

The Complex Relationship between Corporate Management, Stakeholders and Accounting

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Abstract *The purpose of this study is to exam the complexities of corporate governance and how it has changed as a result of Sarbanes Oxley. The convergence of agency theory, stewardship theory, and stakeholder's theory are discussed to determine their influence on corporate governance. Best practices are identified for challenges of compensation committees.*

Key words Corporate management, stakeholders, accounting, information, compensation committee

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1. Introduction

The evolution of corporate governance began from a growing concern of protect the interest of investors. Accountability became the framework to ensure corporations operated with a certain degree of trust. Dragomir's (n.d.) study explained, "Accountability is a means of concretizing relations between institutions, delineating responsibilities, controlling power, enhancing legitimacy, and ultimately promoting democracy." Corporate accountability does not imply the delegation of authority, but a collective group of social norms that puts a wedge between power and abuse. In 1960s, the concept of strong managers and weak owner gave substantial power to managers. Owners of businesses sought to protect their personal assets from being at risk due to business liabilities. Corporations increasingly emerged giving rise to the agency problem.

There are two distinctions of corporate governance: shareholder value maximization and social responsibility. Jensen and Meckling are considered the fathers of scientific corporate governance and postulated the concept of agency theory. The theory applies to relationships in which the principal delegate the responsibility of running the firm to the agent who performs that task (Dragomir, n.d.). Two concerns exist with agency relationships: the agent and the principal might have conflicting goals and it is difficult for the principle to verify the agent's activities; there are different acceptance of risk between the principal and the agent. Agency theory assumes the markets are efficient and stakeholders' interests are satisfied as long as there is an appropriate return on their investment. Freeman provided the initial outline of the concept of stakeholder theory. It is defined as, "Any group or individual that can affect or be affected by the realization of the objectives of the company" (Dragomir, n.d.). Stakeholder theory is more focused on constructing a normative perspective for moral behavior. Stakeholder orientation is comprised of three activities (Ferrel, Fraedrich, Ferrell, 2013, p 35):

1. The organization-wide generation of data about stakeholder groups and assessment of the firm's effectiveness;
2. The distribution of this information throughout the firm;
3. The responsiveness of the organization as a whole to this information.

Due to the limited number of resources, corporations have to establish priorities with stakeholders to cultivate effective long-term relationships.

The economic conditions of the marketplace greatly influence the governance structure of corporations. The changes in industries and priorities of investors have a substantial impact on corporations.

In 1980, the U.S. industry received additional pressure from foreign competition and growth slowed. Jackson's (2010) explained, "Power began to shift substantially toward investors due to the rise of new types of institutional investors and the advent of hostile takeovers." Bank investments shifted their business away from supporting long-term investment through corporate bonds and towards fee-based strategies involving trading in equity. Board of corporations also changed wherein banks played a central role as corporations obtained regulated stock markets. Attention grew towards stock prices and shareholder value. Pay for performance and other equity-based incentives became the new standard for corporations (Jackson's, 2010) study discussed: "As Congress placed legal limits on cash-based compensation during takeovers, equity-based incentives came to constitute a growing proportion of total remuneration. Equity-based incentives were also used to reward managers under leveraged buy-out schemes. Shareholders had no say on pay under corporate law, hence leaving it to the board to influence the size and form of managerial pay schemes. This opened the door for the explosion of managerial compensation in the 1990s."

As a result, the board and managers had limited oversight and could implement some questionable decisions.

A decrease in unionized blue-collar workers was associated with corporate restructuring. Unionization rates dropped from 47.4% of the labor force in 1970 to 27.8% in 1983 and 18.2% in 1994 (Jackson, 2010). Corporations favored downsizing and distributing while increasing dividend pay-out ratios. Corporations implemented share buybacks and while wages for workers shrank. Average factory wages shrank by 5%, CEO pay increased by 415% in the same period (Jackson, 2010).

The evolution of business resulted in enhanced significance on stock evaluation and pay for performance for corporations. This focus has produced managers that will implement questionable measures to generate required performance. Clear examples have been indicated with Enron and Worldcom. Corporate governance will have to develop effective mechanisms to ensure accountability.

2. Substantial failures

Establishing efficient markets has been the goal of the stock market to ensure investor confidence. The success of public companies requires the ability to offer stocks to raise capital for expansion. Unfortunately, several incidents of unethical conduct continue the challenge the efficiency of the stock market. An efficient capital market believes that securities are extremely efficient in reflecting information about individual stocks and about the stock market as a whole (Malkiel, 2003). Therefore, all investors will have the availability of the same information for decision-making. Malkiel's (2003) study explained efficient market hypothesis is associated with the concept of random walk. "The flow of information is unimpeded and information is immediately reflected in stock prices, then tomorrow's price change will reflect only tomorrow's news and will be independent of the price changes today. But news is by definition unpredictable and resulting price changes must be unpredictable and random" (Malkiel, 2003). This concept employs that even the uninformed investors can purchase stock because the stock price is an accurate reflection of value of the company.

2.1 Lessons learnt from Enron

The Enron case challenges several preconceived concepts regarding the reliability of the stock market. Enron produced an organizational culture that promoted high performance at any cost supported by performance equity incentives. This environment resulted in the use of special purpose entities (SPE) for keeping massive debt of the company off of its balance sheet and using equities derivatives to hide illegal transaction. Kranacher's (2006) revealed the complexity embodied in financial accounting standards promoted the endless variety of fraudulent schemes. Enron is a one example of the inefficient market that requires continuous oversight and implementation of new regulations to prevent fraudulent activities.

Enron's board did not provide the essential safeguards to prevent the unfortunate crisis. Corporate boards of director's purpose are to investigate and monitor the decisions of executives to ensure shareholders are protected. Enron's organizational culture established a rubber stamp approach from the board of directors. Trinkaus and Giacalone's (2005) study explained Enron had limited criteria for members to service on the board regarding education and experience. There was no mechanism for terminating ineffective directors and conformity was achieved by raising stock prices. Equity-based compensation was used to by Enron's 17 member board of directors. "It became common practice for Enron employees to partnerships in

many of the multiplicity of Special Purpose Entities” (Trinkaus and Giacalone, 2005). In addition, several of Enron’s board members serviced on different boards in which were led by board members. The provision by Sarbanes-Oxley Act prohibits performance based compensation as a method for paying members of the audit committee.

Employee performance-based compensation also contributed to the Enron crisis. Employees were recruited that displayed certain behavior characteristics of being arrogant, tough and intimidating. These characters were necessary for the performance at any cost environment. Enron was quick to set an example by terminating noncompliant employees. Trinkaus and Giacalone’s (2005) revealed Enron conducted performance evaluation every 6 months and those that ended in the lowest category were put on notice to that they had six months to improve or they will be terminated. The rank and yank culture of Enron promulgated fraudulent activity.

The recognition received for Enron’s innovation and performance continued to justify the management style of the corporation. The lack of a board of directors to scrutinize the use of Special Purpose Entities and focus on stock performance resulted in performance without ethical consideration. A major contributor to the Enron crisis was Arthur Andersen auditing and consultant services which resulted in the conflict of interest. A company of historical significance and performance such as Arthur Andersen presented a challenging role to have an opposition to their credibility of accounting reporting. Arthur Andersen’s consultant services orchestrated the methods for absorbing Enron’s poor fiscal health into Special Purpose Entities. Barefoot’s (2002) study concluded, “The board signed off on increasingly aggressive accounting and financial practices that allegedly overstated earnings. Similarly, it approved extremely generous executive compensation plans.” The acceptance of performance groupthink created an entitlement mentality for employees at Enron. Overall, the crisis produced additional regulations that will make it difficult for future occurrence.

2.2 Lessons learnt from Tyco

The Tyco Company endured significant criticisms from the board of directors preventing the allocation of personal loans to former CEO Dennis Kozlowski and CFO Mark Swartz. Symond (2002) explained, “Dennis Kozlowski was running Tyco like a "private bank" and lavishing hundreds of millions in unauthorized loans and exorbitant gifts on himself and his lieutenants.” In addition, board members lacked vigilance due to receiving consultant fees. For example, lead director Frank Walsh was paid \$20 million for assisting in arranging the acquisition of CIT Group (Symond, 2002). Substantial changes were required to return shareholders confidence including changing board members. In 2002, Ed Breen became the new CEO and created the Senior Vice President of Corporate Governance lead by Eric Pillmore. Breen negotiated the removal of the entry board of directors and 300 members of the corporate team.

Breen sought to develop a corporate governance structure that was able to build confidence among all of the company’s stakeholders. The reform of Tyco’s corporate governance included changes in reporting to the board or board committee (Dittmar, 2007):

- An independent corporate audit function;
- An ombudsman program for impartial dispute resolution;
- Established performance and integrity-related education and training;
- Established values an behaviors-based performance reviews.

The changes proved addition responsibility for the board to become more aware of the company’s financial performance and operational performance. Additional changes included moving the company any from mergers and acquisitions and focusing on operations. Increased attention on corporate culture became essential and training prorogated the creation of an ethical climate. Tyco used their published “Guide to Ethical Conduct” as a key reference to encourage employees to assess real life situations. A confidential hotline was established for employees to raise concerns and ask questions. Overall, Tyco corporate ethics was summarized to three areas: presence of strong leaders, web of accountability, and behavior tracking process (Gerard, 2010).

Under Breen’s leadership, Tyco was able to make a great recovery from a dysfunctional organization. The replacement of the board of directors was necessary to end the perception of corruption. The changes implemented by Breen were effective in challenging how we conceive corporate governance structures. It is clear the board members developed a groupthink mentality and failing to challenge questionable decision-

making. Most of the board members were CEOs or served as CEO which aided in their support for Dennis Kozlowski. I think Tyco does have additional opportunity to create processes for hiring individuals that will be the right fit for their corporate culture.

Breen proposed an innovative solution to a growing problem within corporate organizations. Dittmar's (2007) study explained, "Unfortunately, absent a crisis, companies often find it difficult to make big changes in governance processes and even more difficult to make changes in board make-up." Breen used the crisis to justify the creation of a new position, Senior Vice President of Corporate Governance, to offer additional insight for monitoring and assessing risk beyond financial reporting. A majority of the Tyco's executive management team did lose their position within the company. These employees might had little influence or knowledge of the activities that resulted in exorbitant payments to the CEO. Perhaps more investigation could have occurred to determine if their involvement warranted the lease from the position.

3. Literature review

Corporate governance is an essential component of an organizational structure to protect the interest of stakeholders. The term "nexus of contracts" refers to how an organization prevents agency problems by controlling agents or employees. During the nineteenth and the twentieth centuries, companies grew to enormous size that required additional capital without state ownership. As a result, dispersing ownership among several shareholders became an effective approach to grow continent-wide private companies. Davis' (2005) study explained, "Ownership was centrifugal, whereas management control was centripetal. The outcome of this process was the separation of ownership and control, as dispersed shareholders in large corporations became effectively powerless over the professional managers who ran the firms." Concerns grew for signs of mismanagement that would impact share price and leave the company susceptible to buyout. Companies needed to employ methods to avoid mismanagement by utilizing outsiders to serve on the board of directors, hiring rigorous auditors, and incorporating high quality investor protection. Davis' (2005) concluded, "A view of public corporation as a nexus-of-contracts whose structure is driven by the requirements of financial markets, and thus features of corporation and its surrounding institutions are theorized in terms of their function in directing corporations toward share price as a criterion of value." Financial performance of the corporation has become the source of indication for management outcomes. The use of management contracts is an effective tool to for shareholders to implement course corrections with management to produce designated goals. This correlates with agency theory for aligning the principle and the agents to focus on financial performance.

3.1 Agency theory

Agency theory explains the relationship between the board of directors and the shareholders to develop a common interest to maximize the profitability of the company. There are times when a conflict occurs between the managerial agents and the shareholder principals. Mechanisms are required to reduce the agent's interests from conflicting with principal's interests. Verret's (2010) study discussed, "In order to maintain capital flows, manager agent will incur bonding costs to assure principals and principals will incur monitoring costs to minimize instances of agents; abusing their authority over the principals' capital." The relevance of the nexus-of-contract provides opportunity to migrate risk to shareholders. David's (2003) study postulated that a firm is a nexus for a set of contracting relationships among individuals. These contracts provide centralized contractual structures that can enhance the efficiency and transparency of corporations. Two key areas of insight that are influenced by the concept of the nexus-of-contacts on agency theory include: agency cost and debt to equity ratio. Agency cost depends upon the cost of measuring the manager's performance and evaluation. The cost correlates with the owner's welfare and compensation to manager and enforcing specific behavior. The debt to equity ratio reflects the agency costs of monitoring the firm's managers (Verret, 2010). A contractual approach ensures a corporation has an effective method to monitor individuals and progress the corporation toward its goals.

3.2 Nexus of contracts

The nexus-of contracts provides a covenant among individuals to act in the best interest of shareholders. The concept is important to corporate governance because it clearly tackles the issue of self-

interest. Most importantly, it provides legal liability to agents for their actions. Noorderhaven's (1992) study elucidated the execution of task designated by the principal contract involves decision-making by the agent. The agent is compensated by pay-off of the task outlined by the contract between the principal and the agent. The agent has a range of options to maximize shareholders profits. According to agency theory, "The organization is the product of the rational action of parties to maximize their individual utility by concluding agreements concerning the execution of a certain risk" (Noorderhaven, 1992). There is an area of volunteer exchange for the agent to select the course of action that maximizes their utility. The nature of the contract does offer constraints and implies all parties have a certain degree of obligation. Noorderhaven's (1992) study reveal, "Institutional trust builds a generalized source of obligation based on factors other than the personality traits of the other party. Corporate governance offers formal norms for performance expectations and methods of sanctions for individual failures.

Although contracts have been an effective tool to control manager's behavior, there continues to be examples of self-interest decision-making by managers. Corporations have adjusted CEO compensation as an attempt to reduce unethical behavior. The increased performance expectations of corporations have resulted in managers implementing questionable decisions to increase profitability. In today's corporate environment, employee wages are a topic of growing concern with corporation restricting employee contribution and progressing more towards automation of employees' positions. For example, the fast food industry is enduring with several employee strikes regarding livable wages increase by employees. Although wage increase is well justified for employees, shareholders are expecting increased economic performance of these corporations. Shareholders are less likely to accept a reduction in stock performance to grant increased wages for employees. It is expected increased automation will occur in the future to reduce the dependency of allocation of wages.

3.3 Stewardship theory

The concept of stewardship has been used to describe the management function of corporations. It relates to Maslow's hierarchy of need theory of belonging and self-actualization of individuals. By nature, people desire to be a part of a team that will obtain specific achievements. Hernandez's (2012) study discussed stewardship is an ongoing sense of obligation or duty to others based on the intention to uphold the covenantal relationship. Therefore, stewardship can be defined as the extent to which an individual is willing to subordinate his or her personal interest to act in protection of others' long-term welfare (Hernandez, 2012). This behavior characteristic of an individual has the proclivity to be prosocial active and can have a positive impact on others in both formal and informal positions. Two distinct psychological mechanisms are the result of stewardship:

- The individual has other-regarding perspective and a long-term orientation for decision-making that preserves collective resources.
- An affective sense of connections with others that compels beneficiaries of their decisions.

Another distinct element of stewardship is the behavior can occur outside of social dilemma. Group think and collective self-interest decisions that hinder the long-term productivity of a firm is avoided. Stewardship sense of multiple obligations for stakeholders affects the willingness to implement decision for personal gain.

Stewardship and agency theory have different perspectives regarding control structure and rewards for employees. Agency theory is concerned with reducing risk to shareholders by implementing monitoring mechanisms. Hernandez's (2012) study revealed agency theorists proposed a model of governance that constrains employee behavior through the rules and regulations imposed by the organization, stewardship theorists have put forth a model of governance that promotes the ability of employees to contribute to strategic objectives and to make decisions. In addition, agency theory is focused on appealing to extrinsic rewards with monetary incentives of salary, bonuses, and stock options. Stewardship theory is focused on intrinsic rewards of leadership, autonomy, responsibility, and collaboration. Specifically, rewards systems are linked to cultivating employees' self-efficacy and self-determination through developmental opportunities and challenging projects. Self-efficacy is defined as the belief in one's capabilities to perform specified tasks and self-determination is a sense of choice in initiating and regulating one's own actions (Hernandez, 2012).

Overall, the difference between agency theory and stewardship theory is responding to individual motivation and establish an organizational structure that guides individual towards achieving organizational goals.

3.4 Stakeholder theory

Stakeholder theory has evolved to be a concept that supports corporate social responsibility of corporate governance. Nordberg's (2008) study defined stakeholders as any group or individual who can affect, or is affected by the achievement of a corporation's purpose. This comprise of employees, suppliers, shareholders, the community in which it operates and the environment. Stakeholder theory does not draw a distinction among the different parties that have a stake in the corporation. Shareholders are one of several entities that are considered in the corporations objectives. Nordberg's (2008) study revealed, "The argument against stakeholder theory is that shareholders have their entire investment at risk, while suppliers, customers, and employees in general receive benefits from the corporation contemporaneously, and enjoy the added protection of prior standing in contract if things go wrong." This concept refers to corporations as contractual entities and can become burden by contracts which alter their premise of being profitable.

Stakeholders' theory embraces a holistic approach towards business operations and the greater impact on society. Agency theory lacks the consideration beyond shareholders' interests. Nordberg's (2008) concluded stakeholder theory struggles with determining difference between means and ends and is not goal specific. Agency theory does offer a narrow focus for determining a solution to preventing the diverting of corporate funds for private purposes.

It is clear that shareholder value will remain a primary concern for corporations. Stewardship theory offers a greater perspective for explaining why individuals continue to serve on boards of directors with the increased legal consequences and offers guidance for making questionable decisions. Stakeholder theory should collectively prevent incidents of unethical behavior. However, in the Enron case stakeholder silence became a part of their culture. According to Trinkaus and Giacalone's (2005) study, "Enron did its best to insure itself against disparagers from within who feel a need to expose companies practices by covertly bringing on board only those having a high sense of obedience, loyalty, and confidentially." Overall agency theory provides the most credible due to the complexity of human nature. A collective theoretical approach is necessary for effective corporate governance.

4. Sarbanes Oxley (SOX)

The enactment of Sarbanes Oxley (SOX) posed to increase the internal controls and monitoring of public companies. The regulation was enacted after the collapse of Enron and Worldcom that was designed to return confidence to shareholders. Carter, Lynch, Zechman (2005) explained SOX requires principal executives and financial officers to have the primary responsibility for the integrity of the financial reports. Section 302 of the SOX obligates principal executives to certify that financial statements are not misleading. In addition, principal executives are required to reimburse the company for bonuses received if the company has to restate earnings (Carter, Lynch, Zechman, 2005). SOX enhanced the responsibility for principal executives to ensure financial statements are accurate. Before the SOX, principal executives received performance-based bonuses that encourage accrual accounting reporting. Post SOX has encouraged more corporations to decline from performance-incentives and increase in fixed compensation.

Determining appropriate executive compensation is a challenging process because of the differences in industries and markets that require unique decision-making by executives. Historically, principal executive pay has been determined by the board which has a fiduciary responsibility to shareholders. The regulations provide by SOX did offer some necessary restrictions however, the financial crisis in 2008 exhibited questionable behavior by executives for compensation. While the country was in financial crisis and the government issued Troubled Asset Relied Program (TARP) to financial institutions, executives received bonuses with tax contributions. The Dodd-Frank Wall Street and Consumer Protect Act in 2010 authorized financial regulators to prohibit compensation practices that encouraged inappropriate risk taking (Brown, n.d.). In addition, the Dodd-Frank Act required public companies to employ compensation committees consisting of independent directors and gave shareholders advisory vote on compensation payment to principal executives (Brown, n.d.). This regulation offers shareholders some opportunity to interject their point of view.

5. IT issues

There has been substantial change in how firms operate in today's marketplace. Much of it is due to the increased capability of technology to streamline business operations and efficiencies. Thomas Friedman's book (*The World is Flat*) described the primary changes in the 21st century that has contributed to increased competition and a leveling playing field among firms. Wal-Mart has become the world's expert in using technology to streamline sales, distribution, and shipping. Due to firm's dependency on the abilities of supplies, suppliers have become strategic partners for firms to achieve performance goals. Lavie, Haunschild, Khanna's (2012) study explained, "Alliances are voluntary arrangements among independent firms that exchange or share resources for the co-development or provision of products and services. They offer potential benefits, yet most of them fail to meet their objectives, terminate prematurely, or perform unsatisfactorily." These alliances have the proclivity to exemplify challenges as a result of different corporate cultures, misunderstanding of communications, and operational differences.

Establishing mutual trust becomes essential for strategic alliances to share resources and information to complete collective objectives. "Mutual trust refers to the confidence that each party will fulfil its obligations and behave as expected" (Lavie, Haunschild, Khanna, 2012). Technology has increased the ability of firms to share information but also offers opportunity for unwanted information to be accessed. Bart and Turel's (2010) study defined, "IT governance is the responsibility of the board of directors and executive management. It is an integral part of enterprise governance and consists of the leadership and organizational structures and processes that ensure the organization's IT sustains and extends the organization's strategies and objectives." Figure 1 illustrates the contingency based model of IT by Nolan and McFarlan for firms to utilize IT for both defensive and offensive strategies. IT governances offers three main areas of focus for firms by migrating risk, strategic oversight of performance, and control of the flow of information.

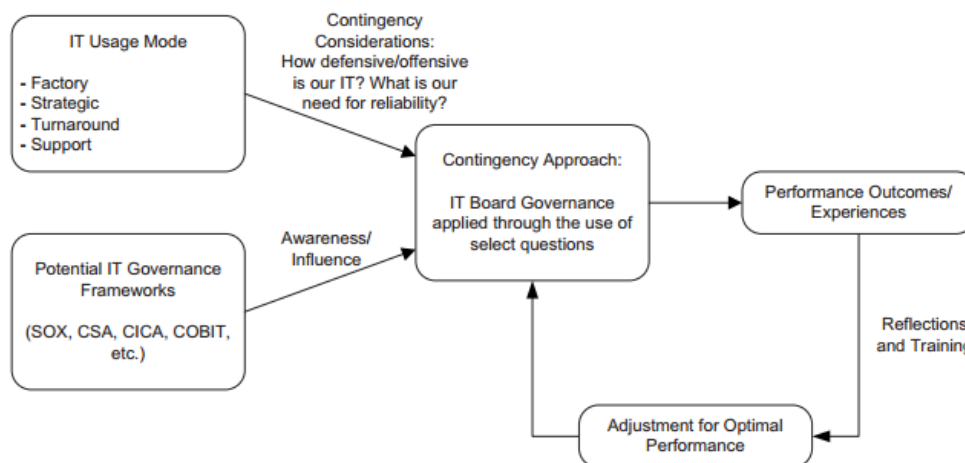


Figure 1. A contingency-based model of IT governance by board members using the Nolan and McFarlan Strategic Grid

The integration of technology has become an essential component for understanding business operations. Best practices suggest the board of directors to establish an IT committee that continuously monitor internal risk and drive compliance. IT governance offers the following benefits ("Holistic management", 2007):

- Improving the clarity of their current overall governance model;
- Defining and executing specific operational and tactical activities;
- Enhancing performance management and measurement;
- Automating some of the data gathering and reporting to support IT governance processes;
- Sustaining the drive for improvement; and
- Ongoing communication and monitoring.

Having a board level IT committee will enhance the competitiveness of the firm to achieve performance objectives.

6. Best practices for a compensation committee

Principal executive compensation receives significant scrutiny by the public for the ratio of pay difference between the average employees. Compensation committees are established to ensure profitability and attract the greatest talent to accomplish the company's objectives. Hermanson, Tompkins, Veliyath, and Ye's (2012) study discussed the following comment from a NYSE compensation committee member: "Top management compensation has gotten out of control. It's difficult to put the genie back in the bottle because boards are also afraid of losing talented CEOs, and if the CEO does not leave, they get mad and that is not good either. Another problem is that consultants provide consistently escalating pay advice. Consultants do not take steps to provide data on how the pie is shared between management and shareholders."

There are certain theoretical references for compensation committees. Institutional theory considers businesses are composed of rules, regulations and standards of professional norms that model successful businesses. Overtime, institutional pressure result in conformity and compensation committees would be focused on fulfill normative requirements. Resource dependence theory would result in a compensation committee that is seeking talent to obtain resources for the corporation. The company's strategic objectives would provide substantial consideration for the compensation committee. Agency theory would establish a compensation committee that has a great concern for monitoring of management and ensure executives are not opportunistic. These different theoretical approaches explain the challenges of compensation committees. Reda's (2000) study revealed six major areas of concern for compensation committee:

- Adhere to good corporate governance principles;
- Know the big picture;
- How much compensation is enough;
- Review programs from the shareholder's perspective;
- Review of complex plans and programs;
- Review of controversial plans and programs.

These areas require talented individuals to resolve complicated issues in an uncertain business environment.

One of the best practices for compensation committee is to know the strategic objectives of the corporation. This includes being aware of shareholders value and ensure shareholder dilution does not occur. Reda's (2000) study concluded, "Do not let the outside or inside legal advisor or compensation consultant take over the writing of the compensation committee report." It is essential for the committee to take ownership of the process and address shareholders' concerns. Overall, the compensation committee has a major impact in influencing the performance of the company.

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