actual cost,
2. timing - at inception, during in-process development, over the expected useful life, and at final retirement, and
3. categorization - type of asset in service and business segment employed.

All of the intellectual capital studies reviewed neither make available models that can predict future performance nor eliminate firm risk. What these conceptualizations do offer is assistance to management in making better strategic choices by identifying knowledge producing activities and knowledge supporting environments that are more likely to improve firm performance. Attempts to measure intellectual capital resulting from knowledge creation and transfer have produced helpful lists of potential
categories of intangible assets to aid managers in the difficult process of distinguishing assets that contribute to competitive advantage versus those that are non-strategic resources. Managers need this assistance in IC recognition, in order for them to attempt to develop, nurture, and protect these “hidden” competences for their capacity to generate value.40

8.5 Knowledge Disclosure Benefits Both Control and Collaboration

A McKinsey survey of over 1000 directors on boards of American corporations shows that, in the great majority, they are seeking more information than management is willing or able to effectively supply, as shown in Figure 8-4 below.

Figure 8-4. Directors Increased Information Requests


Importantly, the categorical groupings of market, organizational, and network health are identified in the McKinsey study by directors as most desired for increased

disclosure. These groups match closely with the human, innovation, process, and relationship capital categories of Joia’s Intellectual Capital Taxonomy in Figure 8-2, as well as with the descriptions of intellectual capital included in the many other international studies referenced earlier in this chapter. It is reasonable to expect that accounting standards setters would react to these identified information needs of boards of directors. Improvements to accounting reporting systems embracing knowledge resources as identified in the classification axis of the agency assurance model should be suggested and implemented based on critical reflections of relevancy for these main users of financial statements.

The current situation of accounting standards is either demanding the expensing of most intellectual capital investments, as in US GAAP, or officially allowing capitalization but discouraging it at the same time through tests involving future revenue projections into the future, as in the IAS/IFRS. This results in an ever-increasing mismatch of today’s revenue earned with the expenses required for tomorrow’s revenue in financial statements. The world’s businesses are continuing to advance more deeply into areas of producing and offering non-inventoriable services and intangible asset based goods in international markets.

Unfortunately, more and more the accounting and reporting of businesses resemble those of charities and other non-profit entities. These non-businesses receive donations as income and provide services as output, and there is generally no requirement to match donations received with expenses for services provided. There is no legal consideration that must pass to the donor. However, in a business the client pays a specific sum for a specific consideration. With services and intangibles, the client has generally a reasonable expectation that the provider already has the inherent capability in place within the business, before making any commitment to the provider. This inherent capability stems from the investments in differentiation costs that the business has made, and these resources should be identified as amortizable intangible assets in the financial statements.

The understanding of knowledge management and intellectual capital has advanced to the stage that it is possible to create a detail classification system identifying many different forms of useful intangible assets. These assets can also be categorized further as stemming from knowledge that has emerged as explicit or that remains tacit. With
this new understanding and detailed classification guidelines, the next appropriate step is for accounting standards to embrace capitalization of the differentiation costs invested to create these assets. The immediate step, thereafter, is to set-up an appropriate classification system for monitoring the value of these assets. This would involve a proper schedule of amortization over appropriate useful lives of the intangible asset groupings in each industry and/or each business, as well as a regular requirement for revaluation due to any distinctly identified issue resulting in impairment of these assets. Revenue would be more closely matched with expenses, and long-term assets would be more closely matched with long-term liabilities in the financial statements. Cause and effect would be more apparent to the users of the financial statements, and the transparency barrier would be lowered considerably.

Financial statements make a singularly critical contribution to assuring that the proper financial controls are operating within the firm. Management as well as investors, creditors, tax authorities and other stakeholders expect that the firm’s cash is accounted for fully and that management is accountable for the investments and expenses that are made. This has to be aligned somehow with the idea that:

“The knowledge management process is not so much about control as it is about sharing, collaboration, and making the best possible use of a strategic resource.”

In fact it could also risk failure if employees perceive that the process is more about control than it is about “motivation, creativity, and adaptability”.41

A straightforward, highly objective, and consistent historical cost basis in accounting makes the integration of both of these requirements of control and motivation most achievable and auditable. This should also serve to reduce the transparency barrier by reducing asymmetry of information and by improving quality of earnings disclosure. As agency assurance model presented here has shown, the material relevance of identifying and recognizing the investment basis value of intangible property at actual cost in today’s knowledge based economy outweighs any doubts about the value or risk of this activity to financial reporting.

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CHAPTER 9.

Classification as a Principles Based Approach

9.1 The Audit Committee and Active Involvement in Accounting Standards

The audit committee is reliant on all internally prepared financial statements and reports, whether they are produced by an accounting officer, i.e. the historical results of the financial statements, or by a financial planner, i.e. future budgets, forecasts, and prospectuses, to be consistent with the generally accepted accounting principles. These employees report to and represent management, therefore all of their statements and reports must be recognized as management supplied information. The committee, board, and the public they represent can remain fully dependent on management and auditors for validation of this MSI. The sheer volume of MSI and of GAAP makes this dependence in large part a certainty.

The audit committee can reduce the impact of its dependency by playing a more direct role in how it approaches the preparation of this MSI. Directors can be much more active in the debates over the requirements for new accounting principles and reporting standards as well as risk assessments and disclosure requirements. Accounting standards was one of the key indicators employed by researchers in a study spanning financial results of firms and economic results in 31 countries from 1990 to 1999 of the effect of legal systems on investor protection. One of their conclusions was:

“well-enforced accounting rules can limit managers’ ability to distort reported earnings as well as shape the properties of reported earnings.”

The lobbying efforts in critical legislation proposals and GAAP standards additions must be supported through far more active contribution by directors groups and their board associations. This is especially urgent while many of these issues that go under review are generally delineated as direct responsibilities of boards of directors in corporate governance principles.

Boards of directors clearly recognize the critical role that knowledge management plays in all strategic and operational activities pursued by their firms in today’s

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economy. An improved understanding of investments in differentiation costs as well as the return on these investments, the revenues and profits directly associated with differentiation costs, is therefore required for directors to fulfill their responsibilities effectively. Stewart was highly critical of what he calls “generally unacceptable accounting principles” when he stated:

“Among many ways of creating financial opacity – managed earnings, one-time charges, and so on – the failure to account for intangible assets is probably the greatest in [monetary] terms.”

Audit committees, as the representative group of the board responsible for reviewing financial statements and internal controls of the firm, are in a clear position to provide the needed focus on the reporting and monitoring of these key knowledge resources. Differentiation costs must first be recognized as identifiable assets by generally accepted accounting principles and specific accounting standards. The capitalization and subsequent amortization, as well as any write-off, of the value of these assets also must be identified and categorized as reportable transactions in the accounting system.

9.2 Oversight of Self-Regulation and Reform in the Accounting Industry

9.2.1 Principles Leading the Standards Process

Accounting researchers and professional experts are responsible for the development of accounting principles. In the US, the Accounting Standards Board, a non-governmental, independent, non-profit organization, determines US GAAP, without ties to taxation regulations. The SEC transforms US GAAP into a set of quasi-regulations by legally requiring that public companies comply with these principles. The newly created PCAOB has added a new dimension in regulating more closely public company auditors and audit standards they follow. In many countries, including most of the EU members, GAAP has historically been set directly by government regulators and very closely tied to taxation regulations. More recently, the governments of EU and many other international countries have reconsidered this position and are adopting the International Financial Reporting Standards collectively set by the International Accounting Standards Board.

Properly trained and certified accountants are responsible for following principles and interpreting standards in preparation and validation of the financial statements that are published. In a principles-based system, when a new transactional situation develops naturally such as when technological developments make possible entirely new products or processes or when management devises a new business method, accountants must adopt accounting practices in the firm that are consistent with the broad set of principles that combine to make up the body of the standards. Rather than an individual accountant creating an accounting method that is convenient for his company until the standards board devises a specific rule to apply often years later, the fact that a void in practice exists should set off an alarm. The firm chief accountant responds to the alarm by studying the existing accepted principles to make every effort to apply and adapt them to the new situation. The firm’s external auditors, as well, can and should be informed and consulted, to take advantage of their independence of opinion in the fit of any new accounting practice with the full set of broad principles.

Especially following the many public cases of accounting fraud and error in the early years of the 21st century, accounting standards reform has been called to generally re-embrace a principles based system instead of a rules based system. The process of updating or introducing individual GAAP provisions specifically, however, is usually a long, drawn out system of study, proposition, negotiation, compromise, and implementation. Therefore, reforming ALL of GAAP as an objective provides little comfort for today’s investors. What are needed are specific targets for GAAP reform, based on a ranking of relevance and urgency, which can be proposed and implemented on a fast track. Investors should also receive confidence that the directors who they elect to represent their interests are actively supervising management’s lobbying of the standards board committees, if not directly participating themselves in the new standards proposals.

9.2.2 A Process for Recognition and Valuation of Intellectual Property

Research and development organizations, managed on a project basis where direct performance objectives are coupled with assigned funding, time and other resources, are good formal mechanisms for knowledge creation. Most marketing functions and

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4 Doshi (2004).
5 Bolinger & Smith (2001).
departments are similarly organized and incentivized on a project basis (excluding direct sales). With the rise of our consumer-oriented society, demands are being placed for marketing to be directly involved in product and service specification and design. Further, the 2001 FASB study on financial reporting states that accurate accounting for the cost of project based intangibles should prove to be an achievable organizational task, similar to other cost collection methods.

The Dow Chemical Company’s Intellectual Asset Management (IAM) model provides a mature system of procedural guidelines for recognition and valuation of most categories of R&D intangible assets. The IAM was implemented for Dow’s patent inventory in 1995 after two years of development of the process. Dow’s founding manager of IAM has openly published the details of its purpose and performance, and the process is illustrated in Figure 9-1 below.

Figure 9-1. Dow Chemical’s Intellectual Asset Management Process


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6 uit Beijerse (1999).
The authors of a recent study summarize why Dow was particularly successful with the IAM applied to R&D created assets:

“[They] chose to start with an area within the corporation that was familiar to many, had a high probability of success, would be an obvious value contributor, and could be accomplished quickly.”

As the diagram illustrates, there are six identified phases of the IAM process:

1. strategy – the intentional decision to pursue specific existing or new market segments with specific technology programs oriented to product and service development,

2. competitive assessment – recognition of the advantages and disadvantages of the company’s offerings in a market environment that is shared with other suppliers,

3. classification – identification of the expected use of R&D assets created, either for the company to include in its offerings or to license or divest to other organizations,

4. valuation – derived from the calculation of the estimated commercial revenue and profit opportunity over the expected life of each respective asset,

5. investment – the actual costs to the company for the creation of the R&D assets, and

6. portfolio – the resulting organized system or family of products and services derived from the company’s strategic technologies.

These phases are not necessarily chronological process steps, but rather required interdependent elements. The classification axis of the agency assurance model broadly embraces all six of these phases as a complete system, not only the third classification phase. The system is equally valid for all classes of intellectual property when applied to externally acquired technology as it is to internally managed development programs consisting primarily of labor and labor-related expenditures.

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8 Chase (1997).
9.3 Classification Standards for Internal Intangibles

9.3.1 Overview of the Proposed Accounting Principle for Differentiation Costs

An accounting principle would have to be adopted for recognition of internally developed differentiation costs as assets in the financial statements. Capitalization would be limited to explicit knowledge assets, and expensing would remain for tacit assets. There would be a reduced need for accounting rules, as the principle would require explicit description of the asset in question, which would include a reasonable estimate of expected life. Amortization would be the lesser of a standard life for each category of like assets or a specific life based on the productive span of the individual asset placed in the firm. At the close of each quarterly and annual accounting period, intangible assets would be reviewed for impairment, as is required for evaluating any assets held in the financial statements.

9.3.2 Capitalization Standards for Intangible Assets

As research and practice of knowledge management progresses, and greater understanding of intellectual capital is gained, more assets could become explicit in nature. Under the differentiation costs principle, assets in these new categories could be recognized and capitalized at that time, without adaptation or change of principles. The existing consistency principle should require a note to financial statements disclosure only that if the implementation of a new category has a material effect on profits for comparison to past results. In addition, once a category has been recognized, there must be consistency in recognition for the future. There must be no picking and choosing by management and their internal accountants as plagued the practicers of the rules for capitalization of software.

What this new principle should achieve is greater consistency with all purchased intellectual assets and with assets recognized in M&A transactions. Recognition of more classes of assets and more costs to capitalize in those categories would mean that during M&A, the accounting books of the both organizations involved will contain a higher value of intellectual assets. This should reduce or make more accurate the valuation of true goodwill in the M&A transaction. If this goodwill, then, is equivalent to tacit differentiation costs, the accounting standards boards may have to reconsider their very recent decisions to stop the amortization of goodwill. It
could even convince them to expense this reduced value of goodwill at acquisition, to remain consistent with internal tacit expenditures that would be classified as expensed differentiation costs.

Investments in differentiation costs are highly related to human resource contributions. All salary and labor related costs, including contract engineering and scientific work, should be either capitalized or expensed based on the activities the employee was hired or assigned to do in advance. This assumes that an intrinsic approach to motivation in a creative work environment of scientists, engineers and marketing professionals is more effective and desirable.\textsuperscript{11} A knowledge worker, therefore, will not have to be subjected to the disincentive of reporting of fractions of hours worked on projects. Instead they will be empowered and entrusted to manage themselves towards achievement of project goals and individual objectives they possess.

Standards for capitalization start dates should be applied liberally and very early based on what is happening operationally in the business. They should not to be delayed by administrative approval, planning, or review processes. Nor should they be subjected to arbitrarily conservative and inconsistently applied standards such as \textit{technological feasibility} as found in the US standard for capitalization of software development costs and the IAS standard for intangible assets. The vast majority of internal projects in corporations are planned and considered to be commercially viable or funds would not have been allocated to them. This will assist in timely capitalization of expenditures, as retrospective methods would cause uneven and misleading profit streams, especially considering shortened product lives. Finally, in the case of intangible assets acquired in a merger or business unit acquisition, book revaluations and useful life changes should be severely limited for acquirers. Due to the high tacit contribution to the asset development and service life decisions, these initial values decided by the original development organization should be bound closely to the asset throughout its life.

Knowledge management can also assist in identifying where to place the boundaries for expense versus those for capitalization and subsequent amortization. Completely tacit organizational and personal competences, e.g. goodwill and non-project specific know-how, are not tradeable.\textsuperscript{12} These efforts should be expensed, whether they have

\textsuperscript{11} Osterloh & Frey (2000).
\textsuperscript{12} von Krogh & Roos (1995).
been internally generated or externally acquired. Certainly, true costs of selling, administration, basic scientific research, discovery, exploration, and corporate image promotion can and should remain expensed, but the burden of proof should fall with these activities. This means that any of these expenditures should be justified as expenses through a no less stringent audit trail than the categorization of expenditures for capitalization. But almost all of the now generally recognized intangible assets including brands, trademarks, copyrights, designs, patents, software programs and applications, business processes, territory/branch establishment, etc., should be capitalized whether they are developed or purchased.

9.3.3 Critique of the Process of Capitalization for Intangibles

Accountants could criticize a method of cost allocation for asset capitalization that is based on management’s planned project assignments. It is true that financial statements should capture the costs of actual activities, rather than the expected activities. Therefore, labor resource allocation plans should be adjusted by some perpetual or periodic (e.g. weekly or monthly) updating mechanism before they are used for allocating costs in the accounting system. At one extreme the update could be a management approved and certified schedule for each day, week, or even month. On the other extreme, it could be an actual minute-by-minute automated tracking system, such as a computerized timecard or time clock, of all human resource activities in marketing, engineering, and R&D departments.

The key to any method is to recognize that material accuracy is the standard. Any precision beyond this is a potential cost wasting administrative activity. As engineers are fond of saying, “it is like measuring a plank of wood with a micrometer before cutting it with an axe.” There would have to be training involved so that management is aware of the purpose, methods, and standards. However, the desktop applications for payroll timekeeping and project scheduling and billing that are readily available in the market today, and even spreadsheets, would suffice in most situations. There is little reason to doubt any organization’s ability to meet a materiality standard.

The same doubt could be applied to almost any direct manufacturing or overhead expense reporting system being employed in every major factory in the world. In process manufacturing of foods and chemicals, for example, there are often joint products that are produced simultaneously, and joint costs are allocated to each
product based on a total production volume or quantity comparison. Because both products are desired and planned for in advance, they share indirect costs that must be allocated. The process splits at some time point, and direct costs for each program are measurable thereafter. Therefore, a development project, once officially identified, can be accounted for like a joint product, with the direct costs measured from point of formal acceptance, and indirect costs allocated similar to methods for production overhead.

Another accounting concern could be the legendary engineering practice of bootstrapping. Creative people, who generally include most engineers and scientists, enjoy tinkering with new ideas. They may stray for short periods from their planned activities to investigate or even create an unapproved, previously undisclosed invention. They may steal time to work on a clever, but unsubstantiated hunch, without reporting the activity for fear of embarrassment if the idea fails. Many of these activities are even performed by workers on their own time, during unpaid evenings, holidays, and weekends. It is in their nature for engineers and scientists to experiment and invent. This is a release of tacit creative energy, and tacit costs are the most difficult to identify and measure separately.

Bootstrapping is also actually not much of an accounting concern. It is a reasonable and customary practice in engineering, and the cost normally can be borne by the assigned, approved project. Manufacturing cost accountants have another method of accounting for indirect cost of products which may apply to bootstrapping, i.e. the costing method for by-products. A by-product is different from a joint product because it is an inevitable, natural output of the production process. By-products are often unwanted because of their high cost of disposal compared to any revenues that can be gained by selling them. The costs of by-products are borne by the product that is desired and chosen to be produced. If the by-product is able to be sold off, usually at some relatively small value, this gain is used to reduce the costs of producing the desired product. The cost of non-material bootstrap projects can be similarly borne by the desired development projects. However, if a bootstrap project becomes visible and measurable, the joint product method can be applied.

Some group managers with many resources at their disposal may even purposely sequester a small group of engineers and technicians (or scientists and lab assistants)
for a skunk works project, one that is kept secret from everyone. They may feel that higher-level management has cut an important activity out of the plans and a few resources pared away from the many other approved projects will not be missed. They justify this as protecting the team’s, and the company’s, future. They do this in order to ensure that a potential blockbuster innovation stream is not totally abandoned. The truth is, actual skunk works where the cost is not identified is more of a legend than a reality. Overall, even where it does exist, it is highly infrequent and underreporting is probably not material to the corporate financial results. Consider the IBM PC team in 1980 and 1981 in Florida. This team was formed as the result of a well thought out strategic decision. Its purpose was held secret from the competition, but not from executive management. Finally, the potential for true exceptions is not justification for throwing out all a measurement system entirely.

Capitalized development and marketing projects will not add new risk to balance sheets or mislead investors. On the contrary, precedents everywhere in our current accounting practices show that this would improve disclosure quality. Reporting consistency especially would be enhanced in every dimension. Economic evidence shows clearly that the value content even of tangible, physical assets is now primarily knowledge-based. Accounting for internally developed intangible assets should therefore resemble more closely the treatment of tangible assets.

Accounting standards do not require the intangible component of cost to be stripped away and expensed before the value of a business process project is capitalized. The full implementation costs are included on the balance sheet for projects as diverse as the outfitting of a state-of-the-art laboratory with instruments and equipment, a new customer resource management system, or payroll reporting compliance software. When one company designs a manufacturing process and factory layout, all of the unique costs of the vendor system customization and installation of equipment are capitalized without concern in GAAP for the competitor’s comparable cost of outfitting its own factory for its directly competitive products, even with clearly material differences in these values.

Consider, as examples, the very different methods of distribution of technologically and functionally generic personal computers in the 1990’s for IBM – large corporate customers, Compaq – reseller partners, Dell – direct to consumer internet and
telephone sales, and Packard Bell – retail stores, which structurally require quite different assembly and inventory management methods. All of these firms applied actual historical cost basis accounting without concern for the incomparability between competitors of overhead costs capitalized into inventory. Similarly, when one of these companies purchased materials at a lower negotiated discount than another, the actual cost was capitalized, there was no requirement to expense the difference. In fact, it was considered more valuable to the readers of the financial statements that these costs were inventoried in order for them to be clearly matched to the revenues generated over their useful life. The ability of a company to acquire a larger customer base for revenue and for spreading its fixed costs, including depreciation and amortization, over a larger volume of goods and services produced is also an expression of IC generated competitive advantage. The new gross profit and other intermediate and bottom-line profit margin values that result from this treatment provide additional profit and loss IC value indicators.

The disadvantage of putting these new assets on the balance sheet at risk of impairment rather than expensing them is expected to be offset by the advantage of the added disclosure reducing the transparency barrier. Both managers and investors would be supported in affirming that these assets are properly cared for and controlled over their productive life. Product life cycles have been shortened measurably since US and International accounting standards for intangible assets were issued. Therefore, the at-risk period of these assets will be commensurately shortened. Disclosure will also be improved through adding the time-based indicators of project start, useful life, and retirement even if they are aggregated on the consolidated statements.

9.3.4 Scheduled Amortization and Impairment Review as Risk Limiters

Asset impairment rules could be seen as a weakness for financial statements, potentially supporting asset overstatement risk. However, the agency assurance classification places limitations on this risk. Using an actual cost valuation method is substantially more conservative than a capital market valuation method. Differentiation costs are amortized per a schedule; therefore, the average carrying cost over the life cycle of a project is lower than the total cost. Construction in progress

builds the value until completion, and then amortization takes it back down to zero. The processes of asset amortization and impairment review do not need invention, because they are already in place for externally acquired intangibles.

Even the limited risk of the occurrence of some discrete impairment events should be allowed due to the value of the signalled information for investors on how well management is able to extract value from its efforts versus management’s own expectations at the point of project inception. Capitalization and amortization of costs of many internally developed intangible assets would eliminate their illogically contradictory and obviously inconsistent accounting treatment versus externally acquired (purchased) identical classes of intangible assets.\textsuperscript{14} In addition, acquired intangible assets, as well as internally developed items, invariably require follow-on internal investments for product extensions and replacement. The current method of capitalizing and amortizing purchased intangible assets, which often immediately require follow-on development expenditures, often leads to a doubling effect for expenses – the period expense from internal development plus the amortization expense from the externally acquired item. This unconservative and inconsistent issue would also be mitigated by internal intangible asset capitalization.

9.4 Classification of Differentiation Costs in Relation to Transaction Costs

9.4.1 Transaction Cost Theory

Accountants measure management efforts as discrete transactions. Transactions are identified, valued, and classified according to accounting principles that are elaborated in detailed standards. Transactions occur regularly, almost continuously at a high frequency, while principles can remain virtually unchanged over a very long-term passing of years. Principles overlay transactions to provide clear direction for entry of values to the accounting system. Audited financial statements and other reports produced by the accounting system are among the most critical outputs of management-supplied information.

Nobel laureate Ronald Coase, as a young economist at the London School of Economics in the 1930’s, developed the concept that has come to be known as Coase Theorem or transaction cost theory. Coase used this theory to explain why firms exist
as suppliers to each other and as intermediaries in the distribution channel between producers and consumers. Each new participant necessarily introduces its costs in the supply system or the distribution channel. These are the transaction costs. However, traditional economic theory predicted the elimination or marginalization of costs, not the introduction of new costs. Coase was able to show that new business entities enter into the supply chain system not by adding costs, but by providing an intermediate service, function, or good that meets consumer demand at a utility value preferable to the pre-existing entities in the system.

Although this improved value is often identified with lower costs of to the consumer, Porter’s strategic model in Figure 7-1 also presents consumer choice providing value through differentiation along the productivity frontier. These costs are those that occur tangential to the basic delivery of products and services required by the customer from the supplier. Normally economists expect that such functions are performed by a company or by its customer themselves. New firms arise in market economies when an intermediary, supplier, or service firm inserts itself into the transaction, and the new firm is able to demonstrate a better value in performing the function than the original supplier or its customer.15

Transaction costs theory also helps to explain two modern ubiquitous business strategies, outsourcing and disintermediation. Specifically, transaction costs are classified as search, information, bargaining, decision, policing, and enforcement related costs. Outsourcing refers to contracting responsibilities that have been performed within the firm to a third party supplier, service provider, agent or merchant. Disintermediation, on the other hand, is the severing of the contractual responsibilities of a third party, usually a wholesaler, retailer, or other sales channel affiliate or intermediary. A further extension of this idea is found in The Law of Diminishing Firms. Innovation in the form of a “Killer App” can be directed at lowering and eliminating transaction costs and hence diminishing the firms in the supply chain contributing these costs. It is now possible to rationalize all functions including, but not limited to, the supply chain and the sales channel, for opportunities for efficiency and disintermediation.16

The rules based expensing of most of the corporate world’s investments in intangible asset producing activities severely limits directors’ and investors’ ability to monitor and analyze the transactions that amount to corporate performance using today’s standard financial statements. MSI related to specific major new programs is often presented to boards by management in order to gain approvals or elicit support for management’s strategic plans. However, once strategies are implemented, there is no required systematic accounting system for reporting the financial results of their related operational activities over the life of the programs. MSI reverts to current GAAP, and the expensing of most intangible investment activities, in presentation of the quarterly and annual financial statements.

9.4.2 Revenues and Expenses as Key Performance Indicators

Among the large body of accounting principles that accountants and auditors should ensure are followed, there are two lead principles that the audit committee can use as a focus mechanism for differentiation costs, as shown in Figure 9-2 below.

Figure 9-2. Audit Committee Accounting Principles

<table>
<thead>
<tr>
<th>Revenue Principle</th>
</tr>
</thead>
<tbody>
<tr>
<td>“The general principle guiding when to record revenue says to record revenue when it has been earned – but not before…. The business has done everything required by the agreement and has transferred the good or service to the customer….”</td>
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<tr>
<td>The general principle guiding the amount of revenue says to record revenue equal to the cash value of the goods or services transferred to the customer.”</td>
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<table>
<thead>
<tr>
<th>Matching Principle</th>
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<tr>
<td>“…directs accountants to perform three activities:</td>
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<tr>
<td>1. Identify all expenses incurred during the accounting period,</td>
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<tr>
<td>2. Measure the expenses, and</td>
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<tr>
<td>3. Match expenses against revenues earned during the same period.”</td>
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Revenue is a first, key indicator that the firm is able to interest customers in its goods and services offered. Segmented reporting standards require revenues and their associated expenses to be reported in summarized fashion by geographic territory, line of business, product line, customer grouping, or other relevant category in the income statement. Most major corporations today have a structured, verifiable customer relationship management information system in place that makes this reporting requirement easier to accomplish. CRM provides a searchable and reportable database of highly detailed revenue segments, which are reconciled in total to reported GAAP revenue. The revenue principle of GAAP dictates in which specific time period revenue can and should be reported, which is known as “revenue recognition”. For example, the receipt of an order from a customer, is not the same as revenue. Normally product delivery or service performance, customer acceptance and assurance of likely payment must be fulfilled for revenue to be recognized.

While revenues measure level of interest, in order to be profitable over the long-term, the company must also prove that it provides value to customers above the costs incurred to produce its revenues. Where there is inventory handed over to customers in performance of revenue transactions, generally great care is made by the selling corporation to value it first as an asset in process or stock on hand and as later, upon delivery, as cost of sales. GAAP requires firms to accumulate and carry their inventory at full acquisition cost or full production cost as a reported short-term asset. There is no leeway for the expensing of these costs when they are first acquired as long as there is a reasonably predictable potential market and adequate price for future sale of the inventory. The matching principle of GAAP requires that great care is taken in preserving inventory value. The inventory asset value is converted to expense as cost of goods sold or cost of sales exclusively in the period where the revenue gained in exchange for the inventory is recognized.

Many other expenses begin as capitalized assets of the firm, for example, natural resources, buildings, machinery, and equipment. The physical and economic consumption of these business resources normally occurs in the production of revenue over the life of the company’s respective product or service. Accountants use the adjusting process in bookkeeping to reclassify these asset values as depletion or depreciation expenses, in order to represent appropriately that their true economic value is declining. The matching principle also requires that these costs, like inventory
cost of sales, are reported in the appropriate period as closely as possible against their complementary revenues. Similarly, purchased patents and designs, rights of manufacture and distribution, and all other acquired intangibles are required to be amortized over their estimated useful lives. There is, therefore, no barrier from the accounting system procedurally, to capitalization and amortization of internally developed intangible assets for recognition of differentiation costs.

9.4.3 Margins as Key Transactional Indicators

Compliance with the revenue and matching principles provides users of financial statements with additional valuable indicators of performance. The difference between revenues earned and resources, such as inventory, directly consumed and matched as cost of goods sold is gross profit. For firms which produce goods and services, as well as wholesale and retail merchandisers, gross profit is a key firm financial measure. It provides a first indicator of the company’s ability to add value above the component cost of the goods and services delivered. Financial analysts especially use the gross profit percentage as one of their key fundamentals because it provides a first view of the ability of the company to earn a profit. When expressed in relation to sales, the gross profit percentage is a simple, well-accepted statistic to measure operational performance. Financial, credit, government and other investments analysts monitor the movement of gross profit margin and measure the company’s ability to sustain margins competitively very closely. Gross profit is also needed to cover all research and development, general and administrative, interest, and discretionary period expenses, as well as income, property, and other taxes, before the firm is able to earn a bottom-line net profit.

At first glance, the importance of the gross profit as a measure is explained by what follows in the income statement. All of the company’s period expenses must be covered by the gross profit, and what is left is the company’s pre-tax operating profit or loss. If the company has a profit, it will have to pay one other expense, that is income taxes, generally calculated as a percent of pre-tax profit - operating profit plus other gains and minus other losses. Whatever is left after taxes is final net income, which can be distributed to the owners as dividends by the board of directors, as the law and the company’s cash balance allows, or held and reinvested in the business as retained earnings. If the company has no profit, it does not pay any income tax.
Gross profit is not just an interim step in the calculation of net income, or it would have no place or purpose being displayed on the same page as net profit. As an intermediate profit measure, movement in a company’s gross profit can be a leading indicator of changes that will have to be made to the company’s strategy and organization. When period expenses include significant investments in internally developed intangible resources, they are not clearly identified with and matched to the revenue they produce. In this situation, gross profit and the gross profit percentage are far less valuable as performance and forecasting indicators.

For traditional merchandising businesses, including wholesalers, distributors, traditional retailers and web-based e-tailers, who purchase goods from suppliers and resell them to other businesses, government agencies, and public consumers, gross profit has significant meaning on its own in light of transaction cost theory. Higher margins tend to indicate a higher requirement for investment in service inputs. Specialty stores, who, for example, offer a high level of personalized advice to high fashion consumers, serious sports enthusiasts, members of skilled professions, etc., generally must maintain higher prices to support their higher labor and training expenses, i.e. a stronger competitive positioning. Lower margins, it follows, can be an indicator of serious competitive weakness, especially where established companies have seen their gross profit margins deteriorate compared to their prior consistently higher levels.

However, transaction cost theory can also help explain lower margins as a form of competitive advantage. Mega-retailers like Wal-Mart and Amazon.com, both relative newcomers in their segments, generally discount their products as their primary value-add to consumers. Both have invested heavily in logistics technology that helps them keep their inventories, and therefore their cost of storage and handling, relatively low. They turnover (sell) and replenish their inventories much more often than their competitors. Of course, both of them also claim that they add value by providing an enjoyable shopping experience. However, Wal-Mart’s genuinely friendly staff must not necessarily know anything about how to compare the products on its shelves with the competitive products not found in its stores. Serious book lovers may not find as much enjoyment perusing the “stacks” or reading the handy reviews of amateur “critics” on Amazon.com’s webpages. Arguably, speed in inventory management is
one of Wal-Mart’s and Amazon.com’s main actual competitive advantages. Transaction cost theory recognizes this advantage in competitive markets.

Similar to transaction costs presenting how competitive advantage is attained in the market, margin analysis assists in explaining how competitive advantage is accomplished internally in the operations of the company. The amortization of differentiation costs arising from product and process innovation are likely to add more analytical value to gross profit analysis. This will add more technology and innovation related cost categories to the inventory costs already disclosed in gross profit of merchandisers and manufacturers, while also helping to establish gross profit as a new measure in many service providers and technology licensors.

Because of the revenue principle and the matching principle in GAAP, and their required application to merchandising companies, gross profit can be easily calculated. MSI normally reports on gross profit in detail and explains all material movements in the gross profit percentage, even predictively, because of its transparency and great interest to analysts. This interest has transaction cost theory as its additional rational economic explanation.

9.5 The Impact of Differentiation Costs on Financial Statement Disclosure

A new classification of discretionary expenditures, differentiation costs, as intangible assets to be amortized over their useful life can change the dynamics of the financial statements dramatically. In today’s knowledge-based economy, the value for users of statements accruing from these additional disclosures cannot be ignored. The following charts illustrate this through the reporting of a new business with one intangible product. The financial statements span over a two-year useful life consisting of the design, development and licensing of the technology for this one product. The product in the example could be special system software to be embedded in semiconductor controllers for use in automotive electronics, factory machinery, home appliance, or other applications.

In the top graph presented in the following Figure 9-3, the financial statement results are summarized based on current GAAP standards. The technology company starts out with some basic assets including cash and office and laboratory equipment and equity from the owner’s investment. The efforts to design and develop the technology
begin in the first quarter and the costs are expensed in the period incurred. This generates a large loss and reduction in equity. As engineering and administrative activities grow in the second and third quarters, the firm borrows cash to acquire more equipment and to hire more employees. Assets and losses increase commensurately, driving equity even into a negative position (showing return on equity as a meaningless measure).

**Figure 9-3. Financial Reporting: Current Practice vs. Proposed Principle**

Source: Own Representation.\(^{17}\)

\(^{17}\) See Appendix 7 for comparative financial statement detail values in tabular form.
The firm starts to license the technology to customers and receives its first revenues in the fourth quarter. The firm’s only product costs, which are minimal, are for the copying of CD’s that contain the software and the printing of client user manuals that are shipped to the customers. Therefore, gross profit reported is nearly equal to revenue, providing no additional insight to financial statement users. In the fifth and sixth quarters, revenue growth and administrative activities accelerate, while engineering efforts and expenses drop off quickly. Very high profits result which simultaneously add to equity. In the final seventh and eighth quarters, revenues and profit margins decline. Equity grows, but more slowly. Cash increases from collections from customers, but is used to pay down debts and pay remaining expenses. The value of equipment assets declines ratably each period through depreciation expenses.

The bottom graph of Figure 9-3, in comparison, displays how the financial results under the same conditions and activity levels might look like if much of the engineering activities for development of the technology is allowed to be capitalized as an intangible asset. The main difference in the new system is clear in the first quarters that the differentiation costs related to developing new technology are treated as investments. This is reflected as an increasing value in internally developed intangible assets in the second graph as well as the differences in values of total assets between both charts. All of the administrative activities and a minor portion of the engineering efforts are not capitalized. Therefore, there are still losses, but they are much smaller, and equity does not decline as quickly. The higher asset and equity values more appropriately moderate the return on investment and return on equity measures during the revenue generation period of the technology licenses.

Once revenues start to be earned, amortization of the technology assets can also begin, matching the revenue to expense more closely or directly. Gross profit continues to provide an additional indicator over the remaining quarters, and can signal changes in expected life, technology extensions, unexpected obsolescence, and other environmental, competitive, or internal firm changes. Bottom-line profits are moderated, reflecting that revenues are earned through associated creative productive efforts of the engineers in the firm. By the end of the two years, assets and equity match completely with the first chart. The product technology has reached end-of-life,
and is fully amortized. Total revenues and total expenses from the entire two-year period added together are the same under both systems.

The users of financial statements are benefited also by a more transparent view of the level of investment value entrusted to management throughout the useful life of the intellectual property. The Balance Sheet assets will be subject to the regular schedule of internal control and external audit substantive tests and analytical procedures of existence, valuation, and impairment. The Income Statement will be markedly enhanced by providing regular margin indicators which more evenly invoke the revenue and matching accounting principles. As previously mentioned, the updated balance reported in the Statement of Shareholders’ Equity will serve as a reminder of a higher up-front investment in intangibles in-use.

Especially important to analysts as users, the Statement of Cash Flows would provide multiple indicators or the contribution of intangible assets during the life cycle of the firm’s respective product or service. Currently most differentiation costs are simply lost as period expenses in the operating uses of cash section of the statement. In the proposed approach, first, the capitalization of internally developed assets will be reported in the investing uses of cash section. Second, the scheduled amortization expense will be shown as a non-cash adjustment to expenses in the operating uses section. Third, in the case of an occurrence of impairment, a non-scheduled adjustment will be made as a non-cash adjustment to other losses in the operating uses section. Finally, the financing sources of cash section will explain how funds were raised for strategic projects and the investing uses of cash section will more closely illustrate how these funds were used for these projects.

The example chosen for comparison in the two charts is certainly not indicative of all situations. However, a moderately successful firm example has been devised and presented because financial reporting should certainly function well when normal profitable situations are encountered, as this is the most prevalent situation in firms of interest to corporate governance reform. Current GAAP clearly comes up short as being less informative when compared to the proposed new standards in this highly indicative example.

As an alternative example, if the intangible technology were to be commercially unsuccessful, a situation that occurs in the minority, the new system would display
unfavorable results and disclose risks to the firm more clearly to the broad audience that make up users of financial statements. This would appropriately indicate a poor return on investment in the specific periods where the previously unexpected poor results actually become apparent to management. With current GAAP, unfavorable results (losses) for individual programs are virtually guaranteed during the development phase when up-front investments normally dominate activities, regardless of the program’s actual condition or situation. This illogically assumes the likely occurrence of the worst expectations for financial results for every internally developed intangible resource, without exception.

9.6 International Accounting Principles for International Financial Markets

Among the expected users of financial statements are the average investors whose money funds the bulk of corporate debt and equity. They are, in general, not experts in accounting and financial matters, but they are increasingly making investments in publicly traded securities, stocks, and bonds. Their investments are not only in domestic securities, but they often venture into international securities markets as well. Protection of the interests of the fast growing international investing public should be of major concern for the well-being of national, regional, and world economies. The adoption and promotion of a system of common accounting standards would provide a higher level of protection by eliminating this key contributor to cross border investment information asymmetry.

Harmonized standards first give financial statements from different countries a similar appearance in structure and terminology. As important, harmonization would also assure higher consistency of the content of financial statements. Requirements for the methods of calculation and timing of disclosure as well as definitions of the terms used would be embedded in the accepted international standards. Customs, culture, and language differences would still cause some remaining issues in achieving full harmonization and comparability. However, the reduction in disparity gained from international standards would succeed in reducing significantly the IA for cross border investments caused from differing accounting systems. The development of new standards and potential for improvement of existing standards would also be enhanced
significantly by a system which invites input and values opinion from a more widely dispersed and culturally diverse international group of experts.

Unfortunately, in February of 2002, Frits Bolkestein, the EU internal market commissioner, chose to publicly criticized US GAAP, apparently without first considering that some sections of the IAS that the EU was championing had been copied outright from US GAAP. In August of the same year, the German federal finance minister, Hans Eichel, also declared that American standards made fraud easier to commit than the counterpart European standards did. Despite this acrimony in political relations between the EU and US, that the International Accounting Standards Board (IASB) has held on to its objective of maintaining a principles-based system is behind the motivation for US standards setters to agree to at least seriously discuss cooperation with their IAS counterparts for future financial reporting standards. The EU should use this apparent advantage to promote their influence in a more constructive way, of benefit to all stakeholders worldwide.

9.7 Enhancing Management Motivation and Control

Differentiation costs result from firm internal development and external procurement efforts, as exemplified by Dow Chemical’s Intellectual Asset Management model for managing R&D. In order to recognize a new class of financial statement assets, accounting principles must make room for a new standard. This new element must prove to fit into the entire accounting system, allowing for all of GAAP to continue to function in an effective integrated fashion while adding distinct material value to financial statement disclosure and identifiable improvement to transparency. In Ownership and Control, Margaret Blair highly recommends that accounting principles are changed and boards of directors provide leadership to recognize and attend to the strategic contribution from the firm’s specific human and organizational capital. She admonishes that “even directors and managers who understand their jobs to be maximizing total wealth creation and who are well motivated to pursue that goal, are

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18 Guerrera & Norman (2002). IAS is now referred to as the International Financial Reporting Standards (IFRS). The International Accounting Standards Board remains responsible for IFRS.
19 Schumacher (2002).
generally receiving partial and misleading information about the sources of wealth in their firms.”

Capitalization of project expenses that contain a substantial component of salaries, benefits, and other related costs will also serve to reposition labor from operational expenses to investment in assets. This should elevate employees’ hierarchical economic and governance status. Capitalization would highlight these uses of cash as value-add components to the firm. This supports the important recommendation of those researchers who are concerned with fair treatment of employees. Because employees are clearly major contributors to the overall economic wealth of firms, they should be treated equitably in relation to all other stakeholders. These researchers note that announcements of lay-offs of employees are often rewarded immediately in the financial markets by higher share prices. They argue that this reaction is seriously misguided that trades-off long-term wealth-creating competence for easy short-term profits. Changing the perception of human resources from expense to investment should also assist in furthering the development of these resources by encouraging further spending on education and training. Improving the information disclosure of human resources could also benefit the firm operationally through improved allocation of available skills and identification of gaps in capabilities. This benefits investors in analysis of these capabilities and their strategic employment by management.

The transparency advantages of an accounting standard for capitalization of differentiation costs under strict adherence to accounting principles regarding disclosure, revenue, matching, and conservatism are too many to continue to ignore:

1. Recognition of long-term knowledge resources,
2. Monitoring of these assets in the formal system of controls,
3. Recording of material events such as obsolescence and impairment,
4. Higher visibility for recognition of associated long-term liabilities,
5. Generally higher equity values representing shareholder claims,

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23 Petty & Guthrie (2000).
6. Categorization as investments in cash flow statement and analysis,

7. Systematic matching of revenue with expenses of resources consumed,

8. New intermediate gross profit margin measures,

9. Clearer visibility to true period expenses,

10. More deductive bottom line profit measures,

11. Possible lower goodwill values resulting from acquisitions, and

12. Consistency with purchased intangibles for all of the above.

The differentiation costs approach provides great instructive value to the strategic guidance and monitoring of management expectations of boards. The disclosure of this information would benefit shareholders as well as all stakeholder groups. Since the information also would be presented in consolidated form and applying accounting standards that all corporations would follow, disclosure would not present a competitive disadvantage, nor represent a loss of trade secrets. It is also important not to allow the differentiation costs argument to deteriorate into a pro- vs. anti-capitalization issue. If this would be a simple decision of asset vs. expense, expense would always win out as the conservative solution with its long history of practice in its favor. However, this unreasonably ignores a great majority of the benefits that differentiation costs reporting would bring to today’s business and investment decision-making environment.

As discussed in earlier chapters, corporations are increasingly making these internal investments to create intangible assets such as designs and patents, brands and trademarks, literature and copyrights, and other items such as customer lists, operational processes, and business ideas. With GAAP, these costs are required to be expensed as they are incurred and are paid, during the development period, not during the period of use. Therefore, the costs of the investment in these highly strategic assets are not recognized in the book value reported as the corporation’s equity. Customer revenues, which are earned after the development period, are reported without any matching of the costs of the intangible assets that are employed by the corporation in delivering their products or services.
Intangible assets are recognized as valuable, reportable assets by the EVA system. This means that the values of each asset will be identified in an inventory listing, which highly increases the opportunity and the responsibility of management to protect each individual item. This could help in leading the company to find additional uses for their assets. They could be licensed in whole or in part to other companies. They could be enhanced in order to extend their life in similar applications into the future. They could be adapted for dissimilar purposes creating new product lines and business segments. However, without incorporation of these concepts into GAAP, there is little accountability for monitoring to function in the system. Audit committee members and audit firms are absolutely required to give priority attention to the legally required GAAP statements. If differentiation costs were institutionalized and systemized through capitalization within GAAP, they could be cared for appropriately rather than remaining orphaned by expensing.

Unfortunately, management’s opinion has been allowed to carry significant weight in the submissions to the SEC and FASB, while directors have generally remained casually unrepresented, during the official period of the call for comments for recent US financial reporting initiatives, such as the following:

1. fair disclosure (FD) regulations,
2. expensing of stock options, and
3. executive pay disclosure standards.

Regulation FD was widely criticized by management for the chilling affect it could have on disclosures by stifling management’s discussions with investor representatives. However, in the year after Regulation FD was established in October of 2000, a great number of firms opened their quarterly analyst conference calls to investors through teleconferencing hook-ups or internet webcasts. Over the following years, there have been very few problems for firms with FD compliance, and the US SEC has only rarely had to warn or fine firms for errors or omissions. There have been many more SEC disclosure administrative filings after FD as beforehand, but the high volume is certainly not evidence of a disincentive to disclosure.

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Expensing of stock options was turned down several times in the US before finally being adopted in late 2004, despite Robert Monks credible criticism that the “current level of executive compensation in America, of which stock options contribute a large portion, represents one of the largest – non-violent – transfers of wealth from one class to another in recorded history.”

Monks credited intensive lobbying of the Business Roundtable, where CEO’s are key members, for overwhelming the Financial Accounting Standards Board in the past whenever this proposed reform had been defeated. As Figure 9-4 below clearly illustrates, management’s financial self-interests have eclipsed those of the shareholders, firm, and employees as well as any reasonable economic or societal expectations in the 1990’s. Even the correction following the stock market meltdown has not succeeded in resolving this inconsistency.

**Figure 9-4. CEO Pay vs. Performance Measures 1990 – 2003.**


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In 1995, when FASB Statement 123 clearly recommended expensing of stock options in financial statements, the compromise that was actually accepted had stock options being finally included with executive pay disclosures, but not recorded in the financial statements. It took ten years for expensing finally to overcome management’s objections, in the wake of the many corporate scandals. However, even in 2004 the FASB succumbed to pressure and delayed the required implementation by firms to their fiscal years beginning after June of 2005.²⁶

In fact, the AICPA has a history of backing away from many formal reform proposals under pressure from management lobbyists. In late 1994, the AICPA even decided against implementing its own recommendations for making financial reporting more meaningful, almost completing rejecting the substantive results coming out of a multi-year study it had commissioned.²⁷ Executive pay in Europe, although substantial, is nowhere as high as that in the US. However, it was not until the beginning of 2005 that top executive income disclosure was finally made mandatory in Germany, the EU’s largest economy. Management was still crying foul over the loss to their privacy, but perhaps they were actually concerned that the investing public would be more critical of their pay than their supervisory boards had been.

Despite the strongly expressed arguments against the three initiatives, not one of them has turned out to be overly intrusive and burdensome and anything but misleading. Regulation FD has increased significantly the number of SEC disclosure filings. This may be considered a small nuisance, but not a burden. It appears to prove that prior to the regulation, financial market analysts had often been receiving material information in advance of the general public. Therefore, FD has been achieving its intended regulatory control over management and analysts. German firms providing information on top executive compensation has brought these firms in line with the firms and investor expectations in the US and UK. This new openness has improved the standing of German firms in international financial markets. In late July and early August of 2002, Fortune magazine reported on ten high profile US firms which announced they had begun including stock options expense in their financial statements, reducing their profits measurably. The immediate response of the public stock markets in the days that followed these mid-2002 earnings announcements was

²⁶ Jaffe and Schmidt (2004).
favorable, and the share prices of these largest firms performed on average admirably better than the S&P 500 average. In fact, all three of these initiatives have succeeded in improving transparency and the firm’s reputation, reminding management that their fiduciary duty to shareholders can build trust in their leadership and bring unexpected advantages to them as well.

The establishment of a new accounting standard for a knowledge management basis requiring concrete recognition of differentiation costs should not face such a roadblock from management. Such a new standard provides the necessary economic foundation for logical classification of differentiation costs for the firm. These costs can be classified as investments when they produce explicitly identifiable firm assets. When these costs are incurred for advantage to the firm that can only be tacitly recognized, they should remain as period expenses. Management will receive motivational recognition in the financial statements for their efforts leading to creation of strategic value. Moreover, internal and external controls will be enhanced by providing an additional basis for monitoring activities.

28 Stires (2002).
CHAPTER 10.

Communication – Disclosure Motivation and Methods

“Systems thinking teaches that there are two types of complexity--the ‘detail complexity’ of many variables and the ‘dynamic complexity’ when ‘cause and effect’ are not close in time and space and obvious interventions do not produce expected outcomes.”

Peter M. Senge in *The Fifth Discipline*

10.1 The Communications Axis of the Agency Assurance Model

Publicly traded corporations are highly complex systems of interlinked and interdependent customers, suppliers, financiers, employees, and contractors. Government workers from various agencies and departments also participate in enabling or blocking the many activities of businesses within their legal jurisdictions. Peter Senge’s quotation, above, serves as a reminder that organizations must interact with these stakeholder constituencies on two levels – the detail level and the dynamic level. A firm’s day-to-day operational activities are fully dependent on the communication of detail requirements and expectations with these groups. This is clearly the responsibility of management. A firm’s long-term strategic goals also are dependent on communication of a dynamic nature. This communication carries the added complexity that its audience is the general public. Therefore, the board of directors, which is ultimately responsible for strategy, must ensure that this communication not only is informative, but that it also is distributed in a fair and equitable way.

Only at the point of its disclosure does management-supplied information accrue any value to the organization. Giving authority to the audit committee, through constitution, and regulating the content and presentation of information, through classification, are valid activities only if the MSI process culminates in reporting. Communication is therefore presented here as the third and final axis of the agency assurance model. The following Figure 10-1 presents the communications axis as a function of the audit committee concerned with and influenced by the three factors of transparency, channels of disclosure, and shareholder relations.

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First, the objective of communications transparency is for management-supplied information to present a logical and consistent understanding of the firm’s activities to owners and outsiders. Second, management must be directed by the board of directors to erect and employ a physical distribution network, in the form of effective channels of communication, for its various strategic and regulatory disclosures. Third, communications should also be directed at being informative and distributed fairly to maintain good relations with the appropriate primary audience, the company’s shareholders. Today’s 21st century regulatory, economic, technological, and social market environment demands a higher level for professionalism, and so creates a much greater challenge for good performance, in this area of responsibility.

Case Review 10-1 below shows how one major company slipped in the quality of its disclosure and suffered very little negative ramifications. Not long thereafter, the company appears to have embarked upon a pattern of recurring alleged gross negligence and malfeasance in both its quality and quantity of financial disclosures. The disciplinary actors in the governance system may have been impeded by intransparency of critical MSI, but they also did not adequately recognize nor act upon the indicators that MSI had presented to them.
Case Review 10-1. Quality and Quantity Indicators at Computer Associates

Computer Associates (CA) is one of the world’s top five software companies based on annual revenues. The New York Times reported on May 5, 2001:

“Computer Associates said yesterday that a typographical error had caused it to overstate its annual profit by about $130 million in a news release last month.

The company said that under standard accounting rules it earned 16 cents a share, or about $90 million, for the year ended March 31, excluding certain charges.

In the earlier release, issued on April 16, the company said it earned 40 cents a share, or about $230 million….

The April 16 error is not the first overstatement by Computer Associates in a news release. On May 15, 2000, the company reported ‘revenue of $2.13 billion, an increase of 31 percent over the $1.63 billion reported in the previous year's fourth quarter.’ The company's fiscal year ends in March.

Three weeks later, in a filing with the Securities and Exchange Commission, Computer Associates said its sales were $1.91 billion. It said the higher figure in the news release equalled the total value of the contracts the company had signed in the quarter, but that the figure double-counted some revenue the company had booked in previous quarters.”

In the case of the $130 million error in 2001, instead of a healthy profit as first disclosed, CA had barely made it into black for the quarter. Instead of coming close to Wall Street analysts’ estimates, CA had missed those estimates unfavorably.

CA, one of the world’s largest information technology firms, simply attached blame for the inflated value originally reported to a spreadsheet data entry error by a staff accountant. Curiously, CA did not offer a comparably detailed explanation of how management’s original commentary and variance analysis for the first press release could possibly have been consistently and logically reconciled in detail to the falsely stated profit. A typographical spreadsheet error, followed by a variance reconciliation that can only also add up in error, is a clear sign of either very sloppy accounting and management review practices, a lazy disregard or purposeful disrespect for the

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audience that receives disclosures, or an outright attempt at fraud. However, the embarrassment of this issue was allowed to blow over surprisingly quickly by the board of directors.

Not totally unsurprisingly, therefore, by 2003, it was finally uncovered that the company had allegedly perpetrated grievous accounting fraud and given misleading statements. The size of the misstatement this time had grown to the many hundreds of millions, rather than just tens of millions, and there was no simple explanation of an accountant’s spreadsheet error that could provide a cover story for management. For many years, including over the period of alleged fraud, Charles Wang, the chairman of CA had been one of the most handsomely compensated executives in the world. This time, in the less accommodating Sarbanes-Oxley era, the board, the press and financial communities, and most importantly the SEC, could not ignore these actions. Wang and other executives resigned and faced criminal investigations of their actions.

What remains surprising is the following CA disclosure from 2004 as presented on its Investor Relations webpages:

**SEC FILINGS**

On April 26, 2004, Computer Associates International, Inc. (CA) filed a Current Report on Form 8-K to restate certain financial data for CA and its subsidiaries for the fiscal years ended March 31, 2000 and 2001, and to provide certain quarterly data for the quarters included in those fiscal years. The revised financial data for the annual and quarterly periods were unaudited. On September 22, 2004, CA filed an amended Current Report on Form 8-K/A to provide additional disclosures, including disclosures regarding CA's intent to provide audited restated financial statements for the fiscal years ended March 31, 2000 and 2001, and to provide certain related disclosures. CA will file a further amended Current Report on Form 8-K/A once this information is complete.

CA is not amending its Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the fiscal years ended March 31, 2000 and 2001 and related quarters. The financial and other information in such Annual and Quarterly Reports should be reviewed in conjunction with the restatement of certain financial data for those fiscal years, included in the April 26, 2004 Current Report on Form 8-K.\(^3\)

Even after the magnitude of the egregious activity was uncovered, the fine print said that restatements had not been audited by late 2004. The even smaller fine print declared that CA would file a separate disclosure with the restatements included, but the company was not intending on amending the erroneous disclosures made earlier for years 2000 and 2001. Those reports in the public domain, therefore, would still display the incorrect results.

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\(^3\) CA (2005).
The main lesson that Computer Associates represents is that coming out of the period of irrational exuberance of the 1990’s, the many actors responsible for governance of corporate action were too quick to forgive and forget. Clear indicators of poor transparency and selective disclosure by CA management were apparent, but were not given an appropriate level of attention. Lack of disciplinary action could have contributed to an environment of complacency, which set management’s expectations of more of the same attitude in the following years. Especially dismayng is that all of this occurred at CA, an industry leader, despite very visible legal restrictions directed at public software companies. These legal provisions included not only the recent enactment of Sarbanes-Oxley which applied to all public corporations, but also the issuance by the FASB in the early 1990’s of a new software accounting standard for revenue recognition, a set of rules specifically targeted at the software industry’s often less than conservative and sometimes fraudulent sales accounting practices.

The audit committee, as a representative of the board, should provide oversight and supervision of the disclosure process. With the support from the constitution and classification axes, the audit committee is in arguably the best position to judge that disclosures are accurate, fair, and timely and, therefore, transparent. Constitution relegates management in the communications reporting hierarchy under the authority of the audit committee. Classification dictates principles for content, structure, and presentation of disclosure information. Management must be relied upon to administer all proprietary operational communications. Communications of a material nature, including the release of any financial results, however, must be supervised by the audit committee and board of directors. These public disclosures are made by members of the board, most often by the chairperson, or delegated to management, most often to designated officers such as the chief executive or head of finance.

10.2 Transparency Through Communications

In return for the privilege of access to public financial markets, corporations pay a requisite price of openness in communication of their strategic intentions. They also must follow professional and regulatory standards for reporting their actual performance in the use of funds acquired from its shareholders in the financial markets. The intention of the government and quasi-governmental regulators in
establishing these requirements is to protect the investing public from the potential of misuse or fraud by firm managers.

The audit committee has traditionally concerned itself with the quality of the content of the financial statements. External auditors are contracted as a legal requirement to provide an independent assessment of the integrity of the accounting system and compliance to GAAP standards for financial reporting. It is the act of disclosure that brings any relevance to these activities, by allowing those constituent groups outside of the firm to assess the firm’s performance and potential. Investor communications connects the firm’s interests to those of its own shareholders and to other potential investors, creditors, and external stakeholders. In most public corporations, these same disclosures also provide the basis of information for the average employee to make their own assessments. Where employee compensation is also tied to performance, such as in profit sharing plans, these communications take on a particularly critical motivational quality and legal status.

Transparency does not require that the firm is an open book. Rather, management and the board, represented by the chief financial officer and the audit committee, respectively, must ensure that mandatory accounting reports present a true and fair view of results. No additional financial measures should be presented to contradict the audited financial statements. These supplements should provide extra details that expand upon and shed further light on the standard reports. Any other disclosures that the firm voluntarily communicates cannot be misleading, regardless of whether it is the result of deliberate intention, undiscovered error, or innocent omission.

The prior chapters of the classification axis showed that audited financial statements, rather than presenting a true and fair view, as is expected, have quite unfortunately been presenting a skewed view of company financial performance. Where revenues and expenses are no longer properly matched in time, the dynamic complexity of the financial disclosures is unnecessarily heightened. In some highly publicized cases, the skew is caused by management’s outright intentional disregard for GAAP in seeking further personal financial gains for themselves. This is evidenced by the many instances of fraud that have recently been exposed. In other cases, the skew arises from assumptions and estimates that have been measurably distorted by management’s own subconscious conflicts of interest, driven by alternative views of results of Value-
Based Reporting systems promulgated, and seemingly validated, by their external accountants. However unintentional this result may be, the financial statements still reflect a mistaken view of reality.

The negative attention that outright fraud and unintentional error have invited includes:

- landmark lawsuits with sentences of substantial multimillion dollar corporate and personal fines as well as severe jail sentences,
- extremely embarrassing and widespread publicity in international news and business media, and
- new, relatively strict, and costly legislation and regulation, i.e. the Sarbanes-Oxley Act.

Despite all of these undesirable penalties, new cases of fraud and error are continuing to occur quite frequently. Many of the illegal or questionable activities have been perpetrated or even originated in the years after the crisis exemplified by the Enron and WorldCom cases. One of the new provisions of the Sarbanes-Oxley Act is the requirement for companies to report annually on the status and effectiveness of their internal control systems. This is known as a Section 404 filing. The external auditors of public corporations are required to audit and provide an opinion on the internal controls as well. Ernst & Young analyzed a substantial proportion of these filings, and a graphical summary of their findings is provided below in Figure 10-2.

The tested corporations’ and their auditors’ evaluation of the firms’ own areas of material weakness which could lead to potential misstatements show that the most frequent risk area, at 36% of cases, is related to the financial statement close process and subsequent disclosures. This incidence of risk is nearly double the next greatest category, the transaction level at 19% of reported cases. The financial statement disclosures are infrequent events that are required to be performed with due professional care utilizing the highest professional standards. The transactions of the business, however, occur on a day-to-day basis at practically immeasurable frequency in an environment of great uncertainty, complexity, and dynamics. The audit committee must consider statistics such as these in assigning a high priority to their own oversight of the process and content of public communications.
Figure 10-2. Material Weaknesses of Section 404 Filers

Source: Ernst & Young Study in April of 2005.4

10.3 Entrepreneurial Mindset - Motivation for Misstatement

It is highly likely that many additional cases of error, distortion, and fraud in financial statement disclosures have arisen because of skew caused by accounting standards that have not been properly adjusted to modern business situations and reporting requirements. Figure 10-2 even presents a third category, entity level and antifraud controls with an 11% incidence rate, which also could be associated with misunderstanding or mistrust of accounting standards by top management.

The classification argument of agency assurance showed that accounting standard setters, perhaps out of a false sense of conservatism or tradition, have held on far too long to outdated GAAP which is not representative of today’s organizational complexity and make-up. In addition, where standards changes have been recommended, they have at times been blocked from being implemented because of intense lobbying efforts by top management. These executives are influenced by

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4 Matischiok (2005).
intense conflicts of interest from their historically highest relative compensation. The accounting industry, itself, also suffered under influences of its own conflicts of interest, in accountants’ desires to maintain profitable consulting relationships with corporate managers. Where a few new accounting standards have managed to be introduced, compromise has made the standards ineffective or caused them to suffer from inconsistencies and incomparabilities.

Prospectuses, including pro forma alternative statements, are being presented to the public to provide a supposedly fairer picture of performance and prospects. Boards of directors commonly use unpublished, supplemental financial statement measures and substitute calculations, including Value-Based Reporting, for evaluating and rewarding management performance and setting the base for their future compensation. In many cases, stock price has become a key or dominant measure and motivation, without appropriate analysis of the effect on these prices of indirect external firm factors such as short-term favorable stock market forces versus internal direct management factors such as long-term sustainable operational results. This emphasis on stock price is driven not by the firm’s healthy performance interests, but by management’s conflicted personal interests in stock options. This form of pay has come to eclipse most other elements of compensation, such as base salary, performance bonuses and commissions, and profit sharing.

The problem with stock options being a flawed incentive element has been discussed at length in an earlier chapter. However, the intention of stock options was not only to attempt to link management to owners through equity ownership. Stock options received popular notice because of their heavy usage by true start-up entrepreneurial ventures that became highly successful, among them Microsoft, Intel, Cisco Systems, and Genentech. Hoping to achieve blockbuster start-up style results, many boards clearly desired to motivate an entrepreneurial culture in the executive ranks. The boards and executive ranks of WorldCom, Enron, Tyco, Health South, Parmalat, and many others, along with the financial industry analysts and general investing public were quick to equate acquisitions driven expansion by established firms with organic entrepreneurial growth by start-ups. They did not seem to realize that for start-up executives, the risk of not achieving an initial public offering at all is extremely high. Therefore, the vast majority of stock options in start-ups never pay off. There is no such public offering hurdle in existing companies.
What directors also may not have realized is the potential that the entrepreneurial personality is not inherently compatible to supporting transparency required of management of a public corporation. Manchester Business School researchers Michaelas, Chittenden, and Poutziouris interviewed thirty small business owners and managers in and around Manchester, UK.\(^5\) This research was directed at informing policy makers in the UK to help incentivize small business establishment and growth. The authors created a psychometric inventory, or index, of the decision factors influencing the capital structure policy for small entrepreneurial start-up businesses. They found significant similarities to the pecking order theory established by Stewart C. Myers, which shows that larger companies tend to follow a specific hierarchy for funding capital for their existing operations and for growth.

The Manchester study shows also that small business owners, like their large company management counterparts, rely first on internally generated cash from retained profits, second on various sources of debt, and last on issuance of new shares or equity to generate the capital they need for the business. In addition, the Manchester researchers also pointed out that Myers had identified agency costs and information asymmetry as being important issues influencing management’s choices within this pecking order. Myers findings and subsequent research of others, including Vuong Duc Hoang Quan, attest to a rational basis for this pecking order of financial capital they have observed.\(^6\)

The Manchester research shows specifically that the entrepreneurs surveyed were reluctant to give up control and provide collateral to gain capital, as may be reasonably expected of small business owners.\(^7\) In the face of the pecking order theory observations, these small business owners were also reluctant to accept requirements involving information disclosure. They treated even the request for basic accounting statements to be supplied privately to a banker as undesirable. The research showed that this reluctance is, however, not an entirely rational perspective when looking at costs to their firms of the available alternatives. These entrepreneurs preferred trade credit, such as extended payment terms from suppliers, to bank credit, such as formal loans and credit lines, in the pecking order. The Manchester researchers, who referred

\(^6\) Vuong Duc Hoang Quan (2002).
also to earlier research by Chittendon and Bragg, noted that they were able to measure this preference despite the likelihood that trade credit will be more expensive for their firms than bank credit would be. To explain this apparently irrational behaviour, the Manchester researchers noted that, among the factors that affect small business owners’ attitudes toward bank relationships, in comparison to standard bank credit disclosure requirements, trade credit offers the advantage that relatively little reporting is expected of firms.  

As further evidence that entrepreneurial culture and public communications are lacking in compatibility is how venture capitalists (VC’s) have, post Sarbanes-Oxley, chosen to retreat from public scrutiny. Sequoia Capital, one of the world’s largest venture capital firms decided in 2003 to sever its financial relationship with the University of California (UC). The UC had been participating along with other “private” investors in venture funds managed by Sequoia Capital. Many universities, such as UC neighbor Stanford University, have established venture funds themselves with or without participation of venture capital firms. Stanford, as a private university, is able to invest in start-up firms without requirement to disclose much of its decisions to the general public. Start-up firms do not have stock that is traded on the New York Stock Exchange, Nasdaq, London’s FTSE, Frankfurt’s DAX, Tokyo’s NIKKEI, or any other public exchange. They are only required by laws of incorporation to provide information to their private shareholders, and that information is normally held confidential. The UC, however, is a state funded, public institution, requiring a high level of public disclosure for its financial dealings. Sequoia Capital has clearly become uncomfortable with the public having access to information surrounding the start-up investments that Sequoia Capital manages.

Venture firms have developed relationships with universities not only for the endowment money they have to invest. Universities are also significant sources of new technology and innovation. In 1990, new legislation sponsored by US Senators Baruch Bayh and Robert Dole was passed which gave universities and their researchers rights to exploit their ideas commercially, for their own profit, even when their ideas had been developed with support of US federal research grants. Many biotechnology and information technology start-ups were established based on the work of research laboratories of leading universities with funding from venture

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capitalists. These universities chose to extend their involvement in this research by investing a small portion of their endowments in these start-ups. This not only assisted these companies in their infancy in raising the seed capital they dearly needed to get going but also gave the universities an equity stake to be able to sell later at a much higher price after the initial public offering of the company. In making its decision to avoid disclosure requirements, therefore, Sequoia Capital was not only willing to give up the substantial funds that the UC has to invest. It also risked losing access to the same types of high technology innovations coming out of the UC that helped to fuel the original founding start-up successes of the greater San Francisco Bay Area.

Venture capitalists prefer to spread their risks among many start-ups by creating a private equity investment portfolio. The risk of failure of an individual start-up is very high. Venture capitalists often speak about a ratio that is as much as nine out of ten. Therefore, pooling of risks by providing funding to many different start-ups helps to reduce aggregate risk, as in any investment portfolio such as a mutual fund or pension fund. This usually requires VC’s to raise tens of millions of dollars from private investors, a very difficult and demanding process. VC’s also prefer to share their risks with other venture capitalists, which involves communicating closely held secrets about their investment targets. Despite this disclosure risk, it provides the lead VC’s with a higher level of confidence to know that a follow-on peer also sees the potential for value and wealth that they have seen in the firm, enough also to lay down a substantial cash investment. When they can split the start-up costs of an individual firm with other early stage (pre-IPO) private investors, such as traditional venture capitalists or university venture funds, this sharing of risk further assists them in spreading their limited funds.

At an October 24, 2000 conference with the theme “the evolution of Commerce” held at INSEAD, Donald Johnston, Secretary General of the OECD, echoed the OECD 2000 study “A New Economy?” and cautiously suggested that the new economy was real and “sustainable” rather than “a bubble about to burst”. He also remarked that an accelerated rate of change has added uncertainty to the economic environment. He noted, however, that innovations in Information and Communications Technology in particular, are providing previously unavailable information and enabling quicker
assessment and analysis of business risks, especially regarding the investments segment of the economy.\textsuperscript{9}

At the same conference, there was recognition that venture capitalists were somewhat guilty of promoting fads in their choice of investments in certain internet segments. This, it was claimed, was a product of demand for these types of investments in the public financial markets. However, as the new century began, the emphasis of venture capitalists by far has returned to sustainability of earnings, that is, to secure commercial viability for their invested businesses. VC firms are retreating from e-business as a fashion to start-ups whose ventures must be analysed for value and governed in the more traditional fashion, as a repercussion of the bubble bursting.\textsuperscript{10} In addition, venture capitalists are tough negotiators when it comes to dividing up the equity shares between their venture funds and the start-up founding managers of the firms. This results clearly in limiting the number of direct shares and options shares available to management, as should be expected by governance agents. Venture capitalists are so tough in their negotiations, in fact, that entrepreneurs have given them the nickname of \textit{vulture capitalists}.

Nevertheless, venture capital is both an instigator of innovation and a beneficiary of innovation. It may overheat during innovation cycles and also simply due to fashion, as predicted by Schumpeter, but it is a valuable source of fuel for economic growth. Critical corporate governance principles and processes related to both active bonding and monitoring are well understood and undertaken by venture capitalists who uniquely facilitate high-risk, high-return potential business investments. They rely on efficient and responsive public financial markets, i.e. IPO’s, and to a lesser extent, acquisitions by larger corporate firms, to generate very high returns on their investments from the small minority of their portfolio companies that are successful.

The decision then to ban an important university from investing in its venture funds reduces the key opportunities that venture firms value the most – preferred access to new commercializable ideas, an additional source of venture capital funds, and the spreading and sharing of investment risk. The stated reason, limiting information disclosure, must be very compelling to drive venture capitalists into foregoing these

\textsuperscript{9} \textit{The Wall Street Journal Europe Millennium Forum}, p. M7, subtitled \textit{Risky e-business?}
\textsuperscript{10} \textit{The Wall Street Journal Europe Millennium Forum}, p. M6, subtitled \textit{Venture Capital: objective funding or victim of fashion?}
clear economic advantages. The decision is rational when it is recognized that public disclosure has competitive disadvantages. The start-up firm does not want to invite existing firms with significant resources, or other start-ups for that matter, to copy their new ideas or to formulate strategies that could counter their own offerings the marketplace. Some studies have shown that first mover advantage can result in securing over 50% of available profits in the market over the entire life cycle of the product segment. When the stock market crashed in 2000, university endowments that were overweighted in public company stocks, junk bonds, and venture capital investments experienced the largest losses. This invited criticism of the fund managers’ judgement in investing endowment funds. Politicians and public interest groups called for better oversight of fund managers and their choice of risk portfolio for the endowments.

This is a strong argument supporting Sequoia Capital’s decision, and other venture firms have followed Sequoia Capital’s lead in limiting their relationships with public sector investors. However, venture capitalists have been partnering with public universities for over a decade, anyway. VC’s certainly were aware of this competitive risk of information disclosure during the entire decade where stocks were rising in value. Plus, most venture-supported firms have pitched their business ideas to many potential private investors. These presentations, as a rule, are made only after the potential investor has signed a legal non-disclosure agreement (NDA) where they promise to keep the start-up firms’ competitive information confidential. Despite such precautions, information tends to be very fluid and ideas spread quickly and disseminate widely to the public following these presentations anyway. VC’s generally accept this risk as being associated with access to start-up investment funds.

Despite restrictions imposed after Sarbanes-Oxley, management’s continued use of pro forma financial results in disclosures, along with proprietary value-based reporting for their performance measurements, is a further indicator of the challenge that boards face in achieving communications transparency. For example, even firms such as Amazon.com, who have embraced expensing of stock options earlier than most other new technology firms, plan on using pro forma results in 2005 and 2006 which exclude stock option expenses. They, of course, must report their financial results following the new accounting standard, but the public will still be presented with prominent disclosures of the more favorable results as an alternate viewpoint.
A number of the Manchester area entrepreneurs, venture capital investors, and new
economy managers of public companies apparently share an attitude of distrust or
dislike towards new expectations in basic disclosure requirements and reporting. This
attitude simply does not appear to be entirely rational economically. But boards are
likely to continue to promote entrepreneurial attitudes in established firms, in order to
incentivize the economic benefits of internal innovation-led growth. Therefore, boards
must ensure also that monitoring mechanisms are put in place, which recognize the
negative effects of entrepreneurial behavior towards investor communications.

The pecking order for a public company should be aligned differently than that for a
private company, otherwise there will be significant information asymmetry and a
higher transparency barrier. This creates an environment, which does not support an
efficient market and fair treatment for current and potential shareholders. Competitors
having the ability to access the information as easily as the target stakeholder audience
is also a criticism. Two key research studies of the impact of disclosure on a
corporation’s traded securities should calm their concerns. Regarding shares,
Christine Botosan found:

“The results indicate that the lightly followed firm that disclosed the most
enjoys about a nine-percent reduction in its cost of equity capital relative
to the firm that disclosed the least.... In contrast, no association between
disclosure level and cost of equity capital is detected for heavily followed
firms.”¹¹

Similarly, Partha Sengupta looked at cost of debt and found:

“...firms that are perceived by financial analysts to be superior in their
disclosure efforts, on average, enjoy ... a lower effective interest rate on
their new debt issues .... the firm with the highest disclosure ... enjoys a
total interest cost that is approximately 1.1 percentage point lower than
the firm with the lowest disclosure....”¹²

The implication of a lower cost of equity and debt for a corporation becomes evident
when looking at return on investment (ROI). A lower discount rate, a combination of
the cost of equity and debt known as the weighted average cost of capital, infers a
higher ROI for investors and higher net profits and more cash available for the firm.

These studies with public companies showed that embracing transparency can have economic advantages for firms. From the agency theory perspective, disclosure practices are also important tools for managers to employ proactively towards bonding with the board of directors who represent the shareholders and other stakeholders. The agency assurance communication axis is, therefore, oriented to the true and fair view of financial results and the fair and timely disclosure of relevant and material events for the investing public. In addition, there are signs that society has come to accept and even condone management’s attitudes and activities, such as these, which undercut efforts for improved transparency in communications.

10.4 Channels of Distribution for Effective Shareholder Communications.

10.4.1 Regulating Fair Disclosure

When MSI must be tailored and disseminated to other stakeholders, it must, wherever possible, be made available to shareholders as well. Of course, the details of many legally entered contracts and negotiations must remain internally confidential to the firm. Protecting the valid interests of the firm along with its suppliers and customers from competitors also protects the value of the shareholders’ investment in the firm.

Management often obliges requests for additional information through its investor relations personnel and policies. Too often, specific requests are answered privately, rather than publicly, even in the face of recent regulation in the US against such practices. More recently, in more and more countries, new restrictions against unfair trading on insider information have been implemented and judicial enforcement of these provisions has been stepped up. Such restrictions have long been in place in the US, but the many scandals of the past few years have significantly increased awareness of this fairness issue.

In October of 2000, the US SEC enacted Regulation FD with much fanfare. This ruling closed another insider tipping loophole that previously had been sanctioned by the SEC. According to Regulation FD, company executives are no longer allowed to disclose material information to financial analysts of investment companies and brokerages without simultaneously disclosing the same relevant information to the public at large. Such two-tier communications had been allowed for many years by
the SEC when it was \textit{reasonable} to expect analysts to manage access to such information in an ethical manner. Analysts, after all, are even today still expected to provide an important service to the system of corporate governance by making the disclosures public as part of their \textit{unbiased, objective} stock recommendation reports.

Throughout most of the 20th century, as well, the ICT infrastructure was not sophisticated enough for widespread, simultaneous communications of all material corporate disclosures. Financial analysts from the world’s investment banks were especially needed in the communications loop. They provided their unique systematic capability of absorbing and digesting corporate disclosures and then summarizing and publishing their professional opinion on these disclosures to the investing public through their buy/sell recommendations. There has also been a rise of more sophisticated individual investors with widespread access to internet based, analytical software tools, as well as innumerable forms of news media publishing on the World Wide Web. Some of these news sites were established by traditional, established television and print media, e.g. CNN.com, economist.com, businessweek.com, etc. Others developed out of the merger of new media and old media, e.g. Microsoft and NBC, AOL and Time-Warner (owner of CNN), Multex and Reuters, and Dow Jones and MarketWatch. Many totally new publishers developed exclusively out of the web including many finance and trading oriented web portals, weblogs (“blogs”), and web newsletters, investor discussion boards, etc. The traditional financial analysts in the investment banks still play a predominant role, but due more to their proprietary professional expertise and analytical tools in forming their recommendations than to their exclusive access to management-supplied information.

With Regulation FD, the SEC concentrated on the mode of distribution of communications rather than the message itself. In 2000, at the height of the period of stock market hype, some considered Regulation FD to be the first major inroad for securities regulations since the original Depression Era establishment of the Securities Acts. In the 2000 regulation, the SEC set its sights on the two tier system of information distribution. However, advances in communications technology made a change to the logistical system an obvious target, perhaps more so than any newly realized motivation of fairness. Instead, the change was more likely a readily apparent advancement of an area long regulated against – insider trading. Under the old system,

\textsuperscript{13} SEC (2000).
information could only be physically distributed through a two-tier channel. The analysts were required as a peg in the logistical communications system, besides also adding a measure of analytical intelligence. However, with the advent of the 21st century technology allowing instantaneous publication through company webcalls and news media web publishing, analyst disintermediation only made sense.

10.4.2 The Advent of New Communications Technologies

As early as 1987, Alan Greenspan, Chairman of the US Federal Reserve Board, recognized:

“‘on-line databases, coupled with powerful computers and wide ranging telecommunication facilities, can now provide potential investors with virtually the same timely credit and market information that was once available only to [banks].’”

The advantages created after this statement by more than a decade of innovation in ICT when added to the Chairman’s observations should combine to create a highly effective and attractive internet-influenced marketplace for public securities offerings. This should improve the environment for venture capital firms’ investment exit strategies. An improved venture investment information environment should attract more capital, allow for better informed investment decisions, increase funding for entrepreneurs, and incentivize further innovation, consistent with Gompers’ and Lerner’s virtuous circle introduced in Chapter 7. The emerging technological capabilities of mobile business provide insight into the current and future environment for investment communications channels.

10.4.3 Mobile Business Connections

Siemens, a world leader in telecommunications and networking technology, defines mobile business as an integration of three technology enabled activities: internet, electronic business, and mobility. Internet here refers to the now familiar world wide web, e-mail, ftp (file transfer protocol), bulletin boards, EDI (electronic data interchange), etc. capabilities that operate over the internet communications backbone standard. Internet programming & publishing languages such as XML, HTML, and

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JAVA are required to participate in the infinite opportunities of the internet, among them the disclosure regulations and investor communications requirements for businesses.

Electronic business includes the applications and processes that automate and upgrade the standard paper dependent functions previously transmitted and communicated “manually” through standard mail (post), express delivery, fax, and phone. Customer relationship management, supply chain management, enterprise resource planning, internet retailing (“e-tailing”), e-banking, direct advertising, and promotions are among the most adaptable responsibilities to internet channels.

Mobility refers to the third generation (G3) standard for primarily wireless “always-on” telecommunication services.\(^\text{16}\) Portable hand-held devices with Bluetooth microchips for local radio network transmission and reception provide the human interface to the telecommunications network.\(^\text{17}\) G3, with speeds of up to 2 megabits per second targeted a few years into the future as compared to cellular service which only delivered 14.4 kilobits per second in the early 2000’s, will allow Bluetooth and standard PC devices to connect to the internet at high speed required for advanced video, audio and database transactions.\(^\text{18}\) These always-on devices will include mobile telephones, PDA’s, laptop and notebook computers, e-books, and lightweight web pads/tablets (for use in dedicated rather than general purpose applications in factories, restaurants, hospitals, police and fire vehicles, homes, etc.).\(^\text{19}\)

Table 10-1 below shows how deeply seated mobile business facilitating technologies had penetrated the populations of the UK, France, Germany, and the US at the beginning of the new century. Even though the collapse of the bubble coincided with a slowdown in growth rates of these resources, it was clearly temporary, allowing the human factor to absorb all of these technology advances that were introduced virtually simultaneously to the public. The rates of acceptance and satisfaction are so high that there is actually no chance that there will be any reversal or rejection of these new services.

\(^\text{16}\) O’Shea & Crowe (2001).
\(^\text{17}\) The Economist (2000-1).
\(^\text{18}\) The Economist (2000-2).
\(^\text{19}\) Marriott (2001).
Table 10-1. Mobile Business Enabling Technologies

% penetration of population as of October 2000

<table>
<thead>
<tr>
<th>e-index</th>
<th>UK</th>
<th>France</th>
<th>Germany</th>
<th>USA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal Computer</td>
<td>33.8</td>
<td>24.9</td>
<td>32.6</td>
<td>57.4</td>
</tr>
<tr>
<td>Internet</td>
<td>33.3</td>
<td>15.6</td>
<td>20.8</td>
<td>54.3</td>
</tr>
<tr>
<td>Mobile Phone</td>
<td>58</td>
<td>44</td>
<td>50</td>
<td>30</td>
</tr>
<tr>
<td>Digital TV</td>
<td>29</td>
<td>15</td>
<td>9</td>
<td>24</td>
</tr>
<tr>
<td>E-banking</td>
<td>5</td>
<td>2</td>
<td>6</td>
<td>18</td>
</tr>
</tbody>
</table>

Source: Adapted from Connectis, which used various sources including Net Profit, Wireless Internet, Strategy Analytics, and Salomon Smith Barney. e-index is sponsored by UBS Warburg.

10.4.4 Mobile Business Applications

The Information and Communications Technologies listed in the table have already made possible new mobile organizational concepts such as:

1. Telecommuting – the primary workspace is in the employee’s home. Technology, however, is only an enabler, not a replacement for human resources. This concept requires workers who are independent, self-motivated, and technically self-sufficient (i.e. PC savvy), and managers who can build trust and monitor for accountability from a distance.20

2. Corporate Hoteling – workers have no fixed desk of their own, instead they are allocated small storage spaces in the office (e.g. storage lockers) and an area of small cubicles that they check-in and check-out on a first available basis. This method is for “road warriors” including salespeople, auditors, consultants, etc. who spend most of their time in client’s offices, meeting rooms, training classrooms, and airport or train station lounges.

3. Teleconferencing, Videoconferencing, and Webcasting – the first two are now so ubiquitous that they are self-explanatory while the latter is being increasingly used for corporate investor conferences and annual meetings which are most often open to the general public, not only to selected institutional analysts.21

The internet embodies the technological promise not only for mobile organizational forms but mobile investment communities as well. The following paragraphs survey some of the key technology elements which can serve to mitigate the issues in the agency assurance communications framework, especially the free rider problem’s costs of monitoring (mentioned in Chapter 6), asymmetry of information issues of fairness, as well as insider disclosure risk.

The Hypertext Mark-Up Language (HTML), in a nutshell, is a simple device for creating web pages by formatting text, graphics, audio and video files on a screen ‘page’. In order to find anything on the page, internet users must employ a hypertext search program as is supplied by the website itself or a service such as Google, HotBOT, iLOR, etc. Anyone who has employed one of these ‘search engines’ on the World Wide Web can attest to the power in coverage, reach, and speed of these tools. However, like trying to predict where pieces of the Russian MIR space station would land upon re-entry to the Earth’s atmosphere, many of the search results ‘hits’ are not actually useful because some hypertext searches lack a contextual filter.

The eXtensible Mark-up Language (XML) is the newest version and direct descendant of HTML. XML extends the features of HTML partly to solve this issue of search precision by adding non-viewable ‘tags’ as categorization codes next to the programming code for information displayed on webpages. These tags act as exact identification markers for the type of content the information holds. XML then will not only assist with the general identification of location or placement, but also will supply a specificity of context valuable not only for human interface, but also opening up the ability for programming of many automated applications. Tags are standardized within XML for complete consistency for all programmers and users of web sites. XML’s roots in HTML, make it easier to learn, adapt, and employ by today’s web programmers.

The introduction of worldwide-accepted standards for an industry has the potential for dramatic increases in business activity and permanent reductions in unit transaction costs. Containerization in the shipping industry serves as an effective example in the physical world of this phenomenon. Standard dimensions in form and fit as well as in fabrication techniques and materials for containers allow them to be passed from and

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22 Hoffman, et.al. (1999).
carried on all major modes of transportation: ship, air, rail, and truck. And the sheer number of these containers and the requirement to track and locate them would be unthinkable without computerized databases, hand-held (i.e. mobile) bar code readers, wireless networks, and satellite communications.

Specific XML dialects comply with the latest standards for World Wide Web sites and embedded applications developed using XML. They have the potential to revolutionize the virtual world of information delivery, just as containerization realized in the physical world of tangible goods delivery. These XML dialects include:

1. Wireless Application Protocol (WAP) which makes possible the transmission and receipt of critical messages and alerts to issues virtually anywhere, anytime;

2. Rich Site Summary (RSS) which is used for on-line news publishing headlines and links to other news sources on the world wide web; and

3. eXtensible Business Reporting Language (XBRL) which is a “chart of accounts” and disclosure template, i.e. taxonomy, standardized by industry and country for publishing financial statements and other accounting related communications.

These XML standards can greatly assist in automating the key information delivery components of investor relations. The direct audience served has the potential to include not just a few financial analysts, but all shareholders and stakeholders worldwide with internet access. The technology allows for a single communications channel for simultaneous transmission of the following:

1. Sales and profitability growth – the main proxy indicators for cash flow return on investment in valuation models,

2. Differentiation costs investment requirements and timing – signalling opportunities for investors,

3. Risk recognition and management including internal controls,

4. Notable strategic resource allocations decisions and activities,

5. Corporate governance, audit, legal, and regulatory requirements, and

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6. Warnings, alerts, and urgent news.

Institutions, banks, corporations, financial portals, information providers, and investors are able to use the standardized tags to interconnect directly with their expert systems, which utilize pre-programmed decision routines, neural network models (artificial intelligence) which search for complex patterns in predicting trading and valuation, and proactive models, which identify and categorize information for risk management. The information can primarily be sourced from a corporation’s own investor relations pages on its website, but the entire web could also be searched for other related disclosures, opinions, situations, and news from competitors, customers, vendors, etc. Automated ‘BOT’s’ could be set to continuously survey the web not just for hypertext matches, but also for direct hits on specific XML tags.

It is also important to be aware that the SEC and other countries’ government agencies will certainly be making rules regarding XBRL disclosures, including how XML will be incorporated into public filing requirements. The US has been operating a central computer repository for filings called the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system since 1984. In 1996, electronic filing was made a requirement for all US domestic public corporations. In 1999, HTML and Adobe Acrobat capabilities were added to the system. The SEC normally has a period of public review before a rule is put in place, which gives companies the opportunity not only to prepare for the introduction of the rule, but also to influence the implementation methodology.

10.5 Communications Challenges for the Future

The current environment for IR entering the 21st century is one where new or updated models for processes and practices can logically be expected to be needed. The internationalization of financial markets is in some important ways, especially the trading of equity shares on multiple country exchanges, entering unchartered waters. The introduction of new information and communications technologies like the World Wide Web in the last decade also is revolutionalizing functional capabilities available to corporate IR directors. Increasing securities regulations as well as both legally required and voluntary principles of corporate governance are contributing to political

24 Zarowin and Harding (2000).
landscapes with a heightened awareness of the role and requirements of the IR function.

Managers and directors may be concerned that an increase in disclosure incidence and content could backfire against the company. It is most feared that disgruntled shareholders may use the disclosures as evidence in a lawsuit. However, a relatively new law implemented in the US, provides a ‘safe harbor’ for public disclosures and communications. The enactment of the Private Securities Litigation Reform Act of 1995 was a major event in corporate governance in the US, as it amended both the Securities Act of 1933 and the Securities Exchange Act of 1934. It encourages managers to comply with the principles of more disclosure and improved transparency by defending them from having their own honest and forthright statements from being used against them later in court. The law protects management when making “forward-looking statements” from frivolous lawsuits based solely on the fact that future results differ from the statements. As long as it can be demonstrated that the future results were produced by decisions made after the original statements and from performance factors and reasonable business requirements that also developed subsequently, the safe harbor is invoked. For example, the specific definition of one type of forward-looking statement in the law that applies in this situation is “a statement of the plans and objectives of management for future operations, including plans or objectives relating to the products or services of the issuer”.

Transparency is to its greatest intent associated with the content of MSI, to secure its usefulness and its applicability to the public. Channels are necessary for the physical delivery of MSI and its availability to the intended and expected audience. Therefore, the agency assurance model calls for transparency and channels to be ultimately concerned with the material and mode, respectively, of MSI disclosures. These communications must serve, support, and satisfy relations with, first and foremost, the company’s shareholders and, subordinately, other relevant company stakeholders.

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CHAPTER 11.

Communications for Shareholder Relations

“By viability, we mean the degree to which the financial objectives of the firm have been or will be attained. . . . Legitimacy refers to stakeholder perceptions that the institution deserves to exist.”

David Heenan & Howard Perlmutter in *Multinational Organization Development*

11.1 A Refocusing of Investor Relations Priorities

Any new developments in a business’ functions cannot add directly and immediately to the valuation and, therefore, viability of the firm, if they cannot be effectively communicated to the current shareholders and potential investors available to the firm. Even if communication were withheld until the time that the new development was implemented and allowed to directly affect the profits, and hence book value, of the firm, an effective, yet concise description of these value enhancing activities is still necessary for investors to measure the profit impact against the profit cause. This important communications responsibility falls on the investor relations (IR) function of the business. Yet, it appears that this function has itself not generally been subjected to comprehensive theoretical evaluation.

IR is a function that often is delegated to the finance area, where it is aligned with the accounting and financial reporting function of the company. IR is also often teamed with the Public Relations (PR) function of the firm, normally to ensure that press releases and other public communications are appropriately coordinated in timing and not in conflict with one another regarding content. In companies whose securities are offered to and traded within public markets, IR takes on a critical day-to-day set of responsibilities not required of private companies. The accounting function assists IR by assuring that the requirements of public disclosure regulations for each jurisdiction are met accurately and consistently. The PR function lends its professionalism to IR through the manner and process of investor oriented public communications, as well as through other corporate image building activities, including crisis management. All of these functions form a communications basis for legitimacy of the firm in society.

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1 Heenan & Perlmutter (1979).
The requirement for board of directors to include greater oversight over company IR and PR has become even more critical in today’s internationalized business landscape. Large international corporations have decided to offer their securities on multiple exchanges in different countries and to make significant foreign direct investments including establishing foreign subsidiaries and initiating cross border mergers and acquisitions. The decision by DaimlerChrysler to offer their stock as “global shares” in 1998 at the time of the merger coincided with their decision to adopt German disclosure rules and practices. When trouble appeared at Chrysler in 2000, CEO Jürgen Schrempp made potentially damaging statements to the Financial Times which could have been avoided with a better understanding of US IR practice. The Japanese executives of Bridgestone Corporation were embarrassingly inadequately prepared in 2000 for the IR and PR expectations of the US and many other nations. When their tires were connected with multiple deaths and injuries of passengers in Ford Explorer sports utility vehicles, they were unable to cope with the media attention which culminated in a US Congressional hearing that did not go well for the company. The turbulent public reaction that SwissAir Group experienced with its announcement in January of 2001 of financial and operational problems stemming primarily from its acquisitions of foreign airlines had much to do with a poor preparation of the its board of directors in coordinating its disclosures with a quite capable SwissAir IR department.

The legal requirement for boards to include an audit committee made up solely of independent directors who are also expected to be adept at finance, accounting, and internal control issues is a major challenge for firms to accomplish. Even where there are only the home country disclosure rules to contend with, let alone multiple foreign requirements, the complexity of IR and PR influences on the company’s image and valuation are clear. The audit committee must, therefore, strengthen its capabilities and prioritize its efforts in supervising and controlling MSI communications made through these internal firm functions.

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3 LoBue (2004).
5 Rolf Dubs at University of St. Gallen Corporate Governance seminar on January 24, 2001.
11.2 Strategic Credibility - Illusion vs. Reality

11.2.1 Investor Relations Research and Recommendations

Agency assurance assists the audit committee and board of directors in identifying and implementing measures which support a balance between the strategic resource allocation and control responsibilities of corporate governance. The audit committee must take interest in a widely defined span for investor relations communications, because of the role of management supplied information in these communications. At first glance Higgins and Bannister have developed a “strategic credibility” model directed specifically at IR which could help the board to balance its governance responsibilities. The researchers seek to identify and explain what key elements of IR communication are required to influence financial analysts’ valuation of a company’s shares, as outlined in Figure 11-1 below.

Figure 11-1. Strategic Credibility Model in Investor Communications

![Strategic Credibility Model](image)


To gather their data the researchers provided US security analysts with a survey questionnaire by mail. Higgins relates, “In a statistical analysis of our model, strategic
capability emerged as the most influential determinant of strategic credibility; overall corporate communications was identified as the second most significant determinant. In comparison to these relatively “soft” factors, the remaining two factors which held less influence were corporate performance and CEO credibility, which are relatively “hard” factors. In fact, considering that this study was completed during the stock market run-up of the 1990’s, these results are not so surprising. They represent a classic example of “form over substance” indicative of the bubble period.

Certainly the empirical evidence collected did support the conclusions drawn pertaining to the particular time period of the 1990’s. Studies such as this one which measure and compare market to book multiples must all be called into question since the market has subsequently experienced a dramatic fall in value. In addition, now that analysts and their firms are being investigated and sued by governments and investors all over the world, the credibility of their opinions are under severe negative pressure. Their hardy “buy” recommendations certainly had a strong influence on the M/B ratios of many firms which in the subsequent few years have been exposed for financial fraud and/or incompetence. The “strategic credibility” value of these corporations was lost almost overnight. However, the clearly critical value derived from this research focus is in demonstrating the high level of importance of pleasing financial analysts is clearly indicative of the behavior of companies. Not only Higgins and Bannister, but others such as Marcus & Wallace also present that the internal firm function of Investor Relations must focus foremost on relations with the analysts on Wall Street, in the City of London, in Frankfurt, etc.

11.2.2 Information Asymmetry Through Selective Disclosure

One highly discussed issue affecting the transparency and reliability of the analysts’ recommendations to the investment public is the connection between highly profitable investment banking business with corporations and the form of recommendation made by the analysts at the poorer sister trading divisions of the investment bankers. It certainly appears that this important factor of conflict of interest was not included in

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8 The market to book multiple is equal the ratio of the market value of all of the firm’s outstanding shares to the book value, i.e. shareholders’ equity, of the audited financial statements.
9 DiStefano (2002).
the questionnaire instruments nor disclosed in the analysts’ responses of the investor relations research. A second issue has been the confusing language employed by analysts when they were making their recommendations. Typical words used were “strong buy”, “buy”, “accumulate”, “hold”, and “sell”. Rather than the meanings of these words matching standard definitions of everyday use, they were used as signals to those well familiar with financial markets and trading. For example, the downgrade of a stock recommendation by an analyst from “buy” to “accumulate”, actually was often a signal to sell. It is well documented now that the ‘sell’ recommendation was little used, and that analysts were recommending selling their own fund positions and favored client positions of stocks when publicly that were using any one of the words other than ‘sell’. In addition to these two issues, the dissatisfaction with audited financial results as a credible information source providing utility for financial statement users, especially for management in measuring and monitoring differentiation costs, must also be considered.

First of all, it is practically universally accepted that financial valuation is a mathematical product consisting of the risk factored discounting of the future cash flows produced directly by a particular investment. Since financial statements present results of the past, analysts search out additional information which provides better signals to future firm prospects. To this end, an elaborate disclosure system of analysts’ earnings guidance developed where MSI was provided exclusively to analysts in presentations, meetings and conference calls to assist them in making their projections. Since management was not allowed to provide projections directly, the language used would attempt to signal (guide) the direction and amounts for analysts to predict key measurements like earnings per share, long-term investments, and financing measures.

It is important to recognize that in the last few decades of the 20th century, especially during the accelerated run-up of the stock market throughout the 1990’s, a two tier system of disclosure had become common. Analysts were invited to private conferences by many corporations where disclosures were announced by the companies and analysts were allowed to ask questions for clarification and direction, i.e. guidance. Individual investors would hear, often only selectively and sometimes

after long delays, about the content of these conferences from analysts’ reports. These conferences were first held between company executives and fund managers and their analysts in person. In the late 1980’s and throughout the 1990’s, when advances in telecommunications technology made teleconferencing widely accessible, these meetings were also held through conference calls.

Discussions by executives with analysts have led to pre-announcement and event-period private information, which are partial or full disclosures that occur selectively in advance of or at the time of, respectively, a general public release. These communications could include actual detailed results; management decisions or events of material effect to the company; or just clues, estimates and projections which assist an outsider in discerning, predicting or forecasting these effects.

Researchers Kim and Verrecchia have surmised that the existence of pre-announcement private information as well as event-period private information together describe an added increment to the overall average cost of capital of publicly traded securities. The previous chapter presented studies which showed that the reluctance of entrepreneurial orientation of management to make disclosures generally can affect the cost of capital negatively. In the Kim and Verrecchia study, an additional cost resulted from information asymmetry providing a trading advantage to some groups or classes of investors over others, causing a disparity in the prices paid and therefore the return on investment earned by these different investors. The privileged classes of investors have often been members of the external investment banking community.

In recognition that this led to a time delayed, two-tier disclosure mechanism, which could provide a trading advantage to the first tier, as related in the previous chapter, the SEC adopted its fair disclosure regulation in October of 2000. Regulation FD, as it is called, requires companies to take measures in their disclosure modes to eliminate favoritism, especially towards fund management versus individual investors, through timing of access to discrete strategic announcements and regular revenue and earnings expectations. In addition, any other material information intended to be disclosed to analysts now has to be simultaneously disclosed to the public through timely press releases and SEC filings. If there is a short delay between closed conferences and

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public releases, the analysts are required to use discipline in waiting until after disclosures are released to the public before acting on any information they receive.

However, an important competitive advantage does and should remain for the analysts’ organizations. They can apply their significant expertise and ICT resources to acquire fair MSI disclosure material and process it in sophisticated forecasting simulation models. As early as 1970, Eugene Fama described this advantage generally as follows:

“disagreement among investors about the implications of given information does not in itself imply market inefficiency unless there are investors who can consistently make better evaluations of available information than are implicit in market prices.”

With the added-value accrued from their own preparatory and analytical efforts, analysts can advise their clients and fund managers to act quickly in the financial markets. This is all the more important as traders are increasingly employing automated electronic systems, even in after-hours markets.

More recently webcalls (internet analyst conference calls) and webcasting (broadcasting of company news) have become common with the development of internet technology through world wide web links. To their credit, many companies did realize that this same technology made universal access possible and cost-effective for anyone interested in joining these conferences. These companies voluntarily made it possible for the general public to passively participate, through dialling-in or networking, where they could hear and sometimes see what was going on in these important meetings. In more limited cases, the public could listen-in on a real-time basis, exactly as the conversation was being held, not delayed by a few hours or days. Unfortunately, however, since the introduction of Regulation FD, there have been a number of apparent high profile “snubs” of the new requirements. A few firms, such as Morgan Stanley, continued to meet with analysts privately, claiming simply that nothing of a material nature for investors was being discussed. There also still appears to be a vocal group denouncing the regulations and arguing that the regulations stifle overall disclosure and add significant administrative costs for more

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frequent SEC filings. They do not agree that there are or believe that their firms can themselves accrue the offsetting economic benefits from fair disclosure.

11.2.3 Information Asymmetry Through Insider Trading

Insiders in executive management positions have also used information asymmetry to their trading advantage as well. In their study of 572 firms between 1992 and 1996, Aboody and Kaznik demonstrated that CEOs accelerated voluntary disclosures of bad news and delayed announcements of good news prior to awarding of executive stock options (most often on the day before or day of earnings announcement). The bad news holds down the exercise price of the awarded options. When good news is held for release to the public after options are granted, share prices were shown to rise, which generally provided a windfall profit to managers’ issued options, as shown in Figure 11-2 which follows.

Figure 11-2. Disclosure Timing Influencing Executive Stock Option Pay-Outs

Mean cumulative market-adjusted return from - 30 to + 30 days around the dates of 2,039 scheduled CEO stock option awards between January 1992 and December 1996.


At the 1997 Contemporary Accounting Research Conference sponsored by the Canadian Academic Accounting Association, a research team presented a study with
direct interests to the understanding of selectivity in management disclosures. A sample of 210 firms whose shares were issued in secondary offerings over the period 1984 to 1991 was tested. The researchers stated:

“Specifically, we find evidence of increased voluntary disclosure, greater analyst forecast accuracy, and closer timing of the equity issue registration to the previous earnings announcement for firms with managerial participation in the offering.”

They naturally concluded that executive behavior changed as their firms approached the offering date due to their vested personal interest in profiting from sales of the company’s shares. Firm managers tended to release more information than they normally found necessary, not only compared to their normal day-to-day behavior, but also more than for offerings in which managers did not personally participate. The research team described this activity to motivate a higher financial market interest and higher share price as a reduction in information asymmetry. However, such selectivity in disclosure timing cannot be considered as a positive or fair contribution to capital market efficiency.

Legal restrictions of insider trading, which in the US and many other countries have been in place for decades, also address limiting pre-announcement information by recognizing that management naturally has access to these disclosures prior to public release. Managers can benefit personally not only by trading shares which they already own or can exercise through options prior to or near the time of disclosure, they can selectively leak such information to friends, relatives and other associates for their unfair trading advantage. The following Case Review 11-1 provides a recent example of how these types of close relationships can become self-serving as well as self-injuring.

**Case Review 11-1. ImClone Systems, Insider Trading, and Pre-Announcement**

Sam Wacksal, chairman and CEO of Imclone Systems was found guilty in early 2003 and received a multi-year prison sentence for insider trading in the US. A jury determined that he had traded his own ImClone shares and gave information, i.e. stock tips, to family members. He advised them to sell their shares in the company immediately after he received notice that an important drug that Imclone had

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developed was not going to receive US Food and Drug Administration (FDA) approval. These stock sales occurred before either the FDA or Imclone had disclosed this information to the general public. This automatically made anyone in possession of such information an insider, who’s trading in the company’s public securities is clearly restricted, in sight of the law.

This case drew additional notoriety not only because of Waksal’s and his family’s trades but also because a close friend of Wacksal’s, business executive and media personality Martha Stewart, sold her relatively small block of shares in ImClone the day before the negative FDA decision was announced. The government prosecutors tried to prove that Stewart had received an early tip-off of the FDA issue at ImClone directly from Wacksal or indirectly through her stock broker. Stewart stepped down as chairman and chief executive officer of Martha Stewart Omnimedia once she became embroiled in the affair through her association with Wacksal and also was indicted in mid-2003 on insider trading charges related to her stock transaction.

Stewart claimed her sale was generated when the value of her shares fell to a predetermined ‘floor’ price, through an informal open sale order instruction she had arranged with her stock broker. She disclaimed possession of any pre-announcement information that Wacksal may or may not have communicated had triggered the sale. Finally, in 2004 Stewart was found guilty in court of criminal obstruction for attempting to deceive government officials during the investigation, but not of insider trading. She served a five months sentence from October, 2004 until March, 2005 in a minimum security prison, while always denying any misdeed. Despite serving her sentence, Stewart appealed the guilty verdict during her probationary period upon release from prison, but the appeal was denied by the appellate court in late 2005.

What should have occurred at ImClone to mitigate this insider advantage was adherence to a self-imposed black-out period for any employee or member of management or the board of directors with access to material insider information. Total restriction of trading as well as of disclosure to any outsider must be required by the company and observed by the principals, those with information access, during the prescribed period. This waiting period usually begins with the point of availability to insider information and runs to a point soon after the public disclosure. Anyone who happens to receive such information prior to public disclosure, becomes an insider and
is also legally bound to refrain from trading, buying or selling, any securities or from disseminating this information further until after the public disclosure, regardless of the source of the information.

11.2.4 Information Asymmetry Through Market Smoothing - Manipulation?

Management may be concerned that the capital markets do not overreact to any bad news, and in some instances, even to good news. Therefore, managers might naturally seek to find a way to present news in a manner which tempers market reaction. There are serious flaws in such a strategy of market smoothing. First and foremost, it must be recognized that management’s own strong conflicts of interest will distort their impression of what amount is reasonable and what is an overreaction. Its judgment is flawed and cannot be considered as being superior to an objective external market of many buyers and sellers. The audit committee must be very sensitive to these conflicts as a potential issue and practice extra diligence (or care) in supervising the disclosure actions that managers implement.

Further, the efficient market hypothesis would lead the expectation for the market to react to timely, honest disclosure signals by the exact amount that is rational, based on all information elements disclosed up to and including the present. Common disappointments from shifts in external factors or glitches in internal operations would be balanced by a well documented and communicated history of generally positive results. Since more than 60% of widely traded S&P 500 public corporations are owned in trust by institutions with professional management, capital markets can be expected to react rationally. Therefore, there should be little reason to expect that the system could be somehow tricked into a different, less-efficient result when following fair disclosure rules.

Piecemeal information disclosure to tame the market could also be illegal as it could imply that management still knows something that affects results materially, but chooses not to disclose it. This kind of disclosure process lies on an extreme edge of smoothing financial results. However, it is not a rational expectation that stock market prices would move in a smoothly flowing curve fashion. It is much more rational, in a very mature, efficient market, for prices to move quickly up or down in reaction to

\[16\] As derived by the author from the Multex database.
news of discrete events. Certainly staggered delays in individual traders’ and investors’ ability to absorb, analyze, understand and act on disclosures along with their different perceptions and interpretations will mean that price adjustments are not perfectly efficient and instantaneous. However trading volume and the number of participants in stock markets are so great that even these differences in timing reaction and valuation are acceptably efficient. Management has no grounds to believe that the market is wrong or that it needs to be managed by illegal or unethical withholding of information. In addition, strict insider trading rules and Regulation FD in the US, and similar rules in other nations, make any type of smoothing or profit taking from staggered audience disclosure illegal.

11.2.5 Information Asymmetry Through Blockholding

The US SEC is clearly not the only organization with interest in the topic of fairness in information disclosure and control related to securities trading and corporate ownership. Corporate governance principles like those offered by the OECD as guidelines for all countries to implement, adjusted to local national economic and financial market environments, clearly call for equitable balance in the treatment of company shareholders. The rights of shareholders that are specifically identified in the OECD principles include registration, voting, notification, transfer, disclosure, attendance, etc. These principles are designed to protect minority investors from dominance by equity blocks including founding families and banks with large holdings. The principles recommend that all shareholders are guaranteed the same legal rights in the underlying securities that they hold.17

A formation of informal special classes of shareholders with fewer restrictions or greater influence than a simple per share weighting would allow is recommended to be discouraged or eliminated in order to protect minority investors from expropriation. As examples, banks that are only safekeeping shares for their clients and advising these clients on which shares they should invest in, should not be allowed to also vote those shares on behalf of their clients. By combining these custodial shares with the shares that the banks themselves actually own, banks could unfairly control a block of control and influence on the firm that is greater than their actual ownership interest.18

17 OECD (2004-1).
The bank’s clients are the actual equityholders with rights over the company for these shares, not the banks. Pensions, however, whose fund managers directly make the decisions of which shares to purchase or sell for the benefit of a pool of many investors, should require these fund managers to vote in all situations for the shares that are held in the fund. Both of these examples are classic situations expected to be remedied by corporate governance actors voluntarily or, as one study shows, the board and other actors should be given the requirement directly through formal laws and legal enforcement. These are critical issues for reform but they still are directed at differences in influence over management decisions.

11.2.6 The Impacts and Influences of Information Asymmetry

Information asymmetry is arguably responsible for a large part of the economic resource misallocation of the last decade, stemming from misrepresentations of financial results and misappropriation of firm assets by management. Any additional increment in the cost of capital for public corporations is also an unfavorable economic cost to society. Curiously, it seems that the world’s large audit firms have encouraged rather than discouraged this information asymmetry in their clients’ communications. Most of the audit firms have developed and promoted their Value-based Reporting studies as an alternative view to standard accounting reporting. For example, Ernst & Young (E&Y) surveyed securities investment analysts for its Measures that Matter reporting program and determined that:

“Internal company information such as management presentations and reports are considered the most important sources of nonfinancial information. Easily attainable public information is not a primary provider of this knowledge.”

Figure 11-3, below, is taken from the E&Y study performed prior to Regulation FD, but which nonetheless, remains as a basis for this important non-audit assurance service of alternative management reporting.

The most important information source for the analysts listed in Figure 11-3 was company management presentations. Fortunately, following Regulation FD in the US, these presentations are required to be open to the public or their material content must

19 LaPorta, et al. (2000).
20 E&Y (1997).
be simultaneously released in a public filing. The survey also confirms that company public filings or reports are highly valued in the financial markets as the second most important source in the study. Interestingly, competitors and the business press were given as much or more importance as credible sources of information as the company investor relations department.

Figure 11-3 E&Y Measures that Matter Financial Analyst Survey

<table>
<thead>
<tr>
<th>SOURCES OF NON-FINANCIAL INFORMATION</th>
<th>MEAN SCORE</th>
</tr>
</thead>
<tbody>
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</tr>
<tr>
<td>Company Public Filings or Reports</td>
<td>5.34</td>
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<tr>
<td>Sell-side Analysis</td>
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<tr>
<td>Competitors</td>
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<tr>
<td>Business Press</td>
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<td>Company Investor Relations Department</td>
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<td>Customers</td>
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<tr>
<td>Buy-side Analysis</td>
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</tr>
<tr>
<td>On-line Services</td>
<td>3.77</td>
</tr>
</tbody>
</table>

Source: Ernst &Young (1997).

11.3 Re-Defining the Right Activities

11.3.1 Communications for Collaboration and Control

It is fair to say that management supplied information that is of material interest to the public, specifically firm shareholders and other stakeholders, is of critical importance to the board. The audit committee, therefore, must take a lead role in supervising the entire disclosure process, from setting expectations for content, to arranging modes of conveyance, and finally by closing points of contact. It is also safe to say, that virtually all directors are engaged only part-time in a firm’s board activities, and that the great majority of directors can measure their yearly involvement in just days or
weeks of time, certainly not months. However, it is also fairly clear that either the expectations of the public for directors’ performance or interest in holding them accountable for firm failures has grown significantly. The 2005 McKinsey study of boardroom practice stated:

“To understand the long-term health of a company, directors should monitor not only its current financials but also a broader range of indicators [including]: market performance, network positioning, organizational performance, and operational performance. Risk—including credit, market, regulatory, organizational, and operational risk—plays an important part in each dimension. Without this knowledge, directors will have only a partial understanding of a company.”

From the perspective of purely logical logistical and capacity constraints, therefore, the communications content in agency assurance would be directed at activities of the board which are restricted to three critical supervisory functions:

1. strategic planning advisory and approval,
2. decision implementation oversight, and
3. assurance of legal, regulatory and ethics policy compliance.

These functions are supportive of control and collaboration in recent corporate governance research, monitoring and bonding in agency costs theory, as well as monitoring of management and strategic guidance outlined in the OECD Principles. Overlaying all of these functional activities, the key OECD Principle of accountability to the company and the shareholders takes precedence.

11.3.2 Strategic Planning Advisory and Approval

Strategic planning for the board encompasses first sourcing and then allocating capital requirements for business expansion or divestment. Sourcing of capital funds from banks and other financial institutions is dependent on many factors, not the least of which are relationships with the creditor (lending) community and reputation of the company as a debtor (borrower). Larger, established corporations or smaller, dynamic start-ups can also tap the securities markets for funding, either through public offerings of short-term commercial paper or longer-term bonds (debt) or of shares (equity). During all operating stages of an organization’s life cycle capital is also made

\[21\] Felton & Fritz (2005).
available by supply chain partners providing commercial lines of credit in parallel to their delivery of goods and services. Over the long-term, a business expects to source its capital primarily from sales to satisfied customers. Relationships and reputation of the board are just as critical in the contractual access to customers and suppliers as in public financing arrangements and in private placements with financial institutions.

Allocating capital requirements is most often the subject of strategic planning sessions, strategy training seminars, business strategy books, etc. directed at executives, directors and those with aspirations of attaining these positions. In summary, funds are sourced to be invested in developing or acquiring new products and services, production capacity, or market geographies and segments, as well as for mergers and acquisitions of whole business units. In the process of capital allocation, the closing of facilities, sale of assets, and divestment of “non-core” businesses are also given consideration. These latter types of decisions are often referred to as supporting goals of capital preservation. All strategic planning decisions involve initiating changes with intent to improve outcomes for the business in the future. Making changes is a reminder that such decisions always contain many elements of uncertainty.

Ultimately, the allocation of capital requirements will be tied back, i.e. connected full circle, to the original sourcing of either debt or equity capital funds. Creditors must be paid back, with interest, and the payback funds should be generated by operating activities stemming from the prior related strategic investments. Meanwhile, shareholders expect capital investments to generate returns in the form of increased valuation, at least through a higher stock market price, if not through cash dividends paid out to them as well. Common shareholders normally carry a higher level of risk than creditors, therefore they rationally expect a higher return on their investment than the average interest rate paid on corporate debt. The company’s fulfillment of these financial obligations provides a positive public track record and builds trust that is an absolutely necessary ingredient for a healthy company reputation at financial institutions, in financial markets, among suppliers, and with customers. It is no coincidence that this trust is often referred to as relationship capital.

The sourcing and hiring or firing of top talent in the executive management ranks is also of strategic criticality. Normally, the board forms a nominations committee, a smaller group from within the board’s ranks, to lead the search for new board
members, including the chief executive officer who is usually also a board member, when there is an expected opening. Hopefully, hiring decisions are followed by good or exceptional performance. In this resulting, more stable environment, the board can concentrate on retention, development and succession planning for top management to build on the positive momentum of improved results or prospects. The board compensation committee is called to set initial top executive salaries, benefits, bonuses, and other incentive levels. This group also leads the evaluation process of management performance, including setting of standards and measurement methods, and approves the resultant payout of incentives and changes to base compensation elements. Unfortunately, when performance does not meet expectations, the prospect of firings, and the environmental uncertainty and instability which normally follows displacement, must be accepted. This period of substandard and erratic performance is an opportunity cost of either unfortunate events stemming from expected risks or from errors in board judgement in prior strategic decisions and in their implementation.

11.3.3 Decision Implementation Oversight

An important component to be expected of any strategic plan is an outline or translation of its operational implementation. Strategy could be described as a vision of a desired destination, while a strategic plan would plot out an expected route to arrive at the destination which adds critical details to the map. Management must still operationalize the plans by actively choosing the mode of transportation, selecting the crew, and determining how to outfit the vessel for the trip. They then have to motivate everyone - investors, directors, managers and employees alike - to get on board for the trip. Almost all of the strategic planning and virtually all of its operationalization direction will be performed by the management team. Experienced managers know that the bulk of the hard work lies ahead of them, and that they have not accomplished anything with only their plans in hand.

The financial market analysts, almost all of whom never held the challenge of management in a goods-producing or non-financial services business, set their stock and bond valuations using projections of results. The analysts’ world consists of spreadsheet models of earnings and cash flow forecasts. In this virtual world, the investments in resources have been placed, received, installed and put to productive use; customers have been won; production is complete; products and services
delivered; all other obligations fulfilled; and payment received. Risk factors, spanning small human error to large natural disaster, are mathematically calculated into the analyst’s equations.

Investors react to analysts’ publicly communicated recommendations by buying or selling the company’s securities. This trading activity in the financial markets sets the valuation of the company. It not only succeeds in setting the net worth of the company, but also adds or subtracts from managers’ personal net worth. Often much of their compensation has already been granted in company stock and stock options, or their bonuses and increases are based on stock price. Sometimes, it can appear that managers’ hard work has not had as much direct effect on financial markets as the analysts’ statements about the performance of the company. Too often, especially with stocks, the value is set entirely on projections, and managers notice that they can be compensated for the communication of their strategic plans before they have accomplished anything operationally. Analysts, as well, are well aware of the patterns of market reaction to their recommendations, and the many means they have at their disposal, some more legal or ethical than others, to profit from these patterns.

For the board and the shareholders they represent, reviewing decision implementation allows for accountability of management to agreed strategic goals. It provides a limited but valuable chance for open communication lines for clarifying expectations and for course correction, when necessary. How frequently the directors must meet to perform this function effectively, beyond the normal quarterly sessions each year, must be determined by the board itself. The board meetings calendar will be influenced by the known condition of the company, the transparency of management communications to the board members between formal meetings, and the board’s overall policies allowing for such communications directing their frequency and content.

The impact of unexpected events leading to material changes in performance expectations and business prospects, positive or negative, is also a concern of board members in its regular discussions with management. Most often, there are only enough funds to invest in a single scenario. Unless the company is General Motors, IBM, Procter & Gamble, Citibank, or another huge multinational conglomerate, companies do not readily offer their own products competing with each other in the
same market space. They also cannot afford to offer significantly different products in different markets. Instead they develop a synergistic, consistent family of products, and they offer the entire family or a cross-section of the family in various markets. Their market approach may be adjusted to conform to local needs and cultural expectations, but usually some intrinsic part of their promotions is left intact and identifiable across markets. Trends in many industries appear to moving, albeit slowly, towards favoring a global approach to products and markets.

Internal to company operations, as well, decisions of production and fulfillment methods; supplier, outsourcing, and outside services contracting; and administrative procedures are required. Management generally is expected to make its decisions based on what appears, after examination and analysis, to be the most reasonable choice. However, in almost all cases for all decisions, there are alternatives. In addition, a single scenario, even when it is the best choice, will have a range of expected outcomes. Managers must be able to construct a risk management system of early warning indicators for identifying and avoiding impending business failures or major setbacks. Boards of directors, as well, would benefit from access to the output indicators of this internal risk management system.

In parallel to management’s internal system, general industry reports and specific company reports prepared by select investment, government, academic, and consulting analysts and researchers, should be sourced regularly by management and directors alike. Both groups would benefit from external views in their overall risk assessment, but not only for the additional information that more resources can provide. The internal departments would be less able to identify conflicts of interest that enter management’s decision processes, including the examination of alternative choices and outcomes. They can also, wittingly or unwittingly, become induced into contributing to information asymmetry in the presentation of management decisions. It would therefore be a mistake to consider eliminating some of these outside sources in favor of increasing internal resources. Such a trade-off between transaction costs and agency costs must be made with much discernment by the board.

11.3.4 Assurance of Legal, Regulatory and Ethics Policy Compliance

In the quotation at the beginning of the chapter, Heenan and Perlmutter point out that there are two key forces that serve to maintain the vitality of a firm into the future.
Businesses cannot only concern themselves with financial viability, where maintaining solvency to repay their obligations keeps them a *going concern* in the present, and the profit motive demands a good competitive strategy and well functioning operations to secure their future. Corporations must also perform an identifiably healthy, responsible role that furthers societal goals, in order that they are at least tolerated and at most hopefully encouraged as legitimate economic entities in society. Therefore, the communications of the company must be oriented to serve the financial interests of investors as well as the societal interests of the public.

A firm must operate in a manner that stakeholders accept as meeting the requirements of formal and informal social rules of law, morality and ethics. Many of these rules are unwritten societal and cultural norms, which can be difficult for a firm to discern. Management is first busy with its many competitive goals, challenges and demands, often leaving little time to contemplate current and emerging social problems. The fact that norms are an environmental factor subject to changes of varying degrees, like the surface of the ocean which swells and recedes, only sometimes predictably, adds to this difficulty.

The amount of risk that a public corporation takes is also regulated by legal as well as social norms. Most of the SEC disclosure regulations, and the establishment of the SEC itself, were motivated by the objective of reducing or warning of these risks to investors. Stakeholders, including government legislatures and agencies, also recognize that actions of corporations can endanger the local population by threatening their physical and economic health and outlook. When such actions have been brought to light by disgruntled individuals and the news media, even many good firms have fumbled desperately with their IR and PR communications.

In the last few years, Nike had been accused by public interest groups for employing cheap Indonesian labor in sweat-shops, while the company claimed its working conditions, pay and benefits were some of the best in that part of the world. In the 1990’s, Royal Dutch Shell and Unocal cooperated with the governments in power in Nigeria and Myanmar, respectively, employing thousands in energy-production related projects, later to find these activities to be criticized for supporting corruption and abuses such as forced labor, torture, and murder. Many multinationals withdrew from South Africa in the 1980’s to fully disassociate themselves from rising international
dissatisfaction over Apartheid, even though these firms may also have previously taken great pains to integrate and provide equal opportunity among races of their workers. Also during the 1980’s, Nestle was attacked as a propagandist of misinformation for leading a program promoting the benefits of its infant formula in less developed countries in Africa, when it could be argued that breastfeeding remained a simpler, less-costly, and potentially healthier solution.

Where firms, however, contribute to or fail to see rising social problems of their own making, due to willful or unwillful blindness to their own conflicts of interest, is entirely another matter. This is profoundly evidenced where explicit laws and regulations are broken and disregarded with purpose or even misinterpreted and ignored out of convenience. Legal and regulatory compliance with standard commercial code, trade restrictions, tax law, government bidding rules, fair competition laws, foreign corrupt practices legislation, safety testing and registration requirements, environmental impact and pollution control regulations, and any and all other commercial or criminal laws is a clear minimum standard of evaluating the acceptability of corporate behavior. There are some industries, including banking, insurance, pharmaceuticals, food, transportation, and construction that are subject to very significant specific bodies of regulation, to protect an orderly financial system and the physical safety for consumers, as well. Besides the departments of attorneys and contracts managers found in most public corporations, firms in these industries are apt to employ regulatory compliance specialists as well. They must elevate their awareness of the risks of their activities and the necessity to communicate effectively their plans and actions to keep risks to a reasonable level.

11.3.5 Finding the Right Balance Between Collaboration and Control

Strategic planning advisory primarily supports the collaboration camp, as it enhances dialogue and vision creation between the board and management. The requirement of board approval of the strategy adds an element of control to this function, through the exercise of board authority. Decision implementation implies a collaborative connection to the strategic planning process while oversight implies controls through measurement and evaluation, achieving a fairly even balance between both camps. Assurance of legal, regulatory and ethics policy compliance presents clear links to the control camp. Collaboration can also benefit, because social responsibility,
stakeholder management, and legal requirements can and should often be influenced and negotiated with participation of firms as economic actors in society.

11.4 Signalling for Shareholder Value

Signalling theory was first proposed by A. Michael Spence in the early 1970’s to describe the impact of information asymmetry on labor markets, and the theory has now been applied to many different markets. As Morris has explained the theory:

“Initially, sellers in a market are assumed to possess more information about their product than buyers…. Sellers of above average quality products incur an opportunity loss because their products could sell at a higher price if buyers knew about the superior quality, while sellers of below average products make an opportunity gain.”

Signals are the mechanisms used for indirect communication of potential benefits. The provision of a warranty for a product by a seller is a good example of a signal of confidence in future quality.

This may help to explain why firms who generally disclose more enjoy a lower cost of capital. Signals in the capital markets are consistent with the efficient markets hypothesis. Signals lower information asymmetry by providing capital markets with additional disclosures which the buyers and sellers of securities can analyze and act upon. Management and directors of higher quality companies restrict themselves from making forward looking statements and predictions of future results because of the threat of great liability they would suffer for being wrong. However, if they do not communicate, their shares may often be underpriced.

Consistent with objectives of both collaboration and control and in support of the main activities of the board, communications to capital markets from above average firms should be consciously derived from a balance of disclosures signalling strategic credibility and quality of earnings. The accounting recognition and amortization of differentiation costs provides a fitting set of signals, both margin-oriented and cash flow-oriented, that improves transparency for both camps. Low quality disclosers will be restricted from making promises of future gains. High quality disclosers would be incentivized to communicate their advantages.

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23 Ibid.
As was related earlier, Higgins identifies superior corporate performance as one of the four key factors determining strategic credibility. It is, therefore, advisable for management to return to a focus on quality of earnings through the official audited financial statements. Managers and boards must respect the relevance of these accounting disclosures, and seriously contribute to improving their transparency and reliability. This should be possible through a principles approach to accounting standards to achieve a true and fair view of the financial and operational results. This also requires a fair and efficient disclosure system oriented to the communications needs of shareholders and other stakeholders. The recognition of differentiation costs over the complete life cycle of the firm’s products, services, and programs, specifically, and by the board’s adherence to the agency assurance model for supervising management supplied information, generally.

The audit committee needs to take an active role in the corporation’s MSI communications. A return to the focus on shareholder relations as opposed to investor (read analysts) relations would provide a reprioritizing focus for management. With shareholder relations, the clearer constituency is the existing owners of the firm. Current owners are those whose investment is at risk and those who have voted for the directors to lead the organization who, in turn, appointed management to run firm operations. Of course there must also be some balance between the existing owners and all other stakeholders, among them potential investors and analysts. The disclosure regime must consider and care for their valid needs.

The following Case Review 11-2 presents Wal-Mart as an example of a firm that is generally conservative and deliberate in their reporting and disclosure practices.

Case Review 11-2. Wal-Mart’s Conservative Communications Approach

Wal-Mart, the world’s largest retail operation, which was very careful in its implementation of operational internet capabilities, has seen an impressive growth in its valuation throughout the 1990’s, but whose share price has remained remarkably high and stable compared to the rest of the market. The company’s philosophy can be summarized by the following statement made clearly and directly by its late founder, Sam Walton, in 1992:
“What really worried me over the years is not our stock price, but that we might someday fail to take care of our customers, or that our managers might fail to motivate and take care of our associates.

As business leaders, we absolutely cannot afford to get all caught up in trying to meet the goals that some retail analyst or financial institution in New York sets for us on a ten-year plan spit out of a computer that somebody set to compound at such-and-such a rate. If we do that, we take our eye off the ball. But if we demonstrate in our sales and our earnings every day, every week, every quarter, that we are doing our job in a sound way, we will get the growth we are entitled, and the market will respect us in a way we deserve.

If we fail to live up to somebody’s hypothetical projection for what we should be doing, I don’t care. It may knock our stock back a little, but we’re in it for the long run. We couldn’t care less about what is forecast or what the market says we ought to do. If we listened very seriously to that sort of stuff, we never would have gone into small-town discounting in the first place.”

Sam Walton’s quotation clearly shows he had favored of pursuing consistently good financial results over chasing the expectations of a Wall Street analyst’s forecast model. Wal-Mart continues to show that its management is grounded in attention to fundamentals and remains comparably less interested in Wall Street’s communications.

Wal-Mart’s communications strategy could be categorized as content driven rather than presentation oriented, and it has been very stable and successful using standard financial measures such as long-term sales growth, profitability, and return on investment. The media, analysts, and public hold very positive opinions and even admiration of Wal-Mart’s IR practices, which has also been evidenced by Wal-Mart’s share price stability, its ability to maintain value, even in turbulent times. Perhaps Sam Walton understood the basic economic concept of scarcity influencing prices. Taking care of shareholders convinces them to hold on to their shares in the long-term as well as to allow growing firms to retain profits for growth-oriented investments. A reluctance to sell stemming from loyalty creates a form of scarcity which keeps prices fully valued in an efficient market.

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CHAPTER 12.

Communications Failure - The Widening Information Gap

12.1 Communications Conflicts and Message Mix-Ups

The distinction between relations with shareholders and stakeholders, i.e. the actual owners of and others with direct interests in the firm, and relations with investors, i.e. the notional prospects in the financial markets, should provide a basis for priority in strategic communications for management and the audit committee. The entire community of fund managers, buy side analysts, sell side analysts, statisticians, financial media – traditional and on-line, and credit rating agencies perform an important external examination function for corporate governance, but their focus is investors rather than shareholders. The investor relations function in public corporations has added to the transparency barrier by aligning itself primarily with the interests of these investment advisors in the capital markets and with management. Boards of directors have also internally accepted executive compensation increases significantly out of proportion to basic financial standards of firm performance, which aligns them with management’s interests over shareholders’ welfare. In many situations, therefore, the audited financial statements appear to have not been trusted as the accurate and appropriate measurement system. Information asymmetry is in part the result of the information gap between the financial statements and the sought after true and fair view.

Information gaps tend to act like vacuums drawing all sorts of other information from various sources to fill their voids. Because the accounting industry has not addressed these gaps effectively, specifically in regards to the financial reporting of differentiation costs, microindustries offering alternative information have developed. Some of these microindustries are appropriate in that they effectively support various corporate governance purposes, while others appear to be inappropriate, supplanting rather than supporting the official information sources of legitimate corporate governance agents.

Parallel reporting and valuation systems are being offered as consulting services to management, boards, creditors, investors and other firm stakeholders as more reliable and more relevant alternatives to the disclosures of the official financial statements.
These microindustries of information receive the direct or indirect support of government officials, accounting standard setters, major auditing firms, consulting firms and academics, and internal managers and accountants. In the process of attempting to secure what they believe is the more reasonable and relevant version of the true and fair view of the financial condition of the firm, these actors are more often openly, but mostly inadvertently, succeeding in impugning the reputation of the audited financial statements as a reliable and relevant information source. However, at the same time as casting doubt on their value, the audited financial statements are described by these same actors as the primary and central source of information for establishing the true and fair view. To see how this information contradiction is sustained in today’s business environment, the six management-supplied information categories of the agency assurance spectrum as shown on the right side of Figure 12-1 below are analyzed.

**Figure 12-1. The Spectrum of Management-Supplied Information.**

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Management-Supplied Information
- Audited Financial Statements
- Prospectuses
- Plans and Budgets
- Analyst Forecast Guidance
- Value Based Reporting
- Compensation Measures
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Source: Own representation.

**12.2 Audited Financial Statements**

**12.2.1 Many Overlapping Certifications and Attestations**

The first major area of evidence of microindustries of alternative information slipping into the standard disclosure environment can be found in the manner that the standard audited financial statements are presented to the public. Managers are facing many more disclosure requirements than in the past, and mostly they are complying with the form and timing requirements successfully. In the US, for example, many intricate
rules have been added to accounting standards over the past two decades. The number of official certification letters accompanying audited financial statements or filed with the SEC has grown substantially in the last two decades from the traditional single auditor’s opinion letter. Also, as corporations expand their access to international financial markets, they must report their financial results to the public using the multiple accounting standards regimes of each stock or bond market where the company’s securities are listed and traded. However, when form and timing take priority over content, more disclosures does not necessarily lead to a higher level of investor understanding. Additional disclosures can instead be used like masonry materials that help to erect and prop-up the transparency barrier.

A public company’s annual report normally leads off with a letter to the shareholders from the chief executive officer of the corporation. Some Asian cultures, particularly the Japanese, have been praised for the frankness in the critique and the emphasis on social responsibility of CEO’s comments. In the great majority of international settings, especially in the West, however, this letter is seen as an optimistically unbalanced advertisement from management. It is often presented without effective board editing or filtering of management’s inherent conflicts of interest. Many analysts in the financial community are fully aware of this, and they give little weight to the comments of the letter in their evaluation. However, this unrequired letter still takes up a prominent physical position in the annual report disclosure, crowding out the more balanced analysis of the legally required management’s discussion and analysis (MD&A) attached to the financial statements.

The annual report also contains a legally required opinion letter from the company’s certified public accountant (chartered accountant in the UK), the independent auditor’s report. After they are audited and deemed by auditors to comply with accepted standards, financial statements are presented as a “true and fair view” or as presenting “in all material respects the financial condition” of the audited company. For many decades prior to the 1990’s, it was well known by credit and investment professionals as well as most informed users of financial statements that in order to have full confidence in these statements, which are prepared and presented by management of a business, such an unqualified opinion letter containing one of the above quotations and signed by the company’s external accountants must accompany
the statements. It was quite clear from the content of this one letter that management was responsible for the content of the statements, and that the accountants had followed best audit practices in verifying those statements. In addition, as required by these generally accepted auditing standards (GAAS), the auditors received privately a signed management’s representation letter detailing the information dependency of auditors in their relationship with management, with management certifying that they had been honest and forthcoming during the audit.

In the early 1990’s a new disclosure document requirement was developed and instituted, management’s responsibility letter, which can also be called the “management discussion of financial responsibility”. This letter was most often presented side-by-side to the auditor’s opinion letter with the year-end financial statements in the company’s annual report. The reasoning for the addition of the management’s responsibility letter was supposedly to inform and protect the public openly that management itself was reporting on its own financial performance in the audited statements, which is simply a formal observation of the issue of agency theory.

In retrospect, it is now quite logical to assume that auditors suspected the now apparent weaknesses in the accounting system. The management’s responsibility letter was simply an attempt to shield or limit auditors from higher liability risk, not primarily to protect shareholders’ interests. First, this letter appears to have been redundant when compared to the two letters already in place. It did make public some of the elements of the private management’s representation letter, but it did not have any role in improving the content of the audited financial statements. In fact, as the length of management’s responsibility letter was often longer than the traditional auditor’s opinion letter, it gave the appearance that the audit profession had become preoccupied with form over content, as well as with its own self-interests.

The new management’s responsibility letter was introduced at about the same time as the larger audit firms reorganized their legal entity structure from partnerships to limited liability companies (LLC) or limited liability partnerships (LLP). As an LLC or LLP, audit firms, as well as many major consulting firms who also reorganized their legal ownership structures, can enjoy the structural, taxation and ownership benefits of

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2 Ibid., 42.
partnerships. They simultaneous acquire limitation of liability for their partners similar to the benefits previously only available to shareholders of corporations. It can be argued that the management’s responsibility letter was signalling the deterioration of transparency in the firms being audited. The letter gave auditors comfort that their risks of liability arising from their own suspicions of more frequent incidence of management disclosure fraud would be legally protected. The new letter requirement may also have signalled the accountants’ lack of confidence in their own ability to discover and discern the adequacy and verity of MSI during their audits.

Interestingly, in 2002, in the midst of the financial scandals, the Sarbanes-Oxley Act added yet more document requirements – *management’s certification of financial statements letters*. One letter must be signed by the CEO, another letter must be signed by the CFO, and a third letter must be signed by both the CEO and CFO. Not only are these documents intended to serve as a strong additional reminder to management that they are liable for the content of MSI, but the law also formalized higher legal consequences, such as financial penalties and prison sentences if the chief executive officer knowingly certifies untruthful financial statements.\(^3\) It certainly confirms that the management’s representation letter contained no teeth, even though such a clear public disclosure should have alone provided legal proof of liability. Unfortunately, the expectations that yet another letter will have a meaningful impact on management behavior should reasonably be met with much scepticism.\(^4\) After all, the SEC for many decades has required the CEO and CFO to sign the official annual report when submitting it to the government and making it public.

### 12.2.2 Rules-Based Standards Degrade the Principles-Based System

Once the user of financial statements has most likely skimmed over the generally biased optimism of most CEO letters to the shareholders and deciphered the legal boilerplate wording of the many accompanying certification letters, he or she can try to use the financial statements and the MD&A to evaluate the company’s performance. This determination of management’ financial effectiveness has historically been a relative measure. Industry ratios are the standard benchmark indicators used for performance comparison of individual companies and for segregating the good performers from the poor ones. In addition, as whole industries and large industry

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segments mature, their products and services can become commoditized, or marginalized. Firms within these segments are segregated as less attractive for investment versus firms in industries who can maintain higher value-add through product and service differentiation. From an investor’s perspective, the usefulness of benchmarks calls for specific intra-industry rules and methods of accounting. The comparison of firms in different industries demands a reasonable level of inter-industry conformance in financial reporting and disclosure standards.

To maximize comparability, the test that accounting standards bodies should apply to apparent new situations is to check first and foremost for relevancy of existing inter-industry general standards. Considering especially the painstaking open review process that produce standards, the standards bodies should uphold these precedents diligently and search exhaustively for broadly encompassing application of existing standards. When a situation occurs where truly no general standard already applies, another exhaustive search should be instituted to identify similar cases for transactions in other industries, and a general standard should be developed. Only as a last resort, should a specific industry standard be adopted, as it can isolate the firms in this industry from others, making investment comparability less effective.

Unfortunately, however, we have seen an alternative approach in relatively new industries whose managers have all too often circumspected time-tested accounting standards by claiming that their ‘new’ technology based business methods do not fall under application of ‘old’ general standards. The accounting profession, in response, has sometimes mistakenly accepted management’s arguments and repackaged the general standard into a ‘new’ standard specific to a single industry. The specificity of the new standard causes it to degenerate into a set of rules to follow which are applied only to companies in that industry. Although, this may appear to add more definition and clarity for the firms impacted, the fact that these rules are applied to a single industry can have a serious negative effect. Any firm from another industry could proceed to set aside the apparently vague general standard and put in place their own rules with an interpretation convenient to their ‘new’ environment. The fact that these firms do not belong to the specific industry targeted by the official new standard provides a convenient cover for them to avoid the original standards. An example of this issue is illustrated in the following Case Review 12-1.

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4 The Economist (2002-1).
Case Review 12-1. Special Rules for the Software Industry

In 1983, accountants and financial professionals working at the headquarters of the world’s leading computer firms were asked to participate for the firms in providing expert opinions on a proposed new accounting standard for capitalization of software development expenditures. The standard was later issued in August of 1985 as the US FASB Statement No. 86 Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed (FAS 86).

The basic rules being considered, and which were later adopted, said that the period of specification of a new software product’s functionality was before technological feasibility had been secured. Therefore, these R&D efforts, usually those of software engineers, would continue to be expensed in the period incurred, which is the same treatment as all other R&D expenditures. After this period, however, the coding and testing efforts of programmers and technicians would begin, and the expenditures pertaining to this period were to be capitalized. At first customer shipment (FCS) of the software, capitalization would end. The programmers’ and technicians’ work following FCS usually involved fixing bugs and retesting (“debugging”) to make the software work as intended and specified. These efforts were then to be considered as customer support and either categorized to warranty, which is a sales and marketing period expense, or maintenance, which is a cost of sales item for support contracts. The cost of the capitalized software asset would be amortization over a reasonable period of expected profitability, where forecasted revenue and offsetting expenses could be matched, for the software product being developed.

The strong arguments against the proposed software capitalization standard were not based on the merits, generally, of capitalization, but were directed at its application, specifically, to software. The question asked was, “Is the development of software so different than development of other products in other industries where capitalization is not considered?” It was difficult to answer this question expertly, when only examining the practices in computer industry. However, what appeared true at the time and is obvious now is that new methods in research and development were springing up in virtually every industry. There were new geological exploration methods for the oil and gas industry, ignition and emission systems in the automobile industry, drug delivery techniques in the pharmaceutical industry, animation and
special effects processes in the movie industry, mini-mill production capabilities in the steel industry, mobile transmission services in the telecommunications industry, among countless other product and process inventions in the commercial landscape.

Giving the software industry a specific set of rules, which set it apart from other industries, when it really was not so very different from the others, seemed to be a departure from the intent of accounting principles. It made software development accounting less conservative than other industries. It provided more room for judgement, and for possible manipulation or error, than in other industries. As a controller and chief financial officer in the software industry, primarily the operating systems and systems software area, the author experienced extreme views concerning the application of the new accounting standard from one audit firm to another and one industry financial executive to another. Some felt that FAS 86 clearly required the capitalization of software products in development, because if technological feasibility was not claimed then many other assets employed in the development process could be determined impaired. Others took the interpretation that technological feasibility for new product lines was not determined until FCS and proven customer satisfaction. However they felt that development of a new product within an already existing and related line or family of products was capitalizable. Still others claimed that the company itself could just decide that it was too risky to capitalize any software projects.

A few years after FAS 86 the AICPA felt induced to provide another set of rules and issued Statement of Position 91-1 Accounting for Software Revenue Transactions (SOP 91-1). For example, software companies were treating trials as revenue simply because the software products could be documented as having been delivered to the customer. Future delivery of currently unreleased software containing potential new features was being promised to customers to induce them to accept delivery of the older released version. Future services were being offered as free incentives as well. Some companies were overstocking distributors and retailers to meet quarterly revenue estimates. The high incidence of occurrence of these instances of liberal revenue recognition, among many others, led further to outright fraud of fictitious contracts and shipments being booked as revenue by some software firms.
The AICPA was compelled to issue SOP 91-1 had to be because many software companies had exhibited a tendency to liberally disregard the general cross-industry accounting principles for revenue that had been in place for many decades. However, the adoption of intricate detailed rules by the AICPA in SOP 91-1 for the software industry alone is evidence of a changed culture and attitude among accountants. The revenue recognition practices found in the software industry were not only clearly not acceptable in any machinery or equipment industry where trials, service bundling, and other incentives also had been used for decades. In June of 1981, the FASB had even issued a completely applicable Statement No. 48 entitled “Revenue Recognition When Right of Return Exists.” Therefore, with SOP 91-1, the software industry was being addressed specifically through detailed rules even though existing general industry standards were readily available. Accountants could fairly easily have employed these long accepted methods to the software industry to value and categorize the transactions in the financial statements. Moreover, a decade after SOP 91-1, the AICPA again issued special rules for revenue recognition for the computer games and consumer products industry, even though this industry displayed many characteristics of other industries, especially the software industry.

US GAAP has, deservedly, recently received widespread criticism for having deviated from its original roots as a healthy system based on accounting principles. Principles are broad statements of intention to guide professional accountants in their identification of business transactions and in the accurate, timely and consistent reporting of these transactions. Rules, however, tend to be applied very narrowly, and require frequent updates and changes. It is now widely held that detailed and specific rules, rather than broad guiding principles, are holding too much influence over US GAAP. Transactions that have not been addressed by specific rules are seen to be open to the individual accountant’s discretion. Even worse, situations that are standard in nature simply can either be easily disguised or simply misidentified as being new.

The rules-based system of US GAAP contributed to the breakdown of accounting discipline at many firms such as Xerox, K-Mart, Computer Associates, Freddie Mac, and others. Even after all of the negative publicity and the resulting requirements of Sarbanes-Oxley, major cases of fraud, misrepresentation, and error continue to spring up at organizations like the US subsidiary of Royal Ahold in 2003. In some cases, with Enron as the prime example, the firms’ external auditors appear to have
participated directly in the development or acceptance of “creative accounting” rulemaking practices. However, it is important to note that some of the cases, e.g. WorldCom, appear to consist of clearly fraudulent management disregard for basic US GAAP provisions – rules and principles. Unfortunately, these are clearly not only isolated events. They span almost the full spectrum of industries, and effect companies of diverse management styles, cultures, and histories.

12.2.3 International Politics Raises the Transparency Barrier

In light of the increasing globalization of financial markets and growing investor interest in expanding their portfolios to include securities of foreign corporations., disparate national accounting standards systems make it difficult for investors to compare financial statements across borders. The International Financial Reporting System has been proposed by the independent International Accounting Standards Committee to harmonize many national standards into a single system.

However, as noted in Chapter 9, some key political figures in the world have negatively politicized the concept of establishing an international set of accounting standards. A trend towards adoption of US GAAP as a de facto international standard by European and other non-US corporations interested in gaining access to the world’s largest and most liquid stock markets, i.e. the NYSE trading floor and NASDAQ trading system, was apparently seen as a threat to the emerging sovereignty of the EU in economic matters.

This is a naïve position to take considering that IFRS has been strongly influenced by US GAAP. Criticism of US GAAP also appears to be an economically irrational position to take. Such a strong division in standards would add to the transparency barrier, by making it more difficult to compare the results of international corporations, often with locations in many countries, required to use politically competing accounting standards. The political debate is most likely more of a reflection of the social divide between the US and much of Europe stemming from recent unrelated political disputes on the world stage. Fortunately, as Tommaso Padoa-Schioppa took over the chairmanship of the trustees of the International Accounting Standards Board from Paul Volcker in early 2006, he sought to calm nerves by projecting in a Financial Times interview that protests against IFRS by constituencies in many member EU nations would recede. He compared the
unfavorable opinions to the early negative environment that surrounded the introduction of the single EU currency, which quickly subsided. Regarding the IASB’s influence with the EU members and joint efforts in accounting standards development between the IASB and the US FASB, Padoa-Schioppa also stated conciliatorily, “International exercises of this kind are not a game of one country versus another.”

12.2.4 Differing National Accounting Philosophies and Histories

Perhaps part of the concern for accounting standard sovereignty stems also from the difference in accounting standard philosophy between the US and EU. The very close ties between taxation regulations and accounting standards in Europe imply that control over standards remains with the government. Taxation regulations are critical to revenue for funding government services and as a fiscal policy tool for bureaucrats to employ in affecting economic growth. This is a rational economic concern, but it does not provide explanation for disparaging US GAAP, while this concern does hold a rational solution.

The US system has historically evolved differently than in Europe. The fact that taxation regulations are independent from US GAAP therefore provides the government with more fiscal flexibility. European nations have even at times, but more selectively, adopted taxation regulations that diverged from accounting standards in order to serve fiscal policy purposes. In addition, membership in the WTO already implies a broad devolution of taxation policy authority when regulations touch on international trade. Trade regulation harmonization and internationalization are critical components of EU political policy.

Some US organizations, as well, are naively convinced that their system is the best, and reforms should come only from within the US. They consider compromising with the IAS as tantamount to corruption from foreign elements. By late 2004, even disagreements among the member nations of the EU on a number of critical IAS standards categories threatened to delay the 2005 deadline for IFRS introduction across EU member states.

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12.3 Prospectuses, Pro Forma, and Other Non-GAAP Measures

The SEC requires that all prospectuses for offering of new securities to the public contain a “laundry list” of risks encountered when investing in business ventures. Attorneys have succeeded in enveloping these risks in a very tidy package of standard legalese, which certainly does not assist investors to differentiate between the risks associated with leading a deep-sea treasure hunt versus those of expanding an existing retail operation. This legal language has not succeeded as a warning to investors as much as it has in protecting management from future lawsuits.

Prospectuses are not only used in new emissions of securities to raise cash. Major mergers and acquisitions and privatizations in all industries also require that prospectuses be published. In almost all prospectuses, pro forma restatements of past results are presented. These reports purport to show how results would have looked in the past if the newly established, combined or reconstituted organizations had actually operated in concert in the past. Past results, including any profits or losses of real operational elements of the business that management has decided at the time the prospectus is prepared should be phased out are left out of the restatements. Interestingly, these types of pro forma restatements are actually legally required by government regulators in most jurisdictions, such as the Securities and Exchange Commission in the US.

Users as well as preparers of financial statements were convinced that these unaudited pro forma financial statements and projections presented by company management gave a more accurate view than the published audited financial statements. The idea is that to enable investors to project a fair view of the future of the new business entity these discontinued operations should be excluded from the reports. However, this also serves to wash out past management errors in judgement in business investments. What are likely to be left out of the restatements are losses, often very large losses. This has the virtual effect of allowing management to change history. In the real world future, company management will naturally be making a mix of investment decisions, both good and bad, and losses should not be able to be excluded from the reported financial results. But somehow the message was lost that pro forma statements in these situations are not substitutes for audited financial statements, rather they are supplementary to those statements.
Inflated historical profits in pro forma statements, when relied on too heavily, set
investor expectations too high for future profits. Management is under pressure from
the financial community, supposed representatives of investors’ interests, to show
favorable comparisons of profits in the current year to those reported in past years.
Bernie Ebbers, former founder and CEO of WorldCom (now known as MCI), built the
company up over two decades of increasingly sized acquisitions. In his last major
transaction, before a scandalous accounting practice was uncovered, WorldCom
swallowed MCI, which had been its larger rival. Over its last four or five years, under
pressure to justify its recent acquisitions through the promised growth in profits, line
maintenance costs of many billions of dollars had been capitalized. This fraudulent
accounting treatment meant that these costs were not included as expense in the
quarter where they were incurred, which would have reduced reported profits, as
accounting standards clearly advise. Instead, these costs were categorized as fixed
assets, property, plant and equipment, for long-term use and depreciation. This
practice incorrectly delayed the reduction of profit to future quarters and years as well.

The sheer size of the MCI acquisition, led WorldCom to set even higher expectations
for future profits. Unfortunately, this mammoth transaction came at a time when
telecommunication company values were particularly inflated, which added to the
company’s expense base and severely restricted profits. At the same time, the size of
the MCI acquisition, made it nearly impossible to follow-up with another large
acquisition where losses could once more be excluded from pro forma restatements.
As the years went by and the M&A transactions grew larger, the accounting trickery
had to be ever larger. Finally, the accounting entries became so immense, it made
detection easier. This was not unlike a giant pyramid or ponzi scheme becoming
unravelled when new investors cannot be sourced fast enough to cover current
investors’ claims. Rumors of mergers for WorldCom with various US and
international rivals were even being passed around even the final bankruptcy filing.

Sometimes, it is not only the pro forma results that are restated. Assets themselves can
be revalued in these transactions. Near the height of the telecomm frenzy, the German
federal government privatized one of its largest assets, Deutsche Telekom, by selling
stock to the public. All of the land and buildings to be included in the sale were
revalued higher at reappraised market prices. This increase in the value of these assets
would automatically increase the expense base of the company, putting pressure on
future profits. But was it not appropriate, as well for the government to get the public to pay a fair market price for Deutsche Telekom and its assets? Less than two years later and after the public had purchased shares, however, it was determined that those real estate market values had been overappraised by more than two billion Euros (over two billion US$). Around this same time in the US, Deutsche Telekom had purchased cellular service provider Voicestream for cash at the height of the market bubble. Many more billions have been written off from this transaction, while the Voicestream brand has been withdrawn from the market and relabelled as T Mobile. And in 2005 the courts in Germany finally ruled that investors have no recourse against the company. Shareholders apparently never legally had recourse against the government for the losses in these situations. *Caveat Emptor* - let the buyer beware – is the rule even in dealing with the German government.

Very quickly, clever accountants in firms were presenting pro forma financial results alongside their GAAP prepared accounting statements. Some high profile firms like Cisco Systems and VerticalNet even took one bolder step further and issued press releases with only their pro forma results when they simultaneously filed GAAP compliant statements with the SEC. They always were careful to label the reports as “pro forma”, while they defended the practice as being a helpful extra disclosure for the public. As outlined in Chapter 10, when Computer Associates admitted their typographical disclosure error in mid-2001, restating their annual profit of $230 million to a much lower $90 million, the firm also reported:

> “the mistake did not affect the earnings that it reported under its ‘pro forma, pro rata’ accounting method, which it adopted in October along with a new business model. Under that method, Computer Associates reported a profit of $1.61 a share, or about $930 million.”

Later that same year, when the world’s leading internet firm, Amazon.com, publicized a pro forma profit for the 4th quarter of 2001, it’s first ever profit of any kind, the financial services industry responded favorably to the news. Many saw it as a positive leading indicator not only for Amazon.com, but for many other internet firms as well. After all, Amazon.com had a head start as one of the very first firms established in this

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7 Berenson (2001).
industry. As might be expected, other start-ups shortly followed suit with their own pro forma profits. ⁸

Clearly, the extra disclosure of pro forma results was effectively diminishing the perception of reliability of the standard financial statements. Regulation G stemming from the Sarbanes-Oxley Act, among other regulatory provisions, is finally limiting companies from presenting pro forma disclosure as a second viewpoint of the official quarterly and annual financial results. However, even after Regulation G of the Sarbanes-Oxley Act toughened the rules regarding non-GAAP measures of disclosure, they are not yet disappearing. According to the audit firm KPMG:

“A non-GAAP financial measure is a numerical measure or ratio of a company’s historical or future financial performance...that excludes or includes amounts ... in a GAAP measure....

Regulation G prohibits an issuer from publicly disclosing, in either written form or orally, a non-GAAP financial measure and related disclosure that is misleading. An issuer must present the GAAP measure most directly comparable to the non-GAAP measure, accompanied by a quantitative reconciliation....” ⁹

Firms are also allowed by the new regulations to present non-GAAP measures in equal prominence to those prepared in accordance with GAAP. ¹⁰ In addition, pro forma presentations are still required in prospectuses, where uncertainties allow the preparers to make adjustments which support their desired ends. Regulation G, however, requires firms to use the above reconciliation guidelines in preparing pro forma and other forward-looking reports. ¹¹

12.4 Value-Based Reporting

Parallel reporting systems still compete for the attention of investors, unfortunately often by discrediting the value of audited financial statements rather than by promoting the new systems as supplemental disclosures. Pro forma results are prepared by management specifically for public presentation. A very large and growing microindustry of information, Value-Based Reporting, unlike pro forma reports, generally remains internal to the company. Value-Based Reporting systems are

⁹ KPMG (2003), p. 36.
offered to management and boards by the world’s largest auditing firms, as well as consulting firms, as a lucrative advisory service. In selling their services, these firms do not mince words when criticizing the audited financial statements, stating that they are highly inadequate in displaying the true performance of the company’s results, and therefore, of management’s achievements.

These professional organizations have produced ‘studies’ and ‘programs’ in the 1990’s that claimed to measure the non-financial factors that contributed to the higher stock market valuations of companies that traditional reporting has allegedly overlooked. If these programs are true, then the reporting gap issue of GAAP prepared financial statements could have been solved already. The reporting gap is the difference between the shareholders’ equity value, based on historical cost, of the audited financial statements, and the market value, based on stock price, of the firm’s total outstanding shares. However, now that these actual market valuations have seen deep negative corrections, then a few new concerns have arisen with the measures calculated by these programs, and new questions must be asked, for example:

- Did the stock market decline result from changes in these same non-financial factors?
- Is the post-correction stock market undervalued?
- Do non-financial factors generate the same results in bubble markets as in non-bubble timeframes?

In the following Case Review 12-2, the stated benefits of these alternative reporting programs and the strong criticism of standard accounting reporting is made very clear.

Case Review 12-2. E&Y and Cap Gemini “Measures that Matter”

The first line of the introduction to one leading example of a Value-Based Reporting program, Ernst & Young’s Measures that Matter, states:

“Savvy corporate leaders seeking to meet the key management challenges of the future realize there is a dangerous disconnect between the bottom line and long-term goals. Sharing knowledge, wooing customers, and honing the products that will reinvent their industries represent investments for the long-term—usually at odds with short-term reporting practices. At the heart of this new thinking is a growing body of evidence revealing that reliance on financial measures alone will critically undermine the
strategies leading edge companies must pursue to survive and thrive long-term.¹²

The study identifies that non-financial factors appear to have contributed an average of 35% to investment decisions of buy-side financial analysts, who are primarily working at financial institutions, when applied to US firms in the pharmaceuticals, oil and gas, computer, and food/consumer products sectors. Figure 12-2 below provides a breakdown of the components of non-financial value measured in the study. Since on average the S&P 500 declined by over one-third during the market meltdown, perhaps E&Y and the others have to be considering recalibrating their study instruments for a normalized environment.

Figure 12-2. E&Y Measures that Matter Buy-Side Analysts Survey

<table>
<thead>
<tr>
<th>Non-Financial Criteria</th>
<th>Computer Industry</th>
<th>Pharmaceuticals</th>
<th>Food Industry</th>
<th>Oil and Gas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality of Management</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quality of Products and Services</td>
<td></td>
<td></td>
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<tr>
<td>Level of Customer Satisfaction</td>
<td></td>
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<tr>
<td>Strength of Corporate Culture</td>
<td></td>
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<td></td>
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<tr>
<td>Quality of Investor Communications</td>
<td></td>
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<td></td>
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<tr>
<td>Effectiveness of Executive Compensation Policies</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Effectiveness of New Product Development</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strength of Market Position</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>


Interestingly, the Measures that Matter program had been developed and introduced before the split of the Cap Gemini consulting business from the E&Y auditing business in the late 1990’s, which was also prior to enactment of Sarbanes-Oxley. Both companies have continued to market and consult, albeit separately, with clients using this program. The consulting side, Cap Gemini, promotes this as a strategic management program. The audit side, E&Y, promotes this as an internal reporting program.

In a 2001 white paper, just prior to its dissolution, the audit firm Arthur Andersen defined its own proprietary Value-Based Reporting methodology as follows:

“To help managers find those right things, the strategies that will help them succeed in the New Economy, Arthur Andersen has developed the Value Dynamics™ framework.

It starts by assisting companies to identify and measure the full complement of assets in their organizations—assets that are intangible as well as tangible, both within and outside company boundaries. The balance sheet, the traditional measure of corporate assets, lists just two major categories of assets, physical and financial, both of them tangible.”

Although the authors of this study, all partners of Arthur Andersen, did recommend that companies report the information gained through a Value Dynamics study, and they provided a handful number of company examples to support their ideas, they also led off the white paper as follows:

“A prime example of a company that has successfully followed that path is Enron Corp., a $52-billion energy and communications company based in Houston, Texas. Over the last decade, Enron has continually changed the proportions and combinations of the assets in which it is invested. In the process, it has reaped rich rewards and high praise. Indeed, Fortune magazine describes Enron as the most innovative large company in the United States.”

All auditing firms have now been required under Sarbanes-Oxley to divest their consulting businesses to reduce well-documented issues of conflicts of interest. Nonetheless, alternate reporting system consulting is a primary advisory service that is expected and even encouraged to remain with auditors. Therefore, the confusion continues to be inadvertently disseminated about whether or not standard audited

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financial statements are reliable, or worse yet, causing a “dangerous disconnect” as stated in the above Ernst & Young quotation.

There is a very important social contribution to increasing the understanding of the influence of intangible assets on strategic organizational success and how to exploit them that Value-Based Reporting and Value-Based Management, respectively, have achieved. The offsetting detrimental contribution, however, is that certified auditing firms, along with influential consulting organizations, use their inherent positions of credibility to critically discredit the required standard financial accounting reports. For example, as shown in Figure 12-2, the authors of Measures that Matter are concerned with presenting “Share Price/Payoff” as the goal of their reporting system. These accounting and consulting organizations advise managers that their financial statements fail desperately to present a true and fair view of their own performance. It should not be surprising that many managers who have been introduced to Value-Based Reporting hold very little regard for the entire accounting system. This could only motivate management to desire to change their accounting to have the financial statements more accurately portray the results of their efforts, in their eyes. However, these changes result in deterioration in quality of the statements, as they diverge from GAAP, and the transparency barrier is invariably raised higher.

Although helpful operationally, none of the Value-Based Reporting studies have actually told us something genuinely new in theory. Years and years of highly credible academic research in finance have clearly shown that objective share valuations cannot be determined solely by the book value measured in audited financial statements. However, this must not be misinterpreted as an indictment of the accounting system and standards. After all, the historical cost principle of accounting, in combination with other standards, when followed, protects financial statements from becoming filled with subjective management opinions of the value of the firm’s assets, liabilities, equity, revenues and expenses. In addition, almost all strategic and operational activities of management are, by definition, ‘non-financial’ activities. These daily business activities, when successful, translate into future reported profits and incoming operational cash flows for the organization.  

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12.5 Analyst Forecast Guidance

Well accepted financial theory holds that stock markets adjust efficiently to company disclosures that are distributed widely and in a fair manner, without favoring one group of investors over another, as is physically possible. Audited financial statements of public corporations serve the purpose of informing all investors so that the stock price is valued at the efficient market level, supporting trading that is fair to sellers, buyers, and other bidders, as well. Financial industry analysts, therefore, shift their interest from disclosures of past results, which have already influenced stock price, to expectations for future results. Management, in it’s investor relations function, meets this demand for predictive information by providing forecast guidance to analysts.

Nearly exclusively, management does not provide a forecast directly. Rather, analysts develop their own predictive quantitative models which produce preliminary estimates for revenues and profit margins. The analysts then engage executives of the company in conferences, where they receive guidance to adjust and finalize their models and estimates. In the US, the fair disclosure regulation was enacted in October of 2000, requiring managers and analysts to open conferences to the public and to formally file disclosures with the SEC whenever information of material impact is being shared. There should be no advantage for some investor groups over others created artificially by selective access to management information. In fact, for the year after Regulation FD went into affect, Zacks Information Services noted:

“the median difference between the high and low estimates for stocks in the Standard & Poor’s 500-stock index [had] grown 40% … to 35 cents from 25 cents….16

Analysts should add value to the efficiency of the stock market valuation process and receive advantage only through their quantitative proprietary models and qualitative discernment capabilities.

Some financial theorists say that past results, as ex post measures, bear no influence on value. They calculate stock price as a function of only future cash flows, as ex ante measures. However, US GAAP financial statements based on historical costs, even though flawed, present information that does have a measurable impact for users of these statements. In a recent article, Richard Barker showed that analysts use a variety
of valuation models in preparing their buy/sell recommendations. These models invariably utilize the audited financial statements. The major reasoning presented by Barker was “accounting information is intrinsically reliable …. combine[d] with other information sources that are considered relevant to the reliably foreseeable future”.¹⁷ This is consistent with Leuz, et al.’s findings, as explained in Chapter 9, regarding the relative positive contribution of good accounting standards enforcement.¹⁸ In addition, the book value of the financial statements approximates the liquidation value of the company, often presenting a floor, i.e. minimum, company value.

In 1994, Henry Mintzberg stated in The Rise and Fall of Strategic Planning that “‘discontinuities’ like technological innovations make forecasting practically impossible.”¹⁹ Management at Eastman Kodak, for example, has suffered repeatedly in the early 21st century from a much speedier transition than expected of the world photography market away from traditional images on film requiring chemicals and paper for development to digital cameras, processing, storage and selective printing. The management of IBM certainly did not expect that their own development of a personal computer, which contained almost entirely hardware and software components proprietary to other contracted companies such as Microsoft and Intel, would eventually lead to the sale of the entire business in 2005 to Lenovo of China. Nevertheless, forecast guidance from management remains a financial markets reality, with the resulting analysts’ estimates generally covering short-term time periods, such as the current and following quarter and year-end expected financial results.

12.6 Plans and Budgets

The importance of plans and budgets in the regular course of management’s activities cannot be underestimated. The performance behavioral expectations set in plans and the monetary values contained in budgets are the basis for almost all activity approvals. Managers know that hiring offers should not be committed, materials and equipment should not be ordered, construction of fixtures and facilities should not be started, advertising campaigns should not be placed, etc., if a published plan has not

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¹⁷ Barker (1999), p. 204.
preceded these actions and if there is a chance the approved budget will not absorb the associated costs.

Most managers are leading functions whose budgets list only expenditures as line items, which include short-term departmental expenses and long-term investments in property, plant and equipment. Along with expenditures, purchasing managers in manufacturing areas have materials requirements plans, sales and marketing managers have quotas for customer orders and revenues, while select executives also have funds acquisition objectives to source cash from:

1.) Debt- borrowing using bonds or loans, or

2.) Equity - selling shares in public markets or to qualified private investors.

Plans and budgets form the vast majority of objectives for management performance measurement. Salary increases and other incentives, new professional opportunities and promotions, and, unfortunately, demotions and firings are determined by these measurements. Rewards are usually reconciled to a comparison actual to plan results. The process of measurement has a significant effect on the direction that behavior takes. In most cases, measurement is employed to motivate and encourage positive behaviors for effectiveness and efficiency.

Internal controls, of course, are greatly concerned with management behavior and with conformance to delegated authority, which are associated with measurement and approvals, respectively. Therefore, it is curious that the role of plans and budgets as helpful informational documents are only a very minor factor in the accounting profession’s recommendations for assessing the internal control environment. For example, they are only positioned very far down on a list of considerations in the 1987 Treadway Commission study, and the list is also somewhat buried in Attachment F to the study. Plans and budgets are included only as elements to consider in evaluating “the adequacy of the company’s internal reporting system.”

Budgets are mentioned predominantly in the study, however, but usually with a highly negative connotation attached. Accountants recommend that internal controls should be concerned with top management’s “unrealistic budget pressures, particularly for

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Management should inform the board before public disclosure “if actual financial results for the quarter vary significantly from budgeted or projected results.” At the top of the list of components for assessing the strength of the control environment, management’s emphasis on “meeting budgeted targets” is placed together with its emphasis on “manipulating the market value of the company’s stock.” Surely the former is a desired and expected objective for management, while the latter is a seemingly unethical and probably unlawful activity. Placing them together prominently in the list of worrisome “red flags” for auditors prejudices their control system value.

Even more curious, because of the inherent contradiction to the above statements, are the recommendations published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1994 under the title Internal Control – Integrated Framework. This report, a direct response to the 1987 Treadway Commission study, defines internal control for a firm as a reasonable assurance achieved in three key areas, with the first being “effectiveness and efficiency of operations.” The report concludes that this first area is adequately covered by the board of directors and management when “they understand the extent to which the entity’s operations objectives are being achieved.” Is not meeting budgeted targets central to achieving this desired result?

Further, a more recent study, prepared by the Society of Management Accountants of Canada and promoted by the AICPA, which often cites the COSO studies and reports, also states:

“management accountants and others who become accustomed to rigorous budget-to-actual comparisons each month may take this internal control approach with them when they move from an entity that has this practice to one that does not, thereby helping to spread the practice.”

This approach is recommended because of its potential for internal control value and its widespread acceptance for internal monitoring of operations performance by management, particularly within large organizations. Many internal accounting

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24 COSO (1994-1).
25 COSO (1994-1).
26 AICPA (2000).
departments use this method during the accounts adjustment process prior to closing the accounts and preparation of final financial statements for the period. Rather than “manipulation” of results, this method is used to check for errors and omissions in the accounting entries. Especially when budgets are well prepared and detailed, this method assists in improving the second of the three key areas for assuring internal control in COSO’s recommendations, i.e. “the reliability of financial reporting.”

Plans and budgets clearly hold great interest for management, but not simply as a benchmark for performance measurement but as a guide for most of their activities. However auditors have a very negative perspective of these tools, associating their use in accounting with a potential for fraud. Auditors also hold a negative perspective of budgets because they are convinced that their clients audit budgets have been very restrictive, leading to commoditized audit fees for their firms and compromising audit quality. How great is the risk of a book to budget mentality in the accounting profession? Is it material in its impact? In fact, it is more likely that external forecast guidance pressures are the greater risk, and concern for internal budgets is misdirected. A clearer role for plans and budgets should be defined by the accounting profession, with the expectation of positively influencing accounting and auditing standards and systems. For example, in Chapter 9, a method is recommended for incorporating plans and budgets for development and marketing projects as a mechanism to assist in the classification of actual differentiation costs for enhanced financial statement reporting.

12.7 Compensation Measures

In the US, public corporations are required to disclose most of the compensation elements of their top managers who are the key officers of the company. In a major breakthrough in March of 2005, a similar legal requirement was established in Germany. As Germany has the largest and one of the more openly competitive economies in the EU, it can be expected that many countries will feel pressure to follow suit. For a further example, in early 2006, the Wall Street Journal reported that the SEC proposed “the most sweeping overhaul of corporate compensation in 14

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27 COSO (1994-1).
years" with stricter disclosure rules on pay in the US including “perks, retirement benefits, and total compensation.”29

Privacy issues aside, boards should favor this move towards higher transparency for the terms in executive compensation contracts. It makes comparison for ensuring pay packages are competitive far easier to determine. It will also provide a broader base of influence form disciplinary factors, such as institutional investment managers and other shareholder groups, so that boards won’t have to go it alone. Directors have been criticized for negotiating too easily for fear of antagonizing powerful CEO’s or for not recognizing conflicts of interest from board interlocks inflating pay for everyone, including themselves at their own companies. Transparency assists the board in determining what is fair and in strengthening their negotiation position when presenting their offers to management.

In the US, officers’ salaries, commissions, bonuses, fringe benefits, pension and other retirement-related investments, and any other deferred income elements must be listed in an annual SEC filing and report to shareholders, such as in the Notice of Annual Meeting and Proxy Statement. In 1995, the US FASB Statement 123 only recommended but did not require expensing of stock options in the financial statements and required that stock options be included in a footnote disclosure along with an estimate of their expected value. This value is not easy to determine because most options have an exercise price equal to the current stock price. Therefore, options will only provide real income for their holders when they can be exercised in the future at a price higher than the current price. However, these options are clearly not worthless, and many company executives have come to realize this. As can be seen from Table 12-1 below, a number of large corporations, voluntarily started to expense their stock options given to employees in 2002, after having long before been led in this practice by Boeing and Winn-Dixie Stores.30 Many of these firms use a fair value method, a mathematical formula to calculate the accounting expense, such as the Black-Scholes model, which is well accepted in the financial services industry.31

### TABLE 12-1. Voluntary Expensing of Employee Stock Options

<table>
<thead>
<tr>
<th>Name</th>
<th>Announcement of date of adoption</th>
<th>Millions of options outstanding, year end 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup</td>
<td>8.07.02</td>
<td>364.4</td>
</tr>
<tr>
<td>J.P. Morgan Chase</td>
<td>8.12.02</td>
<td>359.8</td>
</tr>
<tr>
<td>General Electric</td>
<td>7.31.01</td>
<td>354.5</td>
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<tr>
<td>AT &amp; T</td>
<td>10.22.02</td>
<td>317.5</td>
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<tr>
<td>SBC Communications</td>
<td>3.14.03</td>
<td>229</td>
</tr>
<tr>
<td>Cendant</td>
<td>8.28.02</td>
<td>218.0</td>
</tr>
<tr>
<td>Nortel Networks</td>
<td>1.24.03</td>
<td>215.5</td>
</tr>
<tr>
<td>Merrill Lynch</td>
<td>8.13.02</td>
<td>194.5</td>
</tr>
<tr>
<td>Bank of America</td>
<td>8.12.02</td>
<td>184.6</td>
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<tr>
<td>Ford Motor</td>
<td>9.12.02</td>
<td>172.1</td>
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<tr>
<td>Morgan Stanley</td>
<td>8.13.02</td>
<td>151.4</td>
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<tr>
<td>American Express</td>
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<td>Coca-Cola</td>
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<td>BellSouth</td>
<td>2.28.03</td>
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<td>FleetBoston Financial</td>
<td>8.14.02</td>
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<td>Bank One</td>
<td>7.16.02</td>
<td>90.5</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>8.12.02</td>
<td>84.4</td>
</tr>
<tr>
<td>USA Interactive</td>
<td>7.24.02</td>
<td>84.4</td>
</tr>
<tr>
<td>DuPont</td>
<td>11.05.02</td>
<td>73.2</td>
</tr>
<tr>
<td>Home Depot</td>
<td>8.23.02</td>
<td>69.4</td>
</tr>
<tr>
<td>Dow Chemical</td>
<td>8.26.02</td>
<td>67.5</td>
</tr>
<tr>
<td>General Motors</td>
<td>8.06.02</td>
<td>67.0</td>
</tr>
<tr>
<td>Amazon</td>
<td>7.23.02</td>
<td>66.0</td>
</tr>
<tr>
<td>AIG</td>
<td>8.11.02</td>
<td>54.3</td>
</tr>
</tbody>
</table>

Source: Bear Steams

Options grant riskless rights to the holder to exercise them at any time, often for as long as ten years into the future and as long as the holder is still employed by the corporation. Stock prices have risen over periods in history, not only because of the long-term performance of management, but also because of external factors such as price inflation, lowering of interest rates through national monetary policy, general
improvements in economic prospects and growth, and even due to instances of economic instability in other countries. Stock market in the past have often gone through cycles where prices inflated for a period of months or years, which was followed by a ‘correction’ and a period of deflation, leaving the corporation in no better position than before the cycle began. However, managers have been able to exercise their options during this inflationary window for a windfall profit, leaving them much better off than their long-term performance would support. Finally, if financial theory is correct that stock price is truly only a question of discounting of expected future cash flows, then management’s stock option compensation is pay for performance that is virtual, i.e. it has not even yet occurred.

In fact, stock options have grown at a furious pace throughout the 1990’s, and thereafter, to become the major component of many executives’ compensation packages, even while the other components continued to grow as well. It should be no surprise, therefore, that in this time period a shareholder value mentality came to dominate the performance measures upon which compensation rewards were determined. Despite the subjective component of stock market movement, and the riskless potential for gain of stock option compensation, a higher stock price became the prime objective for boards to measure management performance. The extraordinarily long time period enjoyed by the rising bull stock markets convinced many that a new economy had led companies to step up to a higher income growth potential for companies than the average experienced since the Great Depression.32 The realization that stock prices had been temporarily inflated by a market bubble should have convinced most everyone that other financial performance measures which clearly lead to long-term sustainable value should be allowed to influence executive compensation.

Economic Value Add® poses an attractive alternative to stock market price as a basis for performance measurement. It is a formula based system developed and trademarked by the consulting firm Stern Stewart to attempt to quantifiably measure the value added to a firm accomplished by management through its strategic investments and operational performance.33 EVA®, and subsequent derivative measures developed by other consultants and researchers, has been adopted by a

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32 OECD (2000).
significant number of boards and executives of top public corporations. These measures are perhaps second only to the audited financial statements for making decisions affecting executive compensation. The EVA® formula measures the financial contribution generated by the company and compares this to the cost of the long-term funds used to invest in the company, the cost of capital, to arrive at the value added. This should not be confused with the standard audited income statement which measures all revenues and expenses according to GAAP, with the difference being the net income. The following Case Review 12-3 provides a very basic illustration of the EVA® concept.

Case Review 12-3. EVA© – A Simplified, Practical Example.

A real estate entrepreneur starts a new business by constructing an apartment building for US$600,000. The business owner borrows 50% of the construction cost for the building, $300,000, at a simple annual interest rate of 4%, for $12,000 of interest expense per year. He also invests $300,000 of his own money. The $600,000 total cost of the building is depreciated for 30 years at an annual expense of $20,000. Annual operating costs for the building involve paying $30,000 for all other expenses such as utilities (heat, light, electricity, etc.), property taxes, maintenance, city permits, supplies, advertising, telephone, accounting and legal fees, as well as the part-time salary and benefits for the building supervisor. Therefore the traditional expenses according to GAAP add up to $62,000. If in the first year of operating the building, he receives revenue of $75,000 from rents paid by apartment tenants, the profit for the year is $13,000. This is a net profit margin (= profit ÷ revenue) of over 17%.

The EVA® formula takes the same revenue of $75,000 and deducts all of the expenses, except for the $12,000 of interest on the loan, for an EVA® profit of $25,000. At the same time, the cost of long term funds is calculated separately. The interest cost is $12,000, the same as in the standard profit calculation. However, a cost for the $300,000 that the business owner invested from personal funds must be calculated in addition. After all, the owner could have chosen from a large number of alternate investments. If a typical alternative business venture offers a return of 5% on the $300,000, then the opportunity cost of these funds is $15,000, and this is then the cost of equity. The EVA® profit of $25,000 in the example, therefore, is not enough

34 Income taxes, which are the same in both systems, are not considered for simplification of presentation.
to cover the cost of capital of $27,000 ($12,000 cost of debt plus $15,000 cost of equity). This leaves a negative $2,000 final EVA® contribution measure, which is almost a negative 3% return on revenue. Table 12-2 below presents the viewpoint produced by audited financial statements side by side with that of the EVA® system.

TABLE 12-2. GAAP versus EVA® Reporting Systems

<table>
<thead>
<tr>
<th></th>
<th>AUDITED STATEMENTS</th>
<th>EVA® CALCULATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>REVENUE</td>
<td>$75,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>DEPRECIATION</td>
<td>20,000</td>
<td>20,000</td>
</tr>
<tr>
<td>OPERATING COSTS</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>INTEREST EXPENSE</td>
<td>12,000</td>
<td>N/A</td>
</tr>
<tr>
<td>PROFIT</td>
<td>13,000</td>
<td>25,000</td>
</tr>
<tr>
<td>INVESTMENT</td>
<td>$600,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>COST OF CAPITAL</td>
<td>N/A</td>
<td>27,000</td>
</tr>
<tr>
<td>CONTRIBUTION</td>
<td>13,000</td>
<td>(2,000)</td>
</tr>
<tr>
<td>% OF REVENUE</td>
<td>17.3%</td>
<td>(2.7%)</td>
</tr>
<tr>
<td>% OF INVESTMENT</td>
<td>2.2%</td>
<td>(0.3%)</td>
</tr>
</tbody>
</table>

Source: Own Representation.

EVA® in the above example, and also in general, presents quite a different perspective for return on revenue than the standard view of pre-tax profit margin that often appears very positive. In addition, the EVA® methodology is more interested in return on investment. It serves to illustrate whether the business has produced a positive economic value added, which is measured as a positive contribution and % of revenue. In a very direct manner, the EVA® measure reminds management of public corporations that their shareholders have reasonable expectations for a minimum acceptable return on their investment, and that this return may be quantifiable as equivalent to the company’s cost of equity funds.

If identification of the cost of equity was the only new statistic offered by EVA®, then the current EVA® contribution, positive or negative, presents little real advantage to
the audited income statement showing a standard profit or a loss. In addition, the
owner of the building certainly is aware that the profit he earns on the business must
be compared to the amount he has invested, just as an informed shareholder knows
exactly how much he has invested as his basis and the value of earnings per share of
the company’s stock. EVA® has become very popular, therefore, not only because of
its focus on recognizing the cost of equity capital. Unlike in the simplified example
presented, where none of GAAP values were recalculated, EVA® calls for a re-
examination and adjustment of many financial statement values. As a precursor to
many of the ideas enveloped in Value-Based Reporting systems, EVA® measures are
targeted at motivating management to invest in activities that are predominately based
on developing and exploiting intangible assets. The costs to develop intangible assets
under EVA® are categorized as investments, just as the costs of construction of an
apartment building are investments.

In addition, just as the apartment building in the example is depreciated over a 30 year
expected physical life, intangibles must be amortized as expense over the years of their
productive life for the business. Therefore, the cost of developing each asset is spread
quarter by quarter, year by year, over its expected useful life on a pro rata basis.
Amortization as calculated in the EVA® methodology, reduces the EVA®
contribution in the periods that the customer revenue is earned on these assets. This
serves to match revenue to expense more directly, and to reduce the value of the asset
each period in recognition that intangibles are consumed and can reach obsolete status.
Unlike the new accounting standards for goodwill, intangibles in the EVA® system
are generally not expected to have an unlimited useful life.

Of the many alternate reporting systems, perhaps one reason for the EVA®
methodology being popular is because it recognizes the jarring structural weakness in
GAAP, which orphan some of the most important corporate resources from being
reported transparently in the audited financial statements. It recommends that
management adjust the assets and profits, on a cost basis, to account for investments in
intangibles from the beginning of the development to the onslaught of obsolescence of
each asset. These adjusting items, normally unrecognized in the audited asset
accounts, to a great extent represent the differentiation costs for the firm. Consistent
with the classification axis of agency assurance, once these assets are put in place and
made operational, they are expected to strengthen the modern firm and lead to growth
in revenues and profits or improvements in efficiency into the future. EVA® succeeds in bringing to light that the proper reporting of these investments is critical for use by managers for improved decision support as well as control measures and by boards for private executive compensation evaluations.

The EVA® method is relatively simple to implement. It does not attempt to indicate what financial results may be in the future. In the apartment building example, the EVA® contribution will be substantially changed for the better if rent revenue increases in following years while costs were to remain fairly constant, as might be expected. EVA® is conservative, because it is cost based. The impact of the value of the building itself increasing over time is ignored, even if expectations for higher rents and real estate market appreciation may have been the prime motivator of the owner, who is also is the lead manager, to enter this business.

EVA® has many advantages, however, it is not an appropriate accounting standard for disclosure. It assumes a cost of equity based on the performance expectations of the stock market, which could be inflated by a bubble market or set too low by a depressed market. The EVA® rate of return is situational and firm specific, not something that makes for standard comparability. To calculate the cost of equity a risk premium must be assumed. Such a premium is helpful to analysts interested in an investment portfolio. However, when the risk premium is calculated as an average, which includes also some estimate for firms that will become bankrupt, the cost of equity calculated for managing a company may be inordinately high. If the company provides a return higher than many alternatives, but below the average risk premium level, AND the firm remains solvent, the possibility that a negative contribution results may be a false indicator. In addition, the contribution calculation will also be negative, even when a lower return for shareholders in the short term than the bank rate of borrowing can be perfectly rational. Management will need the flexibility to react to dramatic stochastic environmental changes, because the alternative could be insolvency.

It is the less sophisticated investors, distanced from the operations of the company, who possibly could benefit from the calculation of the EVA® contribution, but, unfortunately, EVA® measures are most often neither published nor audited. When they are disclosed, they are accepted officially only as pro forma, non-GAAP financial
measures. Similar to Value-Based Reporting, EVA® is a proprietary method often used by consultants interested in advisory fees, and whose promotional efforts discredit the financial accounting system.

12.8 Returning to Audited Financial Statements

Proprietary reporting methodologies do not only operate in parallel to the audited financial statements. Unfortunately, they often take very different, even opposing directions to GAAP, and make many unaudited adjustments to GAAP as well. When there is measurable value to reducing the transparency barrier to be gained from these studies and their formulas, such new knowledge would better serve firms worldwide as input to improving accounting standards, as illustrated in Figure 12-3 below.

Figure 12-3. Integrated System of Financial Reporting

Source: Own representation.

There is a great investment required, especially post Sarbanes-Oxley, in the audit of the financial statements and the internal control system of corporations. The focus must return to making the official reports and accounting standards as relevant as possible in the 21st century competitive business environment. However, while accountants continue only to discuss, but not to change, GAAP treatment for intellectual capital, consultants will continue to deride the content of standard reports. Agency assurance offers the classification and communications of differentiation costs, consistent with the accepted definition of explicit knowledge and the accounting principles of revenue, matching, and historical cost as well as with the conservatism concept, and not overtly oriented toward unpredictable influences of capital markets, as a solution.
CHAPTER 13. Agency Assurance and the Audit Committee

“... At the dawn of the twenty-first century, which companies aren’t knowledge based?”

L. Edvinsson and M. S. Malone in *Intellectual Capital*

13.1 Technological Advancement of the Corporate Economic Entity

Adam Smith predicted in *The Wealth of Nations* in 1776 that “‘negligence and profusion’” on the part of directors and managers would plague the joint stock company form and ultimately lead to its demise. Smith was not in the position to anticipate the wealth of benefits to be produced by the industrial revolution in the 19th century or by the multiple innovation revolutions of 20th century. The principal advancements developed in the fields of transportation, communication, and information (i.e. data processing) provided a physical foundation for more widespread corporate endeavors. The key inventions within these three fields of innovation helped to form a continuously improving infrastructure for corporate actions, operations, and communications. These inventions listed under the three fields of innovation in Figure 13-1 below have been grouped into four historical periods based on a rough timeline. Each period culminates at the point in time when these inventions reached a relatively mature state of utilization and functional integration.

The first period, the *Industrial Age*, spans close to three centuries from the earliest joint stock companies in the 1600’s to the enactment of securities legislation in the 1930’s, marked by the industrial development of the western world. The second period, the *International Age*, covers just under five decades to about 1980, the post-World War II years of significant international economic development and opening of widespread opportunity for trade between nations. The third period, or *Information Age*, progressed at a much more accelerated pace lasting only about fifteen years with an unprecedented increase in the valuation of stock markets but closing out the 20th century with a just as impressively significant equity valuation correction. The fourth and contemporary period can be called the *Intangibles Age* in recognition of the significance of the majority contribution of services and intellectual capital in the world’s highly developed economies.
### Figure 13-1. Historic Corporate Technological Infrastructure

<table>
<thead>
<tr>
<th>Period in History</th>
<th>Transportation</th>
<th>Communication</th>
<th>Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrial Age</td>
<td>Steamships/Railroads</td>
<td>Telegraph</td>
<td>Adding Machines/Typewriters</td>
</tr>
<tr>
<td>International Age</td>
<td>Autos/Trucks</td>
<td>Telephones/Teletype</td>
<td>Punch Card Readers/</td>
</tr>
<tr>
<td>Information Age</td>
<td>Highway Systems</td>
<td>Broadcast Radio/Television</td>
<td>Digital Computers</td>
</tr>
<tr>
<td>Intangibles Age</td>
<td>Airliners/Jumbo Jets</td>
<td>Broadband Cable/Satellites</td>
<td>Corporate Networks/Internet</td>
</tr>
</tbody>
</table>

Source: Own representation.

In the early stage of the 21st century, the collective knowledge base of the previous ages is continuously being reengineered. With technology as a cooperative reinforcing factor, new innovations are also being added to the historic knowledge base at a rapidly increasing rate. Certainly this is also evidenced by scientific and technological innovations in areas such as energy production and distribution; farming and food processing; and medicine and healthcare, among others, which have all played an important role in support of the above inventions. In addition to all of these directly enabling physical technologies, social advances in government administration, regulation, and diplomacy; banking and other financial services; as well as business education and training delivery were required to secure the legitimacy of the corporate form in the modern economic system.

Smith’s pessimism regarding corporate leadership does, however, remain prophetic in light of the seriousness and frequency of scandals initiated by corporate managers and unchecked by corporate directors over the years. The fact that the issues of inherent conflict of interest of management in corporations did not lead to the fatal end to this economic entity that Smith expected, however, is no indictment of his opinion. His work preceded by many decades even the first stage of innovations which have allowed corporations to expand in size and grow in number surprisingly effectively.

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2 Jensen & Meckling (1976), p. 305.
The contemporary corporate form is also now subject to a significantly more mature corporate governance, antitrust, and financial markets regulatory environment than ever could have been imagined in the 18th century, even by a uniquely prescient thinker such as Smith.

13.2 Agency Assurance – Governance for the 21st Century Corporation

13.2.1 The Developing Scene of Audit Committee Governance

The four historical periods of technological advancement can also form a guide for reflecting on the progression of corporate governance theory and practice for the audit committee. As corporations’ power and influence have increased, so has the interest and visibility over supervision of their activities. Governments and communities, acting in the interests of society, have been driven to intervene into corporate interests whenever use or abuse of power and influence have apparently become detrimental to society’s interests. There are ongoing reminders in the daily news that critical arenas of regulation including anti-trust, health and welfare, labor and hiring, securities, and corporate governance are necessary to direct corporations’ towards a more positive economic contribution to society, one that embraces objectives that are not purely profit oriented. Figure 13-2 below illustrates this historical progression, with each of the four stages of audit committee governance building upon each other labelled as accountability, monitoring, strategy, and agency assurance.

13.2.2 Accountability

Introduced in the Pre-Industrial Age, the view of corporate governance from Adam Smith’s period of classical economics centers on the historical role of the trustee. Economic activity in the 17th, 18th and early 19th centuries was primarily oriented to meeting the most basic needs of a growing populace in a mostly agrarian pre-industrialized society. With the entrance of the Industrial Age, managers of businesses were entrusted with producing goods by employment of historically traditional production processes and standard factor inputs of labor and natural resources. Trustees concerned themselves with oversight over management’s activities with their primary concern being firm productive output. Trusteeship in these centuries held primarily a simple one dimensional view with protection of joint stockholders’ best interests as their almost singular concern.
When Smith published *The Wealth of Nations* in 1776 with expectation that the joint stock company would not last, this view led rationally to an expectation for due diligence on the part of trustees. Trusteeship is still embodied in the “accountability to the company and shareholders” provisions for the board of directors in the OECD Principles. The real challenge is to accept unconditionally and continuously Smith’s opinion as a warning of the likelihood, even inevitability, of counter-productive and self-serving behavior of directors and managers in economic society. The unfavorable economic impact of this behavior has been rationally categorized by Jensen and Mecklin as a component of overall agency costs they named the “residual loss.”3

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3 Jensen & Meckling (1976), pp. 308-309.
13.2.3 Monitoring

The second stage was ushered in by the crisis of the Stock Market Crash of 1929 and the ensuing Great Economic Depression of the 1930’s. A.A. Berle and G.C. Means identified the problem of “separation of ownership from control” inherent in corporations with broad access to public funds in the financial markets (i.e. stock exchanges). Investors had, in comparison to the past, become far more anonymous due to the following factors:

1. the value of their individual investments was far more diluted,
2. their geographic position in relation to management was far more distant and dispersed, and
3. their concern for the individual firms in their ownership portfolio was far more disaffected.

As a result of bitter wars and political rivalries, better diplomatic relations were actively sought after through trade and economic integration. Complex interdependencies between countries developed during this truly international age.

Government agencies and regulations were instituted to watch over the securities markets and their participants. Management’s actions required more active monitoring by the board of directors. Accounting and financial reporting standardization and the necessity for independent auditing of annual accounts were key inputs to effective oversight by the board.

Coase’ transaction cost theory identified that firms provided economic inputs of value that were not obviously associated with direct cost of producing goods. Accountants responded with categorizing those expenditures under broad labels of cost of goods, research and development, sales and marketing, and general and administrative expenses. Accounting principles governing revenue recognition and expense matching, as well as the conservatism concept, provided important direction for all firms to prepare and present financial results in a broadly equitable and understandable manner.
13.2.4 Strategy

Throughout this period there was a clear struggle between financial theorists and social activists regarding firm objectives. Many financial theorists saw little reason for management to interest themselves in anything more than true cash flow, which would reconcile to accounting profits only over the long-term. Michael Porter introduced the value chain concept for firms to identify where investments in differentiation would be most productive and where cost savings could be gained through disintermediation and alternate sourcing. These concepts evolved into shareholder value management, which sought theoretically to maximise cash flow to the firm’s mostly anonymous shareholding owners.

However, management compensation systems based on stock options and stock price supported a shareholder value system which greatly increased the value of management’s interests and intensified their conflict of interests. The resources available to management were also seemingly stripped of personality. Lay-offs, outsourcing, plant closures, elimination of defined benefits, etc. were simply tools of good value chain management. For corporate strategic management, resource dependence apparently came to be seen as a restrictive system to be resisted and rightsized. Simultaneously, technology in the information age provided great fluidity of movement and broad access to innovation and news. Management’s control over physical assets was being monitored, while management’s control over knowledge and information was often overlooked.

It was not until this third stage that the audit committee emerged and became a recognized and recommended individual entity in the corporate governance system. Stakeholder activists were concerned that the welfare of other social groups affected by firms should also be considered by their managers and directors. These activists sought to show that these groups would apply their influences on the firm to ensure their interests were addressed. Firms could be better off to communicate with these groups and anticipate and address their interests in advance. Looking after many areas such as corporate social responsibility, human resource development, creditors’ and suppliers’ participation, and local community needs could help ensure the long-term interests and viability of the firm. This was even legally formalized in Germany by the dual board system and the concept of “Mitbestimmung”, i.e. participatory decision-
making, which provided a voice to employees in corporate strategy by guaranteeing them seats in the supervisory board.

13.2.5 Agency Assurance in the Intangibles Age

The most developed regions of the world have migrated dramatically in the last half of the 20\textsuperscript{th} century from a traditional \textit{bricks and mortar} tangible manufacturing-oriented economy towards a 21\textsuperscript{st} century \textit{clicks and mortar} intangible service-oriented economy. This transition has progressed, relative to all previous business history, in an accelerated fashion and has touched on many factors of business activity. As was presented previously, these factors include:

1. intangibles content stemming from investments in innovation, technology and image;
2. services and the service content of traditional products;
3. internationalization of markets and marketing approaches;
4. commercial trade in property rights due to disintermediation, outsourcing, and integrated supply chain management; and
5. the proliferation of establishment of legal entities for distributing ownership rights and profits.

The almost simultaneous accelerated development of these five factors appears to conspire to place the business world in a new Intangibles Age. In this age, knowledge has an identifiable economic value both as an internal asset and commercial commodity. Knowledge Management, therefore, plays an increasingly critical role in business management.

As presented in Chapter 8, a number of authors appear to describe this current business environment along similar lines to Schumpeter’s theory of creative destruction. They illustrate that the world is experiencing a discontinuous period where innovation has induced widespread disruption to industry. Rayport and Sviokla present this future as an environment where companies operate in two parallel universes. The first is the traditional marketplace of the “physical value chain,” while the second is what they
call the “marketspace” which targets exploiting information along the “virtual value chain.”

Malone and Laubacher, among others, foresee large companies transitioning into a new organizational form overseeing the efforts and results of vast networks of subcontractors and entrepreneurs. The nodes in the network will be connected electronically, functioning under operating and behavior standards primarily created and developed by these larger organizations. For business management, this results in shorter product life cycles and much quicker turnover of technology and other assets than in the past. Constant investments in innovation are required simply to remain competitive. This description of the future remains consistent with Armen Alchian’s and Harold Demsetz’s insights from 1972 when they stated:

“The essence of the classical firm is identified here as a contractual structure with: 1) joint input production; 2) several input owners; 3) one party who is common to all the contracts of the joint inputs; 4) who has the right to renegotiate any input’s contract independently of contracts with other input owners; 5) who holds the residual claim; and 6) who has the right to sell his central contractual residual status. The central agent is called the firm’s owner and the employer.’”

Organizations must be constructed flexibly so that they can be reformed to meet quickly developing market requirements. This puts great stress on organizations and their related human resources. By the end of the 20th century, fewer than one in ten workers in America was a member of a Fortune 500 company, a ratio that had been cut in half in fewer than 30 years. The former management lines are blurring throughout the supply chain of economic activity between direct employees, consultants and temporaries, and project team members from customers or clients, suppliers or other subcontracting partners, service providers, government agencies, and any other stakeholders. Martin Hilb identifies the qualities needed by “glocalpreneurs”, the key managers of both the small nodal actors and the large coordinating transnationals, as competencies of personality, multiculturalism, leadership and entrepreneurship.

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8 Hilb (1999).
Directors and managers are challenged to install some organized approach to creative destruction for their firms. For example, Hilb’s concept of “coopetition” offers a balanced approach between competition and cooperation.\(^9\) Competition addresses strategic resource allocation and rationalization in the tradition of the physical marketplace. Cooperation considers, alternatively, the potential advantages from realignment of responsibilities, not simply cutting costs through disintermediation and lay-offs. This aspect recognizes that uniquely creative human resource connections need to be preserved for the future in the environment of the virtual marketspace. This recognizes that human resources are the producers of the intellectual capital in firms.

As seen above, statistics show that employment is following ownership in becoming greatly dispersed. Through employee stock options and stock purchase plans as well as the general high level of direct and indirect stock ownership, human resources are more and more often also owners of the firm. As owners, they are entitled to all of the rights, privileges and expectations embedded in the locally accepted or required principles of corporate governance. All owners obviously need a reporting system that addresses the intangible nature of firm resources in the 21\(^{st}\) century. Finally, in the intangibles age, establishment of audit committee has been made a requirement. The audit committee can play a central role in the effectiveness of management-supplied information by employing the agency assurance model.

### 13.3 The Triaxial Agency Assurance Model Framework

In fulfillment of the agency assurance model, as illustrated by Figure 13-3, the audit committee reviews and evaluates management-supplied information as its most specific contribution to the board of directors and overall organization governance. Agency assurance directs the audit committee more broadly than the narrow supervision of the audit process. The audit committee must have a vested interested in the quality and quantity of MSI in support of the balanced control and collaboration roles of the full board of directors, not just to standard financial statements and controls. The model is directed at MSI in two equally important and integrated dimensions: 1.) material accuracy and also 2.) direct usefulness and relevancy, where both dimensions are necessary for meeting all relevant compliance standards and strategic decision support requirements.

The word *agency* is a reminder of both the control approach, through agency theory’s call for supervisory monitoring of management, and the collaboration approach, through the groups of agents that perform critical internal and external corporate governance roles. The word *assurance*, because it has come in to use as representing a combination of audit and advisory services for public accounting firms, also is a reference to the control and collaboration governance approaches, respectively. The AICPA committee formed to examine assurance services important to the future of the accounting profession defined them as “independent professional services that improve the quality of information, or its context, for decision makers.” The board of directors is fully dependent on managers, accountants, auditors, and others as agents to supply directors with this information for organization-critical decision support.

**Figure 13-3. The Complete Agency Assurance Model Framework**

Agency assurance identifies the audit committee as the venue through which validating, verifying and vetting of MSI can be best accomplished, and provides a model for corporate directors and managers to define, organize, and support their information related activities. Agency assurance provides the committee with the

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triaxial framework for accomplishing this responsibility consistent with the web of economic theories enveloping material strategic, operational, and financial information of the company.

- **Constitution** presents as the audit committee’s purpose the requirement for the qualified examination and approval of MSI, and to help ensure that MSI, once reviewed is then verified as sufficient in quantity but not misleading in quality. Agency theory places the board, and the audit committee thereof, in the clear position of authority bridging the separation between firm ownership by shareholders and control of resources by management. The board must ensure that the committee’s combined character, which it accrues from the personalities and backgrounds of its members, qualifies it towards its purpose. The committee must also be apportioned a set of rights by society which are respected by management and the board which assists it in achieving its purpose.

- **Classification** proposes a principles-oriented scheme for production and presentation of financial performance-related MSI that enhances understanding of the true and fair view for the work of the committee and full board, as well as for consumption by the public. To accomplish effective validation of MSI, an accurate and comprehensive information system, based on reasonable and practical collection (i.e. input) and reporting (i.e. output) standards, is required. Differentiation costs borne by the firm, represent strategic investments in knowledge based assets recognized through up-front capitalization and subsequent amortization. These costs are related to transaction cost theory, as they provide specific, reasonable evidence for the firm’s unique identity, purpose, and viability.

- **Communication** provides the MSI disclosure standards with their emphasis on shareholder relations, representing the interests of identifiable, existing owners of the firm rather than the nameless, potential investors widely participating in the financial markets. Technology now provides for distribution channels for reaching and influencing shareholders and other stakeholders for equitable vetting of the true and fair view of both the business’ results and its prospects. Recognition of differentiation costs and the profit margins produced from these resources provides more accurate and relevant indicators, signals which satisfy the needs of financial market analysts while simultaneously reducing the transparency barrier for shareholders and other stakeholder users of financial statements.

The three axes of the model, constitution, classification and communication, as presented in Figure 13-3, work together as an inseparable, integrated system applied to modern corporate MSI.
13.4 Gaps that GAAP Can Address

13.4.1 Threats to Transparency

The two greatest obstacles to acceptance and implementation of this integrated system are the expectations gap and the reporting gap. Both of these gaps can be reduced, along with the transparency barrier, when the accounting profession awakens to the critical need for relevancy of the financial statements called for by financial statement users in today’s economic environment. The credibility of standard accounting has been shot full of holes by the investment community and, even more damaging, by the accounting profession itself. An array of alternative reporting methods, all of which are not required to be prepared or audited under any regulated standards whatsoever, have unfortunately taken priority over the official quarterly and annual reports.

13.4.2 Expectations Gap of the Accounting Profession

The expectations gap can be reduced substantially by the classification axis of agency assurance through the capitalization and amortization of differentiation costs. This principle provides for the recognition of most of the internally developed knowledge assets created in firms today. Management especially will see that their most strategic efforts will no longer be disregarded by their accountants simply because of an outdated interpretation of the conservatism concept. Recognition of the validity of management’s efforts, with a more reasonable business assessment of their associated risks, will help to reinstate the credibility of the financial statements which are recording, carrying, and reporting their creative output at actual cost. The validation of differentiation costs and the improved signals they provide, will support broader acceptance of the audited financial statements by users, and serve to reduce information asymmetry and the transparency barrier by acting as a communications bridge between management and stakeholders, as illustrated in Figure 13-4 below.

This provides a significant opportunity for the audit committee as well. The expectations gap in the performance of audits has posed an unfortunate negative influence for the image and reputation of the accounting community. By direct association with that community, the general reputation of the audit committee is also tarnished by the same unfulfilled expectations and insufficient, intransparent reporting. Through a deliberate effort of recognition and reporting of differentiation costs, the
audit committee can take the lead in providing critical information for control and collaboration (i.e. monitoring and bonding).

Figure 13-4. The Transparency Barrier After Differentiation Costs Disclosure

Source: Own Representation.

The contribution of intangible content from innovation, technology, and image to both goods and services has certainly added complexity to all corporate information processes. This has simultaneously added a higher degree of difficulty for all of the responsibilities of corporate governance. The accounting rules-setters cannot allow the purely administrative issues of the former to take precedence over the strategic interests of the latter. As evident from a recent comprehensive survey commissioned by McKinsey, part of which is summarized in Figure 13-5 below, directors place intangible factors of talent, skills, strategy, risk, and developing management highest on their list of topics they would like to allocate more time to understanding and influencing. The agency assurance classification allows accounting to keep up with the pace of new inventions in products, services, technologies and other intangible innovations. The benefits of improved reporting accrue to boards of directors, managers, shareholders, and basically all interested users of audited financial statements.
Agency assurance offers a knowledge management orientation as a new paradigm for account and risk classification of differentiation costs. The long-held view of the resources available to and risks lying before management tends to classify them as either physical or intangible. Knowledge management theory provides us with a further classification breakdown for the intangibles – those that are explicit versus those that tacit in nature. Since the GDP of most of the member nations of the Organization of Economic Cooperation and Development is now more than 50% represented by services, by definition uninventoriable intangibles, it is more than overdue for accounting standards to adapt to modern corporate reality.

A critical contradiction in accounting could be resolved by this approach. Where most intangibles that have been procured from sources outside of the firm are held as assets and amortized as matching expenses against the revenues which they help to produce, comparably internally produced intangibles are expensed on an incurred basis, never to be inventoried as assets or matched against revenue generated. A new intellectual capital approach, consistent with theories of knowledge management, to asset recognition, risk-based liability identification, and related account classification could make an important contribution to MSI disclosure and transparency.

One critical reason supporting this consideration is that the interaction of the disclosure, revenue, and matching principles is consistent with Ronald Coase’ transaction cost theory. Matching and disclosing expenses closely with revenues provides better indicators of management cost management performance. And these measurements will be more consistently calculated for better understanding of trends and expectations. However, also highly desirable is that this trio of principles applied in concert rigorously by the committee can contribute to an organized system of review of the business’ operations.

A great motivational advantage is gained in recognizing, officially in the financial statements, the productive output of the efforts of internal development. These creative activities, as opposed to simply acquiring such assets, are the source of much pride in an organization. These activities are pursued in expectation of building the greatest strategic opportunity for the organization. It is easier now to see that it is a gross contradiction of accounting standards that these assets are valued at zero. A zero valuation can also imply that there is zero trust in the leadership of the organization that these activities, that management has specifically and determinedly chosen to pursue, are considered too risky for accountants to value and monitor on management’s behalf.

By updating accounting standards to incorporate a new principle for recognizing internally developed intangible assets, then assurance services can be enhanced and decommoditized. Special care would need to be taken by organizations for the recognition of these special assets. Models for capitalization of project expenditures will have to be developed, improved, validated, and verified, and matched with associated liabilities, direct debt or arising from derivatives. Similar care will be
required to implement and justify amortization methods and estimated useful lives. Amortization of differentiation costs must be properly matched to the respective revenues won by the firm. Finally, over the actual life of these assets, they will need to be regularly reviewed to ensure they are properly ‘maintained’, that only clear ‘upgrades and enhancements’ are capitalized, that values which become impaired are properly written off, and that proper and timely gains or losses are recorded in the accounts due to obsolescence or disposition, i.e. sale or transfer, of the intangibles. In such a situation, Value-Based Reporting need not be a sideline advisory service.

Auditors would be sought for consultation on all of the above accounting processes. Audits would be expanded to include substantive testing of this class of intangible assets. Accountants could explore the great potential of providing consultative support on performance measurement and strategic planning using the standard accounting database and reporting methods which only they control and maintain. Updating accounting standards would enhance the value of all assurance services, not restricting auditors’ leadership to only the development of proprietary Value-Based Reporting models and advisory services.

Critically, the capitalization classification would need to be continuously reviewed for accounting principles compliance. A scheme influenced by knowledge management research and by the detailed categories recognized in the intellectual capital field would serve as a basis for this purpose. A great new step would therefore be taken in closing the expectations gap currently plaguing the auditing and accounting profession and, by association, the audit committee.

13.4.3 Reporting Gap of the Audited Financial Statements

Differentiation costs create highly valuable investor communication signals in the capitalization period, in the margins they produce over their utilization, and in the transactions at disposition. Capitalization of these differentiation costs as additional intangible assets will also help to trim the reporting gap, which is measured by analysts in financial markets as the market to book ratio. Market value, i.e. market capitalization (or ‘market cap’), is calculated as stock price multiplied by number of shares outstanding. Book value is synonymous with the total shareholders’ equity which equals the total assets minus total liabilities as measured at historical cost. With more assets and a higher value for them included in the accounting system, the
resulting higher book value of equity will, in general, be brought one step closer to financial market value.

However, the reporting gap is not likely to be closed in its entirety, nor should this result be expected. This remaining value of the reporting gap is not bridgeable under any generally accepted accounting principles. This is because the remaining gap is the result of standard financial statements being set apart from financial market valuation. The equity in financial statements represents historical performance and investments at cost, while share price represents primarily market expectations of future performance. Except in the limited case of trading securities in established stock and bond markets, unearned gains are never to be capitalized in financial statements. The future simply is unpredictable, therefore, requirements of all unfulfilled revenue and earnings opportunities clearly consist of contingent obligations. The existence of contingent obligations bars the accounting recognition of sales and profits until these obligations are fulfilled. Alternatively, actual project costs incurred for producing intangibles are accurately traceable by accountants. This requires no changes to their bookkeeping systems and is fully compatible with their accounting methods for their projects which produce physical assets in firms.

On the one hand, the audit committee should logically be in favor of any initiative that can reduce the expectations gap, by improving the performance of the internal accountants and external auditors. On the other hand, the preoccupation with valuing today’s assets through future projections is not good accounting. Certainly, any valuation measure using weighted average cost of capital for discounting of cash flows is suspect. The equity portion of cost of capital, like the underlying share price, is always a measure of future expectations in the financial market. Even past quoted stock market prices include market hype or pessimism and other biases based on feelings. The cost of debt, normally equivalent to market interest rates, is only known for past and current company debt, but not for future issues of debt. Financial markets are not the same as the markets for a firm’s goods, services and supplies. Therefore, historical cost based valuation as presented by audited financial statements is far more transparent, because it is more easily traceable, verifiable, and protectible.

The argument that the reporting gap should be filled so that the book value in the financial statements, as found in the official statement of financial position (i.e. the
balance sheet) is equivalent to the market capitalization of the firm is a terribly slippery slope. The stock price is determined by the expectations that the investment public, made up of institutional fund managers, stock market brokerage analysts and individual investors, has for the future performance of the company. A stock market is efficient when it is a fair, competitive marketplace of many buyers and sellers. Prices should fluctuate based on properly informed, professional expectations for estimates, perspectives, projections, and opinions of performance. The basis for their expectations is the company’s disclosures of management-supplied information, of which financial statements play a critical role.

A properly managed and operating company will generate a profit over the long-term future of its businesses. This profit should be earned not based on anyone’s expectations of the future, but by normally competitive and diligent management efforts. These earnings are only then added to the financial statements to show the financial position at that exact point in time. Some financial analysts and accountants are trivializing the day to day efforts involved in earnings by demanding that the financial statements are updated in advance of those efforts. This is evidence of an ignorance of management responsibility by members of these professional advisory communities who unfortunately deserve their respective nicknames of “spread-sheet jockey” and “bean counter” for their lack of understanding and appreciation for business activities.

13.5 The Compensation Gap

Although, management decries the mindset of many investors and their advisors who are demanding profits from firms today with little regard for the future as “short-termism” in the mindset of investors, this same problem is built into many management compensation arrangements. When executive pay is overweighted with stock options, management can claim a significant windfall gained from short-term market expectations and investment whims, like the internet craze of the late 1990’s. These personal gains, difficult to label as earnings, are too often received long in advance of any operational efforts being planned or performed. They are paid out even in situations where profits for the company later never materialize. This is a most disturbing contribution to conflicts of interest coming from boards of directors who develop and approve the compensation plans of today’s corporate managers.
Executives simply should never receive bonuses for actions which should have, could have, or would have occurred. These same executives certainly would never release profit sharing grants to their rank-and-file employees before their firms had earned profits to share.

According to a study of 367 of the largest US corporations, near the height of the bubble in 2000, the compensation of the average American chief executive of large firms had reached a level of 525 times that of the average production worker, as shown in Figure 13-6 below. With the precipitous fall of the stock market, the ratio dropped, and in 2003 it was 301 to one. However, because the stock market has rebounded and stock options continue to pay off risklessly, in 2004 the ratio jumped to 431 to one, returning to a level higher than any almost any year in history, before or after the stock market correction. The dramatic and disturbing nature of this compensation gap must be considered especially in comparison to the average in 1990 of 107 to one, and in 1982 when it was just 42 to one.

**Figure 13-6. The Compensation Gap**

![Graph showing the compensation gap](image)


On one hand, in some cases, it is appropriate to provide a bonus as incentive for the design of a truly compelling strategy for the company’s future. The payout of the bonus could be made to the designer in special recognition of the strategy’s value, especially if other actors will be charged with turning the strategic plan into operational actions, or if a realizable sale value of the design is determinable. On the
other hand, most of the management who is responsible for strategy resides with a small number of top executives. This group can be expected to participate long-term in both the strategic and operating success of the company, and long-term compensation plans can be set up for this benefit.

The new executive pay disclosure rules proposed by the SEC in early 2006 attempt to provide more transparency to this nagging issue. For example, the disclosure requirement level for individual management perks may be lowered from US$50,000 to US$10,000. However, the SEC has asked that each firm report the complete compensation of the CEO, CFO, and the three remaining highest paid managers only in aggregate, not individually.\(^{12}\) Also, company’s can be very opaque in the types of perks offered, as Case Review 13-1 below illuminates.

**Case Review 13-1. The Contradiction of Perks at Ford Motor Co.**

In March of 2005, the sports writers in the news, not their business counterparts, reported on a dispute between the Professional Golfers Association (PGA) and International Management Group (IMG), a golf management firm.\(^ {13}\) IMG had arranged for four of the world’s top ten professional golfers to be paid US$150,000 each, US$600,000 total, by Ford Motor Co. to play golf with Ford automobile dealers the Monday before the annual Ford sponsored Golf Championship at Doral. Although not reported, it is difficult to imagine that no representatives of Ford Motor Co.’s executives were present.

A golf tournament is a favorite promotional event of automobile firms. It can be argued that the publicity certainly helps to sell cars. The news reporting may begin on Tuesday or Wednesday when the professionals normally arrive to practice. Television coverage begins in part on Thursday for the first round of most tournaments. Full media coverage does not come until Saturday’s and Sunday’s final rounds. Therefore, there has been plenty of time for Ford managers and dealers over the years to do business while hobnobbing with the professionals.

Adding one more day of play away from the office to the schedule is egregious when considering the Ford media disclosures which shortly followed in the business press.

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\(^{13}\) Logan (2005).
Just a few weeks later, Ford announced that its sales in the US had fallen by over five percent in April for the eleventh month in a row of sales declines.\textsuperscript{14} Warnings of major losses at Ford followed shortly thereafter. By January of 2006, Mark Fields, a Ford North America executive was quoted as saying:

“‘The hard but simple reality is that Ford has costs, capacity and staffing that are much larger than our market share can support even under the best of circumstances.’”\textsuperscript{15}

He simultaneously announced that Ford would eliminate up to 30,000 jobs in North America by 2012, almost a 25% reduction in employment.

Finally, the executive pay practices of many corporations are compounding conflicts of interests among their managers. The short-term attitude of some investors and the me-too attitude of some managers appears to be a reflection of our society. An attitude of “I want it now, and I want it all” is currently generating huge deficits in the budgets of many nations. The resulting burden of government debt on the future generations in many economies is growing to worrisome size. Deficits are also showing up in other social and environmental measures, such as growing wealth disparity between rich and poor in societies, widening divisions evidenced by more vehement and virulent conflict between classes and societal groups, depletion of natural resources and the fouling of the environment, and other contemporary societal issues. As shown in Figure 13-7, below, misdirected stock option compensation in the US has been neither costless to the firm nor to its shareholders.

The reporting gap can be filled, but as the evidence illustrates, in extreme cases of market capitalization decline shown in Figure 13-7, this gap can also be narrowed, eliminated, or even driven to a negative value. Mishandling of the economy and mismanagement of companies can send stock prices plummeting. Therefore, there is no need to decry an auditable, transparent, and fair accounting system with a healthy, appropriately positive reporting gap. Rather, the size and intransparency of pay and fees has caused a compensation gap which does not appear to have a relation to actual performance. Such high personal stakes often lead inherently to conflicts of interest and risks of outright fraud or misjudgement.

\textsuperscript{14} Karush (2005).
\textsuperscript{15} Simon & Mackintosh (2006).
Figure 13-7. A Reckoning of the Costs of Executive Compensation

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>CEO</th>
<th>1999-2001 TOTAL COMPENSATION</th>
<th>MARKET CAP CHANGE</th>
<th>LAYOFFS SINCE 1/1/01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adelphia Communications</td>
<td>J.J. Rigas</td>
<td>$4,350,162</td>
<td>-7,858</td>
<td>-99%</td>
</tr>
<tr>
<td>AOL Time Warner</td>
<td>G.M. Levin</td>
<td>$178,364,000</td>
<td>-31,483</td>
<td>-38%</td>
</tr>
<tr>
<td>Bristol Myers Squibb</td>
<td>P.R. Dolan (2001)</td>
<td>$51,566,549</td>
<td>-9,088</td>
<td>-69%</td>
</tr>
<tr>
<td>CMS Energy</td>
<td>W.T. McCormick, Jr.</td>
<td>$5,465,961</td>
<td>2,757</td>
<td>-72%</td>
</tr>
<tr>
<td>Duke Energy</td>
<td>R.B. Priory</td>
<td>$14,931,000</td>
<td>-10,292</td>
<td>-33%</td>
</tr>
<tr>
<td>Dynegy</td>
<td>C.L. Watson</td>
<td>$19,503,064</td>
<td>-17,240</td>
<td>-95%</td>
</tr>
<tr>
<td>El Paso</td>
<td>W.A. Wise</td>
<td>$85,860,000</td>
<td>-28,134</td>
<td>-79%</td>
</tr>
<tr>
<td>Enron</td>
<td>K.L. Lay</td>
<td>$250,834,250</td>
<td>-62,335</td>
<td>-100%</td>
</tr>
<tr>
<td>Global Crossing***</td>
<td>G. Winnick (2001)</td>
<td>$20,787,969</td>
<td>-12,607</td>
<td>-100%</td>
</tr>
<tr>
<td>Halliburton</td>
<td>D.J. Lesar (2001)</td>
<td>$32,186,497</td>
<td>-9,750</td>
<td>-63%</td>
</tr>
<tr>
<td>Hanover Compressor</td>
<td>R.B. Cheney (1999-2000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Homestore, Inc.</td>
<td>M.J. McGhan</td>
<td>$77,754</td>
<td>-2,261</td>
<td>-76%</td>
</tr>
<tr>
<td>Kmart</td>
<td>S.H. Wolff</td>
<td>$4,503,154</td>
<td>-1,563</td>
<td>-94%</td>
</tr>
<tr>
<td></td>
<td>C. Conaway (2000-01)</td>
<td>$18,074,194</td>
<td>-2,206</td>
<td>-86%</td>
</tr>
<tr>
<td></td>
<td>F. Hall (1999)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lucent Technologies</td>
<td>H.B. Schacht (2001)</td>
<td>$10,919,217</td>
<td>-39,786</td>
<td>-87%</td>
</tr>
<tr>
<td>Network Associates</td>
<td>S.M. Fuller</td>
<td>$7,586,000</td>
<td>-7,058</td>
<td>-83%</td>
</tr>
<tr>
<td></td>
<td>G. Samenuk (2001)</td>
<td>$15,833,276</td>
<td>1,131</td>
<td>196%</td>
</tr>
<tr>
<td>Peregrine Systems</td>
<td>S.P. Gardner</td>
<td>$16,359,119</td>
<td>-2,874</td>
<td>-98%</td>
</tr>
<tr>
<td>PNC Financial Services</td>
<td>J.E. Rohr</td>
<td>$22,189,000</td>
<td>-9,260</td>
<td>-44%</td>
</tr>
<tr>
<td>Qwest</td>
<td>J.P. Nacchio</td>
<td>$266,332,104</td>
<td>-66,223</td>
<td>-97%</td>
</tr>
<tr>
<td>Reliant Energy</td>
<td>R.S. Letbetter</td>
<td>$10,909,902</td>
<td>-9,728</td>
<td>-76%</td>
</tr>
<tr>
<td>Tyco</td>
<td>L.D. Kozlowski</td>
<td>$331,765,196</td>
<td>-71,500</td>
<td>-74%</td>
</tr>
<tr>
<td>WorldCom</td>
<td>B.J. Ebbers</td>
<td>$44,062,629</td>
<td>-39,847</td>
<td>-98%</td>
</tr>
<tr>
<td>Xerox</td>
<td>P.A. Allaire (2000-01)</td>
<td>$17,497,107</td>
<td>1,961</td>
<td>63%</td>
</tr>
<tr>
<td></td>
<td>G.R. Thoman (1999)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$1,430,857,895</td>
<td>-530,758</td>
<td>-73%</td>
</tr>
<tr>
<td><strong>Average CEO in Business Week Surveys</strong></td>
<td></td>
<td>$36,500,000</td>
<td>70%</td>
<td></td>
</tr>
</tbody>
</table>

*2001 compensation not available. Figure is for 1999-2000 only.
**2001 compensation not available. Figure is for 1999-2000 only. Total compensation does not include $508 million in 1999-2001 stock sales by Gary Winnick.


Good corporate governance practices, including the agency assurance model for the audit committee, supported by positive underlying ethical values of management,
boards, and owners, may be a good place to start in bringing these issues under proper review and supervision.

13.6 The Agency Assurance Activities and Results of the Audit Committee

13.6.1 Verification of Management-Supplied Information

The constitution axis of the agency assurance model frames the Audit Committee as the central, lead entity in the corporate governance system capable of verification of management-supplied information. Through identification of its definite purpose, supported by a well developed character and its carefully delineated rights, the audit committee can maintain integrity and respect as the leading entity of MSI evaluation. Purpose is fulfilled through both a general, overriding principle of objectives, i.e. the audit committee aim, and a set of firm-specific regulations, i.e. the audit committee charter.

The **aim of the audit committee** is to motivate and evaluate management’s performance in presenting the true and fair view of the organization’s financial condition, including its operational performance and risk profile. The audit committee directs management to sufficiently meet the information needs of the board of directors towards fulfilling all purposes of their critical supervisory function, which includes both monitoring and strategy in measured balance, and to comply with all legal disclosure requirements of the company.

The AICPA has published guidelines for preparing an official charter for the audit committee, but these guidelines are more of a menu of choices. Boards are encouraged to choose from among the menu items as they see fit. Although the requirement of a published charter for each publicly listed company seemingly should establish a clear set of expectations, the menu approach is more likely to lead to exclusion of items that nevertheless are required the public and the government. A global aim, when paired with a firm-specific charter, should help to reduce the expectations gap for audit committees.

Agency assurance seeks to recognize the differences in the constitutional roles of the actors expected to monitor, evaluate, and publicly critique the activities of today’s powerful corporations. That these actors are working in the interest of as well as on behalf of society must remain in the forefront of all policies, practices, and regulations for corporate governance. The public must raise its expectations for these actors and
hold them just as accountable in the performance of their roles as these actors are themselves expected to hold management accountable for the performance of the corporations they lead. Managers and the many other actors participating in the corporate governance system are the agents of agency assurance.

The most important actors other than management for the audit committee to supervise and interact are the external auditors. Unfortunately, weak, sloppy, unprofessional, and even unethically performed audits in many world regions have contributed to the audit function woefully failing to support the audit committee in its monitoring role. The multi-billion dollar, euro, yen, yuan, peso, etc. public cases of grievous fraud, error, or omission serve as clear evidence against the profession. Sarbanes-Oxley and the Public Company Accounting Oversight Board have concentrated much deserved attention on audit standards, audit practices, and the impartiality of auditors themselves, much the same as the Treadway Commission had previously done. The internationally diffuse investing public is dependent on auditors to commit wholeheartedly to making the prescribed improvements and for the audit committee to oversee their successful implementation. The PCAOB reforms are designed to reduce compliance risk embedded in faultily and fraudulently constructed financial reports.

The mighty accounting firm Arthur Andersen suffered a humiliating demise mostly over their failed Enron and WorldCom engagements. The firm was forced to allow itself to be carved up country-by-country and region by region with each piece absorbed by one of its competitors. But not only Andersen was infected, almost of the leading international accounting firms have suffered embarrassments and large penalties. Voluntarily negotiated settlements and involuntarily imposed legal judgements led to multimillion-dollar payouts for bad audits. The establishment of the PCAOB bureaucracy as a watchdog over the audit industry is an additionally sad indictment of the accounting profession. Prior to Sarbanes-Oxley, the US accounting profession had prided itself for decades on its quasi-regulatory role and independent system of self-evaluation and enforcement. US accountants arguably considered themselves to be more reliable regulatory experts than elected politicians and government bureaucrats would have been in setting accounting and auditing standards.
Now they must subject themselves to tighter government oversight, registration, and licensing rules and work diligently to rebuild their credibility and public trust.\textsuperscript{16}

The ability to perform roles effectively is a question of character and rights. For the audit committee as a specific corporate governance actor, character is a combination of both the professional backgrounds and the personal ethical integrity and commitment to social responsibility of the committee members. The audit committee inherits its authority as a working sub-unit of the board not only from the authority of the full board of directors, but through direct legislative and regulatory requirement in most developed and many developing nations. The expectations gap must not be allowed to impede the acceptance of the audit committee as a highly critical element in the board structure. Respect from all directors, management, other internal and external actors, as well as the shareholders provides the basis of rights necessary for the committee to perform its function, the assurance activities of agency assurance.

\textbf{13.6.2 Validation of Management-Supplied Information}

Sarbanes-Oxley and the PCAOB have addressed external auditors, internal auditors and accountants, management, and directors. However, today’s financial statements are filled with many inconsistencies that arise from accounting standards that have not been addressed. Statements that comply with these standards, despite a fully functioning oversight and monitoring system, lead to an often misleading and distorted view of the company, which cannot in a material respect represent the financial condition of the firm, the true and fair view. US GAAP and IFRS fail to incorporate sufficient measures that would decrease compliance-related intransparency.

The classification axis of the model embraces an information system which is dependent upon principles-based, rather than rules-based, accounting standards. Validation of management-supplied information is made more constructive through adherence to principles which are well accepted and understood. The unbridled pursuit of a higher stock or bond price or to meet investor expectations, however unreasonable they may be, is replaced with the mature objective of serving the justified interests of the company’s actual shareholders.

\textsuperscript{16} Revell (2003).
Management’s value-add activities in the 21st century are more likely to be related to research and development, services, marketing, and other intangible pursuits. The classification system should, therefore, at the least be adapted in principle to recognize and represent these deliberately produced assets. The capitalization of all externally-acquired and internally-created intangible assets brings the standard accounting report, the statement of financial position, to a generally higher asset level on average. It therefore values the primarily explicit knowledge-based investment of the modern corporation in the financial statements.

It also should bear witness to accounting standards setters that knowledge management theory has now progressed to a mature enough stage for a reasonably broad accounting recognition of intellectual capital. For example, innovation and creation, the main subjects of creative destruction, have been effectively isolated among the categories on Binney’s knowledge management spectrum. Agency assurance, therefore, holds that KM provides a suitable comfort level in theory and practice for the initial investment value of many internally developed and externally acquired intangible, but explicit, assets to be recorded at cost in the audited financial statements. This concept of asset capitalization, along with a recommendation for asset value amortization and review for impairment, is the core contribution of the classification axis of the model.

Accounting estimates for asset values which are based on future expectations, as often employed in accounting firms’ consultative Value-Based Reporting models, are problematic. The uncertainty and unpredictability of the future is why reserves for items such as contingent liabilities, such as unearned revenues on cash deposits or accrued expenses to be incurred in the future for decisions made today, are governed by the conservatism concept. Agency assurance also provides for conservatism by looking to the present for investment capitalization of actual expenditures for differentiation costs as they are incurred, in compliance with the historical cost principle. It encourages a top-level, corporate-directed policy for the amortization lives and methods of specific programs and general asset categories within the classification system. It calls for consistency of approach between externally-acquired and internally-developed like assets.

The Treadway Commission pointed out that the effects of management’s actions in pursuit of fraudulent financial reporting “is almost always to inflate or ‘smooth’
earnings or to overstate the company’s assets.” 17 The classification principle takes much of the opportunity and incentive for fraud away from management. This is accomplished, respectively, by requiring capitalization of many items previously expensed, making them more visible, and by recognizing the contributions, over their long-term useful lives, of many more assets produced by management’s efforts. Classification lowers the transparency barrier that has been erected by giving directors and other financial statement users a clearer view of the cause and effect in financial results of management’s activities and of the implementation of the board’s decisions and instructions for management.

Finally, the Treadway Commission appears to have erred in its opinion and advice regarding the need for accounting standards and internal control reforms in its 1987 report. The Commission’s praises claiming that “the financial reporting system functions remarkably well” and only “occasionally breaks down” paralleled the implementation of some of the greatest control errors and fraudulent activities ever found in corporations. 18 These statements may have been true when looked at only from the perspective of a majority of public companies compliance with existing standards. However, the minority incidence of fraud has taken on material dimensions in the late 1990’s and early 2000’s, immediately after the publication of the COSO report, which can only be labelled as remarkably unfavorable. The accounting standards lacking a consistent approach to the recognition of the knowledge-based content of intangible assets in businesses over this same period contributed to financial reporting content breaking down too frequently and indiscriminately.

### 13.6.3 Vetting of Management-Supplied Information

Agency assurance finally intends through more frequent and transparent communications to raise the awareness that the public has to the criticality of the corporate governance actors’ roles and the absolute necessity of due diligence in their performance. When heroic and costly efforts are invested by them to attain the true and fair view, the activities and findings of these actors must have a heightened visibility. They must not be allowed once again to disappear into a false backdrop of corporate cooperation and interdependence of interests.

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The true and fair view is not attained if the users of the audited financial statements are not able to evaluate the company’s overall risk situation. Risk management supervision, therefore, must also be a required institution in all audit committees of public corporations. Internal control is intertwined with the determination of an acceptable level of risk-taking. Accounting standards which dictate what is reported on financial statements address rules for evaluating risk, considering especially the conservatism concept. The financial valuation formulas for equity shares and all forms of debt include factors for risk. The higher the risk, the higher rational investors expect the interest rate on debt or the return on investment on equity to be adjusted. The expected returns of various company investments held on the balance sheet are normally adjusted for the level of risk taken in order to ensure the value of these assets have not become impaired.

On behalf of the shareholders and in support of the board of director’s responsibilities, the audit committee must take responsibility for all material disclosures:

1. those that must be verified in advance with assistance from internal and external auditors – the financial statements, official prospectuses and offers of securities, and other government required filings;

2. those that must be approved in advance as part of the review requirements set by the entire board in its direct supervision of management – strategic plans; reorganizations; mergers, acquisitions, and divestitures; and forecast guidance; and

3. the remainder of public MSI that due to resource constraints must be reviewed ex post for purposes of management accountability and compensation.

This requires that the committee not only involve itself in the workings of the shareholder relations function, but the overall public relations function as well.

Society’s economic health is dependent upon the existence of an edge of scepticism between management and the corporate governance actors as well as amongst the various groups of independent corporate governance actors themselves. The differing viewpoints held by these many groups should provide a multidimensional framework for evaluating and valuing the corporation. Whenever the opinions, activities, and recommendations crossover and blend into one another, that is when they should become most suspect that they have lost their independence advantage. This is a
telltale sign that intransparency and conflicts of interest have managed to creep into the machinery of corporate governance.

A management communications strategy directed at the quality and quantity of MSI to be presented to the board of directors as the legal representatives of the shareholders replaces the investor relations practices directed at an anonymous public. The audit committee must assure that disclosures contain the signals to the shareholders and potential investors that allow the shares to be traded most efficiently. The fairer and more transparent the system, the better the valuation.

13.6.4 Addressing Specific Control Risks of Error and Fraud

Agency assurance provides an important extra element of support for the detailed COSO framework for improving the internal control system. The framework consists of a set of five component standards to be used for institution and evaluation of internal controls in a firm, as illustrated in Figure 13-8 below.\(^{19}\)

**Figure 13-8. The Five COSO Components of Internal Control.**

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\(^{19}\) COSO (1994-1).
Weaknesses in accounting controls are not simply a product of the policies and procedures of monitoring. Monitoring, instead, is only one of the elements enveloped within the overall control environment. COSO’s own illustration of the control framework sets monitoring at the top of the control pyramid, while the control environment is the base upon which all other components are fixed. The Treadway Commission’s definition of this foundation follows:

“The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity’s people; management philosophy and operating style, the way management assigns authority and responsibility, and organizes and develops its people; and the attention and direction provided by the board of directors.”

Management commitment to the overall objective of control, called for as a foundation of the COSO system, requires widespread acceptance by management of the legitimacy of the output of the officially accepted measurement system, i.e. the content of audited financial statements.

Agency assurance also provides a fresh perspective to address the major causes of fraudulent financial reporting. The Treadway Commission identified that these causes arise from a mixture of forces and opportunities for fraud which include undesirable personal and environmental incentives, pressures, opportunities, and weaknesses. The model provides the audit committee with a clear structure for supporting the full board of directors in their more active involvement in the supervision of the corporation. The constitution, classification, and communication axes focus the committee’s efforts towards identifying, analyzing, and critiquing the process of MSI production and publication, i.e. the verification, validation, and vetting activities of the audit committee. Improved MSI contributes to all five of the COSO framework components, while also helping to expose the forces and opportunities for fraud through reducing the transparency barrier.

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13.7 Final Statement

The conclusion of the previous chapters can be summed up simply by the statement that the diverse actors who are expected to perform independent roles of corporate governance have, mostly inadvertently, allowed themselves to become co-conspirators in furthering systemic conflicts of interest. Instead of adding value through differing critical perspectives of company performance, they embraced a system which tended to uniformly align their perspectives. The resulting collective viewpoint was fixed on a selectively skewed prediction of the organization’s anticipated future financial results. This viewpoint was in turn valued through the share price traded in stock markets, which themselves were dependent on and whose agents were participating in the influences of these co-conspirators.

In fact, this collective viewpoint was actually a collection of optimistic strategic goals for the future. These goals were being published, disseminated, and accepted by these governance actors and the investing public almost as if they were actually achieved results. In fact, management was also being rewarded for its accomplishments when its strategy had not yet been operationally tested in real world competitive market situations. Management was receiving hefty payouts when no actual profits had yet been produced to pay for these award incentives. Management was rewarded for share price performance in an abnormally favorable advancing stock market, a statistically aberrant bubble market. The share price valuations were quantified by models highly reliant on predictive MSI for input, rather than stricter measures of actual achieved performance.

There certainly is a heightened interest in corporate governance practices, which brings a much needed spotlight to improve public illumination of management and board activities. The scandals have finally motivated the legislative authors of the Sarbanes-Oxley Act to require the SEC to update its SRO rules requiring the implementation of more of the Blue Ribbon Committee’s recommendations for Audit Committees. Finally, therefore, effective in 2004, the NASD and the NYSE updated their listed company rules to require firms to have audit committees of at least three members who were more acceptably independent from employment and contractual ties to the company. All audit committee members were also expected to be financially literate, and listed companies were required to engage at least one member
of the committee who could be identified as a financial expert based on adequate prior professional experience.\footnote{SEC (2003-2), Release No. 34-48745.}

Sarbanes-Oxley has grabbed the world’s attention, especially from anyone involved in auditing and controls. However, is it making a deep impression on average managers? Certainly they are impressed, and somewhat depressed as well, by the monitoring burden and costs, and the potential civil, criminal, and commercial penalties for straying. However, honest and hard-working managers also rightly seek control to be balanced by collaboration. Agency assurance, its focus on management-supplied information, reducing the transparency barrier through recognition of differentiation costs, plays an active role in both pursuits.

Many reforms are being implemented in many nations through new corporate governance legislation and regulations. Not among the least of these laws, Sarbanes-Oxley has a major influence internationally, especially through the establishment of the PCAOB regulating the activities of the world’s large audit firms. Required SEC regulatory initiatives over corporate governance of NYSE, NASDAQ, and other public exchanges and their listed corporations must also be observed by international financial institutions and individual firms seeking access to these globally leading financial markets. Highly active public prosecution of lawbreakers, particularly by Eliot Spitzer, Attorney General of the state of New York, also serves as a strong further judgmental deterrent – both in the specific severe punishments doled out in fines and prison terms as well as in the generally negative opinion resulting from unfriendly media exposure.

Unfortunately, these initiatives have not made much, if any, progress in reforming the content of MSI, the main contributor to conflicts of interest which have clouded judgements collectively. In fact, the Blue Ribbon Committee had already quoted the SEC Chairman at the time, Arthur Levitt, in a prominent place in its 1999 Report as having clearly warned of his ‘‘fear [that] we are witnessing a gradual, but noticeable erosion in the quality of financial reporting’ and the emergence of a ‘grey area…where accounting practices are perverted; where managers cut corners; where earnings reports reflect the desires of management rather than the underlying financial
The agency assurance model therefore addresses the content and presentation of management-supplied information. The model contributes to the call for an integrated theoretical view of the firm as well as a proper framework for firm governance. Shareholders, the true owners of corporations in the Intangibles Age, require a reliably true and fair view of firm performance that is relevant in this ultra-modern corporate environment. The audit committee of the board of directors must use its representational role to secure the reliability and relevance of reported information from management. Although primarily directed at the purposes and practices of the audit committee, agency assurance’s viewpoints regarding management-supplied information’s influences on firm performance could have the potential to be more broadly distributed and of strategic impact for corporate governance today.

There is much to be gained from the balanced pursuit of corporate governance reform. Investment markets adjust the equity valuation factors of businesses to the level of protection generally available from the corporate governance system that the securities are registered under. Lower valuations occur where corporate governance systems are not performing as well, relatively, which discourages entrepreneurs and the development of the market for initial public offerings, and similarly affects the efficiency of financial markets overall. Agency assurance is offered as a mechanism for the members of audit committees to work to close the expectations gap and the reporting gap so that benefits can accrue to their firms and to society at large.

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APPENDIX 1. ICGN APPROACH TO THE OECD PRINCIPLES:
A ‘Working Kit’ Statement of Corporate Governance Criteria.¹

1. Corporate Objective
   The overriding objective of the corporation should be to optimize, over time, the returns to its shareholders. To achieve this objective, the corporation should endeavor to ensure the long-term viability of its business, and to manage effectively its relationships with stakeholders.

2. Communications and Reporting
   Corporations should disclose accurate, adequate, and timely information, in particular meeting market guidelines where they exist, so as to allow investors to make informed decisions about the acquisition, ownership obligations and rights, and sale of shares.

3. Voting Rights
   Corporations’ ordinary shares should feature one vote for each share. Corporations should act to ensure the owners’ rights to vote. Fiduciary investors have a responsibility to vote. Regulators and law should facilitate voting rights and timely disclosure of the levels of voting.

4. Corporate Boards
   The board of directors or supervisory board as an entity, and each of its members as an individual, is a fiduciary for all shareholders, and should be accountable to the shareholder body as a whole. Each member should stand for election on a regular basis.

   Corporations should disclose upon appointment to the board and thereafter in each annual report or proxy statement information on the identities, core competencies, professional or other backgrounds, factors affecting independence, and overall qualifications of board members and nominees so as to enable investors to weigh the value they add to the company. Information on the appointment procedure should also be disclosed annually.

   Boards should include a sufficient number of independent non-executive members with appropriate competencies. Responsibilities should include monitoring and contributing effectively to the strategy and performance of management, staffing key committees of the board, and influencing the conduct of the board as a whole. Accordingly, independent non-executives should comprise no fewer than three members and as much as a substantial majority.

   Audit, remuneration and nomination board committees should be composed wholly or predominantly of independent non-executives.

5. Corporate Remuneration Policies
   Remuneration of corporate directors or supervisory board members and key executives should be aligned with the interests of shareholders.

¹ International Corporate Governance Network (1999).
Corporations should disclose in each annual report or proxy statement the board’s policies on remuneration—and, preferably, the remuneration break up of individual board members and top executives—so that investors can judge whether corporate pay policies and practices meet that standard.

Broad-based employee share ownership plans or other profit-sharing programs are effective market mechanisms that promote employee participation.

6. Strategic Focus

Major strategic modifications to the core business(es) of a corporation should not be made without prior shareholder approval of the proposed modification. Equally, major corporate changes which in substance or effect materially dilute the equity or erode the economic interests or share ownership rights of existing shareholders should not be made without prior shareholder approval of the proposed change.

Shareholders should be given sufficient information about any such proposal, sufficiently early, to allow them to make an informed judgment and exercise their voting rights.

7. Operating Performance

Corporate governance practices should focus board attention on optimizing over time the company’s operating performance. In particular, the company should strive to excel in specific sector peer group comparisons.

8. Shareholder Returns

Corporate governance practices should also focus board attention on optimizing over time the returns to shareholders. In particular, the company should strive to excel in comparison with the specific equity sector peer group benchmark.

9. Corporate Citizenship

Corporations should adhere to all applicable laws of the jurisdictions in which they operate.

Boards that strive for active cooperation between corporations and stakeholders will be most likely to create wealth, employment and sustainable economies. They should disclose their policies on issues involving stakeholders, for example workplace and environmental matters.

10. Corporate Governance Implementation

Where codes of best corporate governance practice exist, they should be applied pragmatically. Where they do not yet exist, investors and others should endeavor to develop them.

Corporate governance issues between shareholders, the board and management should be pursued by dialogue and, where appropriate, with government and regulatory representatives as well as other concerned bodies, so as to resolve disputes, if possible, through negotiation, mediation or arbitration. Where those means fail, more forceful actions should be possible. For instance, investors should have the right to sponsor resolutions or convene extraordinary meetings.
APPENDIX 2.
GOOD PRACTICE GUIDELINES
FOR THE AUDIT COMMITTEE

Introduction
Primary responsibility for the company's financial reporting lies with top management, overseen by the board of directors. To help boards of directors carry out this oversight responsibility, the Commission recommends that all public companies establish audit committees consisting of independent directors. Establishment of such committees, of course, does not relieve the other directors of their responsibility with respect to the financial reporting process. The Commission therefore reinforces its general recommendation with more specific recommendations for audit committee duties and responsibilities. First, specific recommendations directed to audit committees highlight the need for the audit committee (1) to be informed and vigilant, (2) to have its duties and responsibilities set forth in a written charter, and (3) to be given resources and authority adequate to discharge its responsibilities. Among other things, the audit committee should review management's evaluation of factors related to the independence of the company's public accountant, help preserve that independence and review management's plans for engaging the company's independent public accountant to perform management advisory services during the coming year, considering the types of services that may be rendered and the amount budgeted for such services.

In addition, the Commission highlights other important audit committee functions throughout Chapter Two. The audit committee should review the company's process of assessing the risk of fraudulent financial reporting and the program that management establishes to monitor compliance with the code of corporate conduct. The audit committee should have open lines of communication with the chief accounting officer and the chief internal auditor. In fact, the chief internal auditor's direct and unrestricted access to the audit committee is vital to his objectivity. Management should advise the audit committee when it seeks a second opinion on a significant accounting issue. Audit committees should oversee the quarterly reporting process. Finally, the chairman of the audit committee should write a letter describing the committee's activities and responsibilities for inclusion in the annual report to stockholders.

The Commission developed this set of recommended audit committee duties and responsibilities from a review and consideration of the practices many well-managed companies follow today, of the extensive guidance the public accounting and legal professions have published on the subject, and of practices suggested by the results of the Commission's research projects, and by presentations made to the Commission. The Commission believes that more detailed delineation and description of responsibilities is best left to the discretion of management and the board of directors to tailor to the needs and circumstances of each company. In the course of its research and deliberations, however, the Commission has identified additional, more specific practices and procedures that can help audit committees perform their oversight role effectively. The Commission is not prescribing these additional measures, and therefore has not included them as recommendations, but offers this guidance in the form of the following Good Practice Guidelines, which companies can consider within the exercise of their
judgment. To companies that already have audit committees, the guidelines will serve as a standard for review and assessment. Other companies - those just establishing audit committees or those seeking to improve their committees’ effectiveness - may find them to be helpful in suggesting practical ways for audit committees to discharge their responsibilities.

**General Guidelines**

- **Size and Term of Appointment.** An audit committee normally should consist of not fewer than three independent directors. The maximum size may vary, but the committee should be small enough so that each member is an active participant. The term of appointment is at the discretion of the board of directors, but it is desirable to have terms arranged to maintain continuity while bringing fresh perspectives to the work of the committee.

- **Meetings.** The committee should meet on a regular basis and special meetings should be called as circumstances require. The committee should meet privately with the internal auditor and the independent public accountant.

- **Reporting to the Board of Directors.** The committee should report its activities to the full board on a regular basis, such as after each meeting, so that the board is kept informed of its activities on a current basis.

- **Expand Knowledge of Company Operations.** A systematic and continuing learning process for audit committee members will increase their effectiveness. One way is to review various financial aspects of the company on a planned basis.

- **Company Counsel.** The committee should meet regularly with the company's general counsel, and outside counsel when appropriate, to discuss legal matters that may have a significant impact on the company's financial statements. In a number of companies the general counsel and/or outside counsel attend meetings.

- **Audit Plans.** The committee should review with the chief internal auditor and the independent public accountant their annual audit plans, including the degree of coordination of the respective plans. The committee should inquire as to the extent to which the planned audit scope can be relied upon to detect fraud or weaknesses in internal controls.

- **Electronic Data Processing.** The committee should discuss with the internal auditor and the independent public accountant what steps are planned for a review of the company's electronic data processing procedures and controls, and inquire as to the specific security programs to protect against computer fraud or misuse from both within and outside the company.

- **Other Auditors.** The committee should inquire as to the extent to which independent public accountants other than the principal auditor are to be used and understand the rationale for using them. The committee should request that their work be coordinated and that an appropriate review of their work be performed by the principal auditor.

- **Officer Expenses and Perquisites.** The committee should review in-house policies and procedures for regular review of officers' expenses and perquisites, including any use of corporate assets, inquire as to the results of the review, and, if appropriate, review a summarization of the expenses and perquisites of the period under review.
Areas Requiring Special Attention. The committee should instruct the independent public accountant and the internal auditor that the committee expects to be advised if there are any areas that require its special attention.

Selection of an Independent Public Accountant
A primary responsibility of the audit committee should be the selection of an independent public accountant for the company. The actual selection generally is proposed by management, with the audit committee confirming management's selection, and is ratified by the stockholders. Suggested below are a number of considerations that may enter into the decision. There will be variations, of course, including those that depend upon whether the committee is considering management's proposal to retain the present independent public accountants or management's proposal to appoint a new public accounting firm.

Issues related to this audit:
- Opinions on the performance of the public accounting firm by appropriate management and the chief internal auditor
- The proposed audit fee and the independent public accountant's engagement letter; explanations for fee changes
- The expected level of participation by the partner and other management personnel in the audit examination, the mix of skills and experience of the staff, and staff rotation policy
- If a new public accounting firm is being considered, the steps planned to ensure a smooth and effective transition.

Issues related to the firm generally:
- The report of the public accounting firm's latest peer review conducted pursuant to a professional quality control program
- Any significant litigation problems or disciplinary actions by the SEC or others
- The public accounting firm's credentials, capabilities, and reputation and a list of clients in the same industry and geographical area.

Post-Audit Review
- The committee should obtain from management explanations for all significant variances in the financial statements between years. (This review may be performed at a meeting of the entire board.) The committee should consider whether the data are consistent with the Management's Discussion and Analysis (MD&A) section of the annual report.
- The committee should request an explanation from financial management and the independent public accountant of changes in accounting standards or rules promulgated by the Financial Accounting Standards Board, Securities and Exchange Commission or other regulatory bodies, that have an effect on the financial statements.
- The committee should inquire about the existence and substance of any significant accounting accruals, reserves, or estimates made by management that had a material impact on the financial statements.
The committee should inquire of management and the independent public accountant if there were any significant financial reporting issues discussed during the accounting period and if so how they were resolved.

The committee should meet privately with the independent public accountant, to request his opinion on various matters including the quality of financial and accounting personnel and the internal audit staff.

The committee should ask the independent public accountant what his greatest concerns were and if he believes anything else should be discussed with the committee that has not been raised or covered elsewhere.

The committee should review the letter of management representations given to the independent public accountant and inquire whether he encountered any difficulties in obtaining the letter or any specific representations therein.

The committee should discuss with management and the independent public accountant the substance of any significant issues raised by in-house and outside counsel concerning litigation, contingencies, claims or assessments. The committee should understand how such matters are reflected in the company's financial statements.

The committee should determine the open years on federal income tax returns and whether there are any significant items that have been or might be disputed by the IRS, and inquire as to the status of the related tax reserves.

The committee should review with management the MD&A section of the annual report and ask the extent to which the independent public accountant reviewed the MD&A section. The committee should inquire of the independent public accountant if the other sections of the annual report to stockholders are consistent with the information reflected in the financial statements.

The committee and the board of directors should consider whether the independent public accountant should meet with the full board to discuss any matters relative to the financial statements and to answer any questions that other directors may have.
APPENDIX 3. AUDIT COMMITTEE CHARTER

CONTINUOUS ACTIVITIES - GENERAL
1. Provide an open avenue of communication between the independent auditor, Internal Audit, and the Board of Directors.
2. Meet four times per year or more frequently as circumstances require. The Committee may ask members of management or others to attend meetings and provide pertinent information as necessary.
3. Confirm and assure the independence of the independent auditor and the objectivity of the internal auditor.
4. Review with the independent auditor and the Director of Internal Audit the coordination of audit efforts to assure completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.
5. Inquire of management, the independent auditor, and the Director of Internal Audit about significant risks or exposures and assess the steps management has taken to minimize such risk to the AICPA and Related Entities.
6. Consider and review with the independent auditor and the Director of Internal Audit:
   (a) The adequacy of AICPA’s and Related Entities’ internal controls including computerized information system controls and security.
   (b) Related findings and recommendations of the independent auditor and Internal Audit together with management’s responses.
7. Consider and review with management, the Director of Internal Audit and the independent auditor:
   (a) Significant findings during the year, including the Status of Previous Audit Recommendations.
   (b) Any difficulties encountered in the course of audit work including any restrictions on the scope of activities or access to required information.
   (c) Any changes required in the planned scope of the Internal Audit plan.
   (d) The Internal Audit Department charter, budget and staffing.
8. Meet periodically with the independent auditor, the Director of Internal Audit and management in separate executive sessions to discuss any matters that the Committee or these groups believe should be discussed privately with the Audit Committee.
9. Report periodically to the Board of Directors on significant results of the foregoing activities.
10. Instruct the independent auditor that the Board of Directors, as the members’ representative, is the auditor’s client.

CONTINUOUS ACTIVITIES - RE: REPORTING SPECIFIC POLICIES
1. Advise financial management and the independent auditor they are expected to provide a timely analysis of significant current financial reporting issues and practices.
2. Provide that financial management and the independent auditor discuss with the audit committee their qualitative judgments about the appropriateness, not just the acceptability, of accounting principles and financial disclosure practices used or proposed

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1 Blue Ribbon Committee (1999), Appendix C, pp. 56-59. Reprinted by the Blue Ribbon Committee with the permission of the American Institute of Certified Public Accountants.
to be adopted by the Institute and, particularly, about the degree of aggressiveness or conservatism of its accounting principles and underlying estimates.

3. Inquire as to the auditor’s independent qualitative judgments about the appropriateness, not just the acceptability, of the accounting principles and the clarity of the financial disclosure practices used or proposed to be adopted by the Institute.

4. Inquire as to the auditor’s views about whether management’s choices of accounting principles are conservative, moderate, or aggressive from the perspective of income, asset, and liability recognition, and whether those principles are common practices or are minority practices.

5. Determine, as regards to new transactions or events, the auditor’s reasoning for the appropriateness of the accounting principles and disclosure practices adopted by management.

6. Assure that the auditor’s reasoning is described in determining the appropriateness of changes in accounting principles and disclosure practices.

7. Inquire as to the auditor’s views about how the Institute’s choices of accounting principles and disclosure practices may affect members and public views and attitudes about the Institute.

**SCHEDULED ACTIVITIES**

1. Recommend the selection of the independent auditor for approval by the Board of Directors and election by Council, approve and compensation of the independent auditor, and review and approve the discharge of the independent auditor.

2. Consider, in consultation with the independent auditor and the Director of Internal Audit, the audit scope and plan of the independent auditor and the internal auditors.

3. Review with management and the independent auditor the results of annual audits and related comments in consultation with the Finance Committee and other committees as deemed appropriate including:
   (a) The independent auditor’s audit of the AICPA’s and Related Entities’ annual financial statements, accompanying footnotes and its report thereon.
   (b) Any significant changes required in the independent auditor’s audit plans.
   (c) Any difficulties or disputes with management encountered during the course of the audit.
   (d) Other matters related to the conduct of the audit which are to be communicated to the Audit Committee under Generally Accepted Auditing Standards.

4. Review the results of the annual audits of member reimbursements, director and officers’ expense accounts and management perquisites prepared by Internal Audit and the independent auditor respectively.

5. Review annually with the independent auditor and the Director of Internal Audit the results of the monitoring of compliance with the Institute’s code of conduct.

6. Describe in the AICPA’s Annual Report the Committee’s composition and responsibilities, and how they were discharged.

7. Arrange for the independent auditor to be available to the full Board of Directors at least annually to help provide a basis for the board to recommend to Council the appointment of the auditor.
8. Assure that the auditor’s reasoning is described in accepting or questioning significant estimates by management.
9. Review and update the Committee’s Charter annually.

“WHEN NECESSARY” ACTIVITIES
1. Review and concur in the appointment, replacement, reassignment, or dismissal of the Director of Internal Audit.
2. Review and approve requests for any management consulting engagement to be performed by the Institute’s independent auditor and be advised of any other study undertaken at the request of management that is beyond the scope of the audit engagement letter.
3. Review periodically with general counsel legal and regulatory matters that may have a material impact on the AICPA’s and Related Entities’ financial statements, compliance policies and programs.
4. Conduct or authorize investigations into any matters within the Committee’s scope of responsibilities. The Committees shall be empowered to retain independent counsel and other professionals to assist in the conduct of any investigation.
APPENDIX 4.

Audit Committee Charter Matrix

INSTRUCTIONS FOR USING THIS TOOL: Preparing an Audit Committee charter is often referred to as a best practice, and is actually required for many public companies. However, the charter is often prepared and forgotten except for its annual review. This tool is designed to help audit committees make the charter a living document, and use it to manage the agenda. This tool is meant as a sample. Users of the tool should put their own charter in the first column, and use this example as a guide for defining the steps to accomplish each objective, the associated performance measure, and the scheduling. The Audit Committee charter presented here (first column) is based on one from a real company, and in some places goes beyond the requirements of the Sarbanes-Oxley Act of 2002 (the Act) and stock exchange requirements. This is by the choice of the company in question, and may be considered a good practice.
Audit Committee Charter Matrix
For the Year Ending: __________

<table>
<thead>
<tr>
<th>Audit Committee Charter</th>
<th>Steps to Accomplish the Objective</th>
<th>Deliverable</th>
<th>When to Achieve (Frequency Due Date)</th>
<th>Date Completed</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Each member of the Audit Committee shall be a member of the board of directors, in good standing, and shall be independent in order to serve on this committee.</td>
<td>Test for independence, based on the regulations under the Act and any other regulations that may be operative.</td>
<td>Indicate in the Audit Committee minutes whenever a new member is appointed; acknowledge that independence has been verified.</td>
<td>Affirm annually or whenever a change in status by any Audit Committee member occurs.</td>
<td>Completed</td>
</tr>
<tr>
<td>2. At least one member of the Audit Committee shall be designated as a financial expert. (See the tool “Audit Committee Financial Expert Decision Tree” in this toolkit.)</td>
<td>Ascertain that at least one member of the audit committee meets the requirements of a financial expert under the regulations of the Act.</td>
<td>Indicate in Audit Committee meeting minutes which member of the audit committee is designated as the financial expert.</td>
<td>Affirm annually, unless there is a change in status.</td>
<td>Completed</td>
</tr>
<tr>
<td>3. Review the Committee’s charter annually, reassess the adequacy of this charter, and recommend any proposed changes to the board of directors. Consider changes that are necessary as a result of new laws or regulations.</td>
<td>Review the charter each year. Assess the appropriateness of each point in the charter in light of the previous year’s experience. Assess the completeness of the charter in light of new best practices and new legal or regulatory requirements.</td>
<td>Report to the board on the appropriateness of the Audit Committee charter and any revisions recommended</td>
<td>Review annually, unless changes are needed during the course of the year.</td>
<td>Completed</td>
</tr>
<tr>
<td>Audit Committee Charter</td>
<td>Steps to Accomplish the Objective</td>
<td>When to Achieve (Frequency Due Date)</td>
<td>Date Completed</td>
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</tr>
<tr>
<td>4. The Audit Committee shall meet at least four times per year, and each time the company proposes to issue a press release with its quarterly or annual earnings information. These meetings may be combined with regularly scheduled meetings, or more frequently as circumstances may require. The Audit Committee may ask members of management or others to attend the meetings and provide pertinent information as necessary.</td>
<td>In-person meetings should be held at least once each quarter. All members are expected to attend each meeting in person, via telephone conference or videoconference. Telephone conference meetings may be held more frequently. The agendas for meetings should be prepared and provided to members in advance, along with appropriate briefing materials.</td>
<td>Prepare minutes that document decisions made and action steps following meetings and review for approval. Meeting minutes should be filed with the board of directors.</td>
<td>Minutes should be distributed as soon as possible but no later than prior to the next meeting.</td>
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<td>5. Conduct executive sessions with the outside auditors, CEO (chief executive officer), CFO (chief financial officer), chief audit executive (CAE), general counsel, outside counsel, director of financial reporting, controller, and anyone else as desired by the committee.</td>
<td>Establish these sessions in conjunction with quarterly meetings or as necessary. (See the tool &quot;Conducting an Audit Committee Executive Session: Guidelines and Questions,&quot; in this toolkit.)</td>
<td>Develop action steps to be taken, if appropriate.</td>
<td>Review quarterly, and as necessary.</td>
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<td>6. The Audit Committee shall be authorized to hire outside counsel or other consultants as necessary. (This may take place any time during the year.) (See the tool &quot;Engaging Independent Counsel and Other Advisers,&quot; in this toolkit.)</td>
<td>A budget should be established for this purpose. Requests for proposals (RFPs) should be used if time permits.</td>
<td>Report submitted by outside counsel or consultant.</td>
<td>Review as needed.</td>
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<td>Audit Committee Charter</td>
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<td>7. Review and concur in the appointment, replacement, reassignment, or dismissal of the CAE. (See the tool &quot;Guidelines for Hiring the Chief Audit Executive,&quot; in this toolkit.)</td>
<td>Meet in executive session at each meeting with the CAE. Hold special meetings as may be necessary to address appointment, reassignment, or dismissal of CAE. The audit committee chair should be available if any unforeseen issues arise between meetings relating to the CAE. Meet at least once annually with other members of executive management and the external auditors to discuss the performance of CAE. Discuss job satisfaction and other employment issues with the CAE.</td>
<td>Report to the full board on the performance of the CAE including the effectiveness of the internal audit function. Conduct ongoing reviews, as changes can be made at any time during the year.</td>
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<td>Audit Committee Charter</td>
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<td>8. Appoint the independent auditors to be engaged by the company, establish the audit fees of the independent auditors, pre-approve any non-audit services provided by the independent auditors, including tax services, before the services are rendered. Review and evaluate the performance of the independent auditors and review with the full board of directors any proposed discharge of the independent auditors. (See the tools: “Sample Request for Proposal Letter for CPA Services (Public Company),” “Sample Request for Proposal Letter for CPA Services (Nonpublic Organization),” and “Peer Review of CPA Firms: An Overview,” in this toolkit.)</td>
<td>At least once each year, discuss each of these items with management, the CAE, and the board of directors. Review total audit fee in relation to any non-audit services being provided by the independent auditor. Discuss the Audit Committee’s review of the independent auditors with the board of directors. Ascertain that the independent auditors do not perform any nonaudit service that is prohibited by Section 201 of the Sarbanes-Oxley Act of 2002.</td>
<td>Report and recommend on the performance and fees paid to the independent auditors. Review the scope of all services provided by the independent audit firm throughout the organization.</td>
<td>Review soon after year-end, so that the recommendation for the appointment of the outside auditor can be included in the proxy statement.</td>
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<td>9. Ascertain that the lead (or concurring) audit partner from any public accounting firms performing audit services, serves in that capacity for no more than five fiscal years of the company. In addition, ascertain that any partner other than the lead or concurring partner serves no more than seven years at the partner level on the company’s audit.</td>
<td>Establish when the five-year limit will be reached for the current lead partner. At least a year prior to that time, discuss transition plans for the new lead partner.</td>
<td>Document these discussions in Audit Committee meeting minutes</td>
<td>Review annually with the independent auditors.</td>
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<td>Audit Committee Charter</td>
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<td>10. Review with management the policies and procedures with respect to officers’ expense accounts and perquisites, including their use of corporate assets, and consider the results of any review of these areas by the internal auditor or the independent auditors.</td>
<td>Review policies and procedures annually. Discuss with chief audit executive the need for testing by either the internal auditors, independent auditors, or other parties. Report issues, if any, to the board.</td>
<td>Review policies and procedures at the second quarterly meeting and discuss audit plan. Review any significant findings as they arise.</td>
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<td>11. Consider, with management, the rationale for employing audit firms other than the principal independent auditors.</td>
<td>Establish a policy for the Audit Committee to pre-approve engaging auditors other than the principal independent auditors. Use RFPs for engaging auditors or other professionals for nonaudit, or other services that the auditor cannot perform. Review compliance with the policy by management. (See the tools “Sample Request for Proposal Letter for CPA Services (Public Company),” and “Sample Request for Proposal Letter for CPA Services (Nonpublic Organization)” in this toolkit.)</td>
<td>Document auditor selection criteria. Also, use a decision matrix to evaluate and document external auditor selection. Prepare an engagement letter for each engagement.</td>
<td>Continually review the policy and compliance with it. Other auditors may need to be hired at any point during the year.</td>
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<td>12. Inquire of management, the CAE, and the independent auditors about significant risks or exposures facing the company; assess the steps management has taken or proposes to take to minimize such risks to the company; and periodically review compliance with such steps.</td>
<td>Create a portfolio that documents the material risks that the company faces. Update as events occur. Review with management and the CAE quarterly or sooner if necessary, to make sure it is up-to-date.</td>
<td>Submit a risk report including mitigation strategies and quantifiable risks and insurance to cover such risks, e.g., loss of business.</td>
<td>Review at least once each year, and more frequently if necessary.</td>
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<td>13. Review with the independent auditor, the controller of the company, and the CAE, the audit scope and plan of the internal auditors and the independent auditors. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.</td>
<td>Meet with independent audit partner, the controller and CAE to discuss scope of the previous year’s audit, and lessons learned. Later, discuss planned scope for audit of current year.</td>
<td>Document the meeting in the Audit Committee meeting minutes.</td>
<td>At the second quarter meeting each year, review the scope of the previous year’s audit, and the inter-relationship between the internal and external auditors with respect to the scope of the independent auditors’ work. At the third quarter meeting each year, review the plans for the audit of the current year.</td>
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<td>14. Review with management and the CAE: • Significant findings on internal audits during the year and management’s responses thereto • Any difficulties the internal audit team encountered in the course of their audits, including any restrictions on the scope of their work or access to required information • Any changes required in the scope of their internal audit</td>
<td>Review reports of all internal audits from the preceding 12 months and planned for the upcoming six months along with the status of each planned audit. Review and discuss the findings for each audit completed since the prior meeting, and management’s response to the report. Discuss internal audit department budget and staffing with CAE.</td>
<td>Report on the status of all internal audits planned for the next quarter and/or year.</td>
<td>Review at each meeting.</td>
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| • The internal auditing department budget and staffing  
  • The internal auditing department charter  
  • Internal auditing’s compliance with the Institute of Internal Auditors’ (IIA’s) Standards for the Professional Practice of Internal Auditing (Standards) | Discuss internal audit’s compliance with IIA Standards, including the requirement for a peer review once every five years. | | | |
| 15. Inquire of the CEO and CFO regarding the “quality of earnings” of the company from a subjective as well as an objective standpoint. | Discuss “quality of earnings” with the CEO, CFO, and other executives. Identify any issues addressed, and their resolution. | Include in agenda for executive sessions. (See the tool “Conducting an Audit Committee Executive Session: Guidelines and Questions,” in this toolkit.) | Review, as necessary, but at least annually. | |
| 16. Review with the independent accountants and the CAE:  
  • The adequacy of the company’s internal controls including computerized information system controls and security | Review the reports of the internal audit team for all audits completed since the prior Audit Committee meeting.  
  Review key internal controls with the CAE, and understand how these controls will be tested during the year. | Report to the board on issues relating to internal controls, with emphasis on management’s ability to override and related monitoring and testing. | Submit a comprehensive report to the board at the second quarter meeting each year.  
  Update on anything new, or any changes to the internal control system, at every meeting. | |
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<td>• Any related significant findings and recommendations of the independent auditors and internal audit services together with management’s responses thereto (See the tools &quot;Internal Control: A Tool for the Audit Committee,&quot; and &quot;Fraud and the Responsibilities of the Audit Committee: An Overview&quot; in this toolkit.)</td>
<td>Review these plans with the independent auditor to understand their scope with respect to key controls. Review with the CAE the plans for audits of other elements of the control environment. Determine that all internal control weaknesses are quantified, reviewed, and addressed.</td>
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<td>17. Review with management and the independent auditor the effect of any regulatory and accounting initiatives, as well as off-balance-sheet structures, if any. (See the tool &quot;Management’s Summary of Off-Balance-Sheet Transactions,&quot; in this toolkit.)</td>
<td>Independently, through professional reading and CPE, keep up-to-date on new developments related to the industry, and the environment in which the company operates, including any regulatory requirements it may be subject to. Discuss with management and the independent auditors in meetings.</td>
<td>Record discussion and any action steps in Audit Committee meeting minutes.</td>
<td>Review as necessary.</td>
</tr>
<tr>
<td>18. Review with management, the independent auditors, and the CAE, the interim annual financial report before it is filed with the Securities and Exchange Commission (SEC) or other regulators.</td>
<td>At a minimum, meet by telephone prior to any earnings release (annual or quarterly) and any SEC filings such as 10-K, 10-Q, 8-K.</td>
<td>Audit Committee approval of the press release, and/or SEC filings.</td>
<td>Review each quarter and as needed.</td>
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<td>Audit Committee Charter</td>
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| 19. Review with each public accounting firm that performs an audit:  
  - All critical accounting policies and practices used by the company.  
  - All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management of the company, the ramifications of each alternative, and the treatment preferred by the company.  
  (See the tool "Issues Report from Management" in this toolkit.) | Discuss each matter, and related matters that may come to the attention of the Audit Committee and/or the independent auditors through this process.  
  Create an action plan and follow-up plan as necessary. | Submit reports and documentation of discussions and resolution of disagreements. | Review, at least annually, and/or in conjunction with the year-end audit. |
<p>| 20. Review all material written communications between the independent auditors and management, such as any management letter or schedule of unadjusted differences. | Discuss each item with the independent auditors and management (including the CAE) and conclude on the appropriateness of the proposed resolution. | Submit reports and documentation of discussions, resolution of issues, and the action plan for any items requiring follow-up and monitoring. | Review, at the completion of the independent audit. |</p>
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| 21. Review with management and the independent auditors:  
  - The company’s annual financial statements and related footnotes  
  - The independent auditors’ audit of the financial statements and their report thereon  
  - The independent auditors’ judgments about the quality, not just the acceptability, of the company’s accounting principles as applied in its financial reporting  
  - Any significant changes required in the independent auditors’ audit plan  
  - Any serious difficulties or disputes with management encountered during the audit  
  - Matters required to be discussed by Statement on Auditing Standards (SAS) No. 61, Communication With Audit Committees (AICPA, Professional Standards, vol. 1, AU sec. 380), as amended, related to the conduct of the audit. | Discuss each matter, and others that may come to the attention of the audit committee through this process, with management (including the CAE) and the independent auditors.  
Review with management the course of action to be taken for any action requiring follow-up.  
Monitor any follow-up action that requires continued audit committee intervention.  
(See the tool “Discussions to Expect from the Independent Auditor,” in this toolkit.) | Submit reports and documentation of discussions, resolution of disagreements, or action plan for any item requiring follow-up. | Review at the completion of the independent audit. |
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<th>Audit Committee Charter</th>
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<td>22. Review with the general counsel and the CAE legal and regulatory matters that, in the opinion of management, may have a material impact on the financial statements, related company compliance policies, and programs and reports received from regulators.</td>
<td>Discuss whether the company is in compliance with laws and regulations that govern the environment(s) and industry(ies) in which it operates, as well as other applicable laws and regulations.</td>
<td>Report to the board that the review has taken place and any matters that need to be brought to its attention.</td>
<td>Review at each meeting.</td>
</tr>
<tr>
<td>23. Periodically review the company’s code of conduct to ensure that it is adequate and up-to-date. Review with the CAE and the company’s general counsel the results of their review of the monitoring of compliance with the company’s code of conduct.</td>
<td>Review results with the CAE and general counsel. Consider any adjustments that may be necessary to the company’s code of conduct. Consider steps that may need to be taken to ensure that compliance is at the highest possible level.</td>
<td>Report to the board that the review of the code of conduct was done. Recommend changes to the code of conduct to the board as needed.</td>
<td>Review annually at the fourth quarter meeting. Review any significant findings as they arise.</td>
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<td>24. Review the procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters that may be submitted by any party internal or external to the organization. Review any complaints that might have been received, current status, and resolution if one has been reached.</td>
<td>Review procedures with CAE and the general counsel. Review all complaints that have been received and the status of resolution. Ensure that proper steps are taken to investigate complaints and resolve timely. (See also the tool “Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers)” in this toolkit.)</td>
<td>Review an original of each complaint received, no matter the media used to submit. Discuss the status or resolution of each complaint. Review a cumulative list of complaints submitted to date to review for patterns or other observations.</td>
<td>Review at each meeting.</td>
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<td>Review procedures for the confidential, anonymous submission by employees of the organization of concerns regarding questionable accounting or auditing matters. Review any submissions that have been received, the current status, and the resolution if one has been reached.</td>
<td>Review procedures with the CAE and the general counsel. Review all complaints that have been received and the status of resolution. Ensure that proper steps are taken to investigate complaints and resolve timely.</td>
<td>Review an original of each complaint received no matter the media used to submit. Discuss the status of resolution of each complaint. Review a cumulative list of complaints submitted to date to review for patterns or other observations.</td>
<td>Review at each meeting.</td>
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<td>Review procedures with the CAE and the general counsel. Review all complaints that have been received and the status of resolution. Ensure that proper steps are taken to investigate complaints and resolve timely.</td>
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<td>Monitor developments in the regulatory, legislative, and legal environments and respond to any new requirements as needed.</td>
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<td>Review new business, at all meetings</td>
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<td>Monitor developments in the regulatory, legislative, and legal environments and respond to any new requirements as needed.</td>
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<td>Monitor developments in the regulatory, legislative, and legal environments and respond to any new requirements as needed.</td>
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<td>Use information from executive sessions conducted throughout the year. Use a formal assessment tool for each group. (See the tools &quot;Evaluating the Internal Audit Team: Guidelines and Questions,&quot; and &quot;Evaluating the Independent Auditor: Questions to Consider&quot; in this toolkit.) See also the tool &quot;Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers)&quot; in this toolkit.)</td>
<td>Submit recommendations for change in process and procedures. For independent auditors, request RFPs if changes are being considered.</td>
<td></td>
<td>Review after completion of the annual audit.</td>
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<tr>
<td>Use information from executive sessions conducted throughout the year. Use a formal assessment tool for each group. (See the tools &quot;Evaluating the Internal Audit Team: Guidelines and Questions,&quot; and &quot;Evaluating the Independent Auditor: Questions to Consider&quot; in this toolkit.) See also the tool &quot;Tracking Report: Anonymous Submission of Suspected Wrongdoing (Whistleblowers)&quot; in this toolkit.)</td>
<td>Submit recommendations for change in process and procedures. For independent auditors, request RFPs if changes are being considered.</td>
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<td>Review after completion of the annual audit.</td>
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<td>28. The Audit Committee will review its effectiveness.</td>
<td>The Audit Committee will conduct a self-assessment and 360-degree evaluation of all members. (See the tool &quot;Conducting an Audit Committee Self-Evaluation: Guidelines and Questions,&quot; in this toolkit.)</td>
<td>Discuss recommendations for improving the effectiveness of the Audit Committee with the board of directors (BOD). Record in BOD minutes.</td>
<td>Review annually.</td>
</tr>
<tr>
<td>29. Create an agenda for the ensuing year or review and approve the agenda submitted by the CAE.</td>
<td>Complete the &quot;Audit Committee Charter Matrix.&quot; (Use this tool as a sample, and tailor it to your organization.)</td>
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<td>Review at the fourth quarter meeting for the upcoming year.</td>
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<tr>
<td>30. Oversee the preparation of an annual report of the Audit Committee as required by the rules of the SEC and the annual affirmation required by the appropriate listing exchange, if necessary. When required by SEC rules, include in the annual Proxy Statement for the Company a report of the Committee in accordance with the Proxy Rules promulgated by the SEC.</td>
<td>Review and discuss the report prepared by the CAE.</td>
<td>Annual report finalized and issued per SEC regulations and regulations of the listing exchanges as appropriate.</td>
<td>Review annually at the first quarter meeting.</td>
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APPENDIX 5.

Final Definition of "Audit Committee Financial Expert"

The final rules define an audit committee financial expert as a person who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

Under the final rules, a person must have acquired such attributes through any one or more of the following:

1. Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;

2. Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

3. Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or

4. Other relevant experience.

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Appendix 6.

Skandia Value Scheme

APPENDIX 7.

TECHNOLOGY LICENSE EXAMPLE

CURRENT GAAP STANDARDS

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BALANCE SHEET

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Appendix 8.

Ernst & Young Measures that Matter Sell-Side Analysts Survey

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<th>NON-FINANCIAL FACTORS</th>
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<td>Quality of Employee Training</td>
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<td>Employee Turnover Rates</td>
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<td>Environmental and Social Policies</td>
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<td>Ratio of CEO Compensation to Workforce Compensation</td>
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<td>Knowledge and Experience of Investor Relations Contact</td>
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<td>Product Defect Rates/Service Failure Rates</td>
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<th>LEVEL OF CUSTOMER SATISFACTION</th>
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<td>Quality of Customer Service Department</td>
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Member of Board of Directors & Secretary

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UNIX Systems Group  San Jose, California
Senior Group Finance Manager  1987-1989
Micro Products Group  Corporate Headquarters  Blue Bell, Pennsylvania
Assistant Controller, Finance Manager  1984-1987
Personal Computer and Server Factory  Flemington, New Jersey
Staff Financial Analyst  1983-1984
Business Information Systems Group  Corporate Headquarters  Detroit, Michigan
Mainframe Computer Factory  Downingtown, Pennsylvania

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