THE CHANGING ROLE AND RESPONSIBILITIES OF AUDIT COMMITTEES
IN THE UNITED STATES
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The corporate form that developed in the early 20th century created enormous pressure for corporate governance mechanisms to curb the power of corporate managers. Berle and Means, legal pluralists, warned about concentrating economic power in the hands of a small but powerful class of professional managers. They claimed this "new form of absolutism" required governmental oversight and viewed boards of directors as part of management, rather than monitors for shareholders.

The Securities and Exchange Commission (SEC) proposed that corporations establish a special board committee, made up of "nonofficer members" in response to the McKesson & Robbins scandal of the late 1930s. My dissertation examines the evolution of the U.S. corporate audit committee through three specific time periods: (1) 1920–1954; (2) 1955–1986; and (3) 1987 to the passage of the Sarbanes-Oxley Act of 2002. My purpose is to determine if evolution of the audit committee throughout these periods has been a reform continually couched in symbolism or whether the audit committee concept has evolved into real reform, allowing proper corporate governance and mitigation of unchecked corporate power.

My analysis is a traditional empirical analysis, relying on both primary and secondary sources to develop a coherent ordering of facts. I use narrative in a narrow sense as my historical methodology, examining patterns that emerge and interpreting facts to develop a clear understanding of demands for and uses of audit committees. I
use a holistic approach in studying the data, using narrative to show how these patterns ensue from the historical data.
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CHAPTER I
INTRODUCTION

I examine the role that audit committees have had in legitimating private property rights and ensuring good corporate governance during the 20th century in the United States. The emergence of "trusts" at the turn of the century created great concerns about the private power of those who controlled the nation's largest companies. Berle and Means' classic work, *The Modern Corporation and Private Property* (1933), highlighted the danger of corporate power. The authors write that

> the concentration of economic power separate from ownership has, in fact, created economic empires, and has delivered these empires into the hands of a new form of absolutism, relegating 'owners' to the position of those who supply the means whereby the new princes may exercise their power. (1933, 116)\(^1\)

Mitchell (2009, 704) describes how the legal community struggled throughout the century to develop various means of "taming the corporate form." Rather than having direct stockholder participation, a corporate governance model evolved that relied on (a) market forces and (b) the fiduciary relationship between boards of directors and stockholders to protect ownership interests.\(^2\) Financial information plays a key role in ameliorating information asymmetries that exist between insiders and owners. When periodic scandal related to financial accounting erupts, the fiduciary system fails and new calls for more stringent monitoring emerge. Demands for companies to establish

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\(^1\) Although Berle and Means' study is often depicted in the accounting and finance literature as a natural offshoot of Adam Smith, the book was considered a radical book when it was first published. General Motors management found it so revolutionary that they demanded that Commerce Clearing House pull it off the shelves in 1932. CCH agreed, but gave the plates to MacMillan which republished the manuscript in 1933.

\(^2\) Berle and Means (1933, 245) did not believe that boards of directors would constrain "non ownership interests", writing that "as a qualification on what has been known as private property in Anglo American law, this corporate development represents a far greater approach toward communist modalities than appears anywhere else in our system. It is a paradox that a corporate board of directors and a communist committee of commissars should so nearly meet in common contention."
audit committees – subcommittees of boards of directors – have accelerated after financial reporting scandals to silence public outrage and reestablish the viability of the fiduciary system.

I use historical analysis to examine the demand for and development of audit committees during the 20th century. The two anchor points of this study are (a) the initial Securities and Exchange Commission (SEC) recommendation for companies to establish audit committees in the wake of the McKesson & Robbins scandal in 1940, and (b) the passage of the Sarbanes Oxley Act of 2002 (SOX), a reaction to the scandals at the end of the 20th century. My primary research question is: Have the periodic calls for audit committees represented symbolic or real reform? Symbolic reform does not result in redistribution of economic resources or a change in existing relationships. It simply placates public outrage and maintains the status quo (Merino 2003).

I deal with three specific time periods: (a) from 1920 through 1954, (b) from 1955 through 1986, and (c) from 1987 to the passage of SOX in 2002. Periodization is a critical aspect of any historical inquiry. I chose the above time periods for the following reasons:

- The great Crash of 1929 marked the beginning of a period of disillusionment with those who controlled the major corporation and a call for better corporate governance and empowerment of shareholders. The SEC responded to the McKesson & Robbins failure by recommending audit committees (SEC 1940a), but the SEC remained quiescent when the recommendation was widely ignored. This is not unexpected since the fledgling SEC was shifting its position from
promoting shareholder democracy (strengthening ownership) to protection of business.\textsuperscript{3} By 1954, the SEC changed proxy rules so that the "only power shareholders still had, other than selling their stock, was the typically impractical power to launch a proxy contest" (Mitchell 2009, 719). Also, by the mid-1950s, a metamorphosis had occurred as the government became a partner with major corporations and corporate control became less of a concern as the industrial/military complex came into being (Manchester 1974).

- The period from 1954 to 1975 was a quiescent period in the evolution of audit committees. Despite a series of scandals in the 1960s, demand for audit committees occurred periodically but never became strong. This was the period when economists and other academics developed models that rendered managerial power moot, arguing that markets or internal devices could effectively constrain management. The period of quiescence ended when disclosure of extensive foreign bribes by American business embarrassed the nation. Congress passed the Foreign Corrupt Practice Act of 1977 (U. S. Congress 1977) and called for greater managerial accountability, suggesting that audit committees and greater attention to internal controls could be used to curb managerial abuses. The New York Stock Exchange (NYSE) reacted quickly, requiring audit committees for listed companies in 1978. Concerns about private power once again dissipated. The savings and loan crisis of the early 1980s rekindled fears, and the private sector established the National Commission on

\textsuperscript{3} See Mitchell (2009) for SEC’s enactment of proxy rules in 1942 to empower stockholders and its responsiveness to businessmen’s resistance to efforts to empower shareholders and the SEC’s acquiescence to removal of all of the objectionable provisions by 1954.

- The post-1985 period marked the resurgence of laissez-faire theory and calls for the end to governmental regulation. Markets and internal corporate processes offered protection to the stockholder. Theorists depicted the firm as a nexus of contracts and suggested that compensation packages, the managerial labor market, and/or corporate takeovers would protect shareholders from undue exploitation (Jensen and Meckling 1976; Fama 1980; Fischel 1982).

The Treadway Commission was formed in 1985 in response to corporate America's lackluster response to calls for ethical standards and good corporate governance. This body was jointly sponsored and funded by professional accounting organizations (NCFFR, 1987) and issued a strong urging for more effective audit committees. In spite of this, however, scandals of the 1990s and early 2000s generated greater outrage, as lapses in financial reporting undermined stockholders' confidence in the professional gatekeepers who were supposed to protect them (Coffee 2006). The passage of SOX was an acknowledgement of the overt power of corporate management, and a stringent set of rules were enacted to try to make the fiduciary concept work. Once again, audit committees were advocated as a means of monitoring managerial power and curbing further abuses.

My historical analysis is a traditional empirical analysis, a documentary model that relies on primary sources to develop a coherent ordering of facts and a better understanding of the event under study (Green and Troup 1999). However, as recent
historians have noted, "facts" do not speak for themselves; primary sources reflect the views of groups, often elites, and must be carefully interpreted (LaCapra 1987). Nor can a historical study be theoretically neutral, as suggested by "scientific" historians, since the selection of facts requires some a priori theoretical foundation. 4

Berle and Means (1933) focused on the need for greater external oversight of those non-owners who controlled many of the nation's largest corporations by 1930. The authors promoted New Deal policies and regulation of business. The accounting literature, following the individualistic contractarian theory of Jensen and Meckling (1976), has depicted the central thesis of Berle and Means as separation of ownership and control. 5 This study departs from that framework. Means (1983) specifically rejected the separation depiction, arguing that the major focal point of the Berle and Means monograph was that unbridled corporate power would soon rival the power of the state and thus mandated government regulation. Berle and Means' theory met the need for a new rhetoric in the 1930s to support governmental regulation and New Deal reforms. 6 Monitoring of non-ownership control was critical to Berle and Means (1933); they dismissed boards of directors as a viable means of monitoring those in control (who chose board members in the first place). My analysis is designed to gain a better understanding of the circumstances that gave rise to demands for audit committees and

4 Carr's (1961) definition of a historian as a "fisherman" standing at a pool of facts and Dewey's suggestion (Ratner (ed.) 1939) that data be regarded as "takens" rather than givens have gained consensus among most historians who are considered critical historians. I recognize the limitations of the documentary model with respect to development of a broader, interactive understanding of historical discourse, but I do not attempt to assess the "performative use of language" as suggested by many postmodern historians, (LaCapra 1987, 35).


6 At the 1983 conference held at the University of Chicago and funded by the Hoover Institute, to celebrate the anniversary of the issuance of the Berle and Means monograph, most law and economics proponents either harshly criticized or mentioned the monograph in passing. However, Stigler and Friedland (1983, 257) acknowledged the profound impact that the monograph had on justifying New Deal regulations, concluding that Berle and Means were the most influential economic treatise of the century with respect to politics, but had much less influence on academic economists.
how the fiduciary relationship, dismissed by Berle and Means as inapplicable in a
corporate world, became central to our current corporate governance model. My
primary purpose is to place the demands for audit reforms in context and to
demonstrate how motivations and expectations evolved throughout the 20\textsuperscript{th} century as
firm theory paradigms changed.

This research question is important because significant modifications to audit
committee duties and responsibilities are incorporated in SOX (U. S. Congress 2002).
SOX reforms task audit committees with oversight of good corporate governance and
effective internal controls within the corporation. SOX alleges, in effect, that audit
committees are lacking in performing these duties and responsibilities by establishing
stringent, direct rules for (a) various responsibilities of the audit committee, (b) its
independence from management, (c) treatment of employee complaints concerning
accounting and auditing matters, and (d) engaging outside advisors (Section 301).
SOX also alleges, in effect, that audit committees lack financial expertise by mandating
that at least one member of the committee have defined and demonstrated capabilities
as a financial expert (Section 407).

Topic Selection

The use of audit committees can be traced back to the seventeenth century, but
like so many terms the meaning has changed. “Audit committees” were a part of 19\textsuperscript{th}
century railroad companies, but they were primarily made up of prominent company
shareholders and were used as auditors, not overseers. The fiduciary concept of audit
committees appears to be a relatively new concept. From its initial suggestion as part
of Accounting Series Release No. 19 (ASR No. 19) (SEC 1940b) through most of the
20th century, the audit committee concept became more and more a primary means of curbing power in the hands of non-owner controllers, and more recently corporate managers. Mitchell (2009, 726) explains how corporate law has been used to systematically disfranchise shareholders throughout the 20th century. She notes the use of "agency theory to legitimate the status of directors as Platonic masters" while the steady erosion of voting rights became "means of legitimating management's exercise of power" (Mitchell 2009, 726-7). In 2002, SOX prescribed “bright line” requirements for corporate audit committees, and so the question remains: why has this solution, proposed since 1939, not been implemented, and why should we expect it to be a viable means of corporate governance in the 21st century?

Methodology

Pattern Model and Narrative

The history of events and the narrative of them are intertwined. Stanford (1994) posits that history and narrative are not identical concepts: “[M]any narratives are fictitious, therefore not historical; many histories claim to be true but are not stories” (1994, 88). He discusses narrative and history by noting three different positions:

The first position is that narrative is inherent in history. Tell what happened and there you have a story. This is the common-sense view. . . . The second position is the direct contrary. This is the view that the events of history . . . have no shape in themselves and do not naturally form a narrative. The story-shape that they appear to have in a work of history is given them by the narrator. The third position . . . insists that narrative form is found in history itself, but there may be more than one story to be told of it. Thus history is always story-shaped, though not necessarily in the shape of only one story. (Stanford 1994, 95-96, 99)

Hayden White, an American philosopher, expresses the second of these three positions more bluntly. He contends that historical narratives are only
verbal fictions, the contents of which are as much invented as found, and the forms of which have more in common with their counterparts in literature than they have with those in the sciences. . . . [The historical narrative is] a verbal artifact that purports to be a model of structures and processes that are long past and cannot therefore be subjected to either experimental or observational controls. (White 1978, cited in Stanford 1994, 97)

Burke (2001) states that the notion of history as a narrative of circumstances surrounding events was challenged in the early 20th century by French historians who favored a history of structures.

In France, the rejection of . . . “event history” in favour of the history of structures was a major plank in the platform of the so-called “Annales school”, . . . who . . . regarded events as the surface of the ocean of history, significant only for what they might reveal of the deeper currents. (2001, 283)

The debate and confrontation between the two modes of history methodology continued throughout the 20th century. Burke suggests a harmonization of the two.

“Working in this central area [of a continuum], it may be possible to go beyond the two opposing positions [of narrative and structure] to reach a synthesis” (Burke 2001, 288).

Porter concurs with this harmonization assessment.

The examination of narratives has indicated that they involve both a structure and a dynamic process that are common enough to be generalized and abstracted for analysis, regardless of the specific content. The structure may be described as a pattern of emergence from a set of indeterminate conditions, full of possibility, to a realization of one concrete configuration, standing in contrast to what might have been. The one concrete configuration, called the event, provides a kind of focus in the middle of the structure, with the antecedent conditions ranged on one side, and the consequences ranged on the other. The quality of the narrative is judged in part on how coherent this structure is; in other words, on how elegantly the conditions and consequences relate to the focus. (Porter 1981, 20)

I use narrative in a narrow sense as my historical methodology. I examine patterns that emerge, interpreting facts to develop a coherent understanding of demands for audit committees. I examine primary information and secondary sources
to determine how the burgeoning expansion of corporate businesses appeared to facilitate use of corporate resources by those who controlled, but did not own, the businesses. The documentary model forces a certain progression of history, but historical analysis also allows retrodiction, looking back at patterns to identify events which could have been expected to occur and did not occur (Porter 1981). I study this data using a holistic approach espoused by Abraham Kaplan (1964) which uses narrative to show how patterns ensue from the data being examined.

Kaplan (1964, 327-330) describes how the explanation of phenomena results from an understanding of diverse facets. He differentiates a semantic explanation from a scientific explanation by saying that the former is like something being clear, while the latter is like something being true (1964, 328). He states (1964, 329) “[a semantic] explanation may be said to be a concatenated [or linked] description.” The explanation, in other words,

give[s] us a “why” and not just a “what”. For instance, we may describe certain prior events, and thereby provide a causal explanation, or we may describe certain intermediate events to explain why one produced another. An explanation . . . tells us something else than the mere description of what it is explaining, and especially something appropriate to the context in which the explanation is to function. (Kaplan 1964, 329)

Kaplan describes this discovery of the context surrounding the explanation as a pattern of events that give understanding to the examined phenomenon. This holist theory ascribed to Kaplan, then, is appropriately termed the pattern theory.

[T]he works of Abraham Kaplan . . . contain explicit presentations of [this] holist model of explanation. They seek to uncover the implicit structural framework which facilitates holist theorists’ explanations of reality” (Wilber n.d., 1).

Kaplan discusses the difficulties with historical explanation, agreeing with May Brodbeck that “there is no such thing as historical explanation, only the explanation of
historical events” (Brodbeck, cited in Kaplan 1964, 367). He describes the historian’s task, however, in terms of a narrative or story. Porter agrees that the historian’s focus “is always on narrative explanations of the past: how they work, how they can be talked about, compared, and improved in a systematic, critical, and intelligible way” (Porter 1981, x).

Kaplan describes the pattern model by discussing historians’ dependence on background and situations that precede the studied event – what Porter terms “antecedents” – and the temporal flow of narrative.

Of all behavioral scientists the historian is among the most dependent upon the transformation of acts into actions. [T]he succession of actions is seen by the historian, not as a bare sequence, but as a configuration made meaningful by purposive or causal connections. The process of putting the raw data into such configurations has been called “colligation” . . . explaining an event by tracing its intrinsic relations to other events and locating it in its historical context, which is then said to yield a significant narrative. (Kaplan 1964, 367)

Kaplan states,

According to the pattern model . . . something is explained when it is so related to a set of other elements that together they constitute a unified system. We understand something by identifying it as a specific part in an organized whole.

. . . .

[!]In the pattern model we explain by instituting or discovering relations. . . The particular relations that hold constitute a pattern, and an element is explained by being shown to occupy the place that it does occupy in the pattern. . . . The explanation is sound when everything falls into place. . . . Rather than saying that we understand something when we have an explanation for it, the pattern model says that we have an explanation for something when we understand it. (Kaplan 1964, 333-335)

This pattern model provides understanding by linking things together and showing their interdependence. “A prediction, as distinct from a guess, is reasoned – a basis is put forward, some premise from which what is predicted is being inferred” (Kaplan 1964, 350).
Primary Source Research

Primary sources, which are sources of participant sources or other artifacts of events, have been privileged by documentary history. The historian's task is to gauge the authenticity of the sources, the motivation of those providing the source, and interpretation of the data found (Green and Troup 1999). I recognize that the primary sources often available from the elite; "average" persons often do not have a voice in history due to the dearth of records (LaCapra 1987). My sources come from those who have sufficient interest and power to become engaged in the audit committee debate. I visited the following archives to gather data for this study:

- Archives of the New York Stock Exchange and the main public library of New York City
- Archives and historical collections of the AICPA in both Durham, North Carolina, and at the J.D. Williams Library on the campus of the University of Mississippi, Oxford, Mississippi

In addition, I examined

- SEC's enforcement of its mandates concerning corporate audit committees
- Discussions related to the NYSE's decision to mandate corporate audit committees as a condition of listing on the Big Board
- Discussions of the audit committee concept within historical records of the American Institute of Certified Public Accountants (AICPA) and its predecessor, the American Institute of Accountants (AIA)
I reviewed the source material to provide background information, motivation and implementation of demands for audit committees. Additional data concern the events themselves and provide elaborations which were only partially available through secondary research.

Further, primary information reveals, by inference, the stringency in SOX because of the refusal of corporate hierarchy to implement “suggestions” from regulatory bodies. An example of this refusal can be seen in certain replies to a NYSE letter of inquiry that sought corporations' opinions on whether the Exchange should require audit committees as a condition of listing on the Big Board. These businesspeople reacted extremely negatively, contending that the NYSE had no right to dictate internal affairs to corporations (Detroit Edison 1976; Gable Industries 1976; Greyhound Corporation 1976; Northwest Airlines 1976; Helene Curtis Industries 1977).

This negative attitude toward regulation was evident throughout the 20th century. As the SEC's attitude changed from monitoring business to being a partner in business in the post World War II period, I find heightened resistance to any intervention in the private sector. However, this reaction is not significantly different from the reaction to the SEC's recommendation in ASR No.19 that companies institute an audit committee.

I examine the environmental and regulatory constraints affecting the evolution of audit committees in each time period and compare and contrasted the resulting demands with current regulations. I also look at implementation of the proposed reforms to determine if those reforms were symbolic.
Secondary Source Research

Initial research into audit committees revealed an explosion of secondary source articles about the concept during and after the 1970s, but few studies prior to that time. I posit that the spike in interest in a fiduciary concept of corporate governance reflected the growing dominance in the academic literature of private rights theory and positive agency theory (Aglietta and Reberioux 2005) Until the McKesson & Robbins scandal in 1939 the secondary literature on audit committees appears to have been very sparse.

Most discussions of audit committees point out that use of this board subcommittee began in the very late 1930s when the SEC investigated the McKesson & Robbins fraud. One of the results of this investigation was the issuance of ASR No. 19, recommending changes to the methodology used in performing audits of publicly held corporations. Among the recommendations made was a suggestion that corporations form a subcommittee of their boards of directors to oversee, in general, the audit of the company. Interest in the topic faded until the late 1960s when a series of corporate scandals brought renewed interest in greater fiduciary responsibility.

Here, then, is a conundrum: Why was it necessary for such stringent requirements concerning audit committees in SOX if these committees had been suggested to corporate America in 1939? Did publicly held companies follow the suggestion of the SEC and form them? Were the committees functioning improperly? If audit committees were needed for proper oversight of good corporate governance and proper corporate internal control, why was practically nothing said or done by the SEC and by corporate America during the almost three decades following ASR No. 19?
Chapters and Periodization

Chapters II, III, and IV examine three time periods that were critical to the evolution of audit committees. Each of these periods contains changes in attitudes about the concept and notes major events that have been instrumental in determining this evolution. The conditioning environment in each period that shaped attitudes toward regulation, shareholder/non-owner relationships, and the danger of private power centered in the nation's largest corporations. As stated, the time periods are

- **1929 through 1954**, in which the major events were the Crash of 1929, the challenge brought forth by Berle and Means' (1933) monograph that provided the rhetoric for New Deal policies, the SEC's call for audit committees in 1940 in response to the McKesson & Robbins scandal (SEC 1940a), and the slow erosion of stockholders' voting rights during this period.⁷ I examine the SEC's efforts to implement this recommendation to determine if its actions were symbolic or if real change occurred. In addition, I examine the antecedent period from the first of the 20th century until 1929 to provide background and understanding for these events.

- **1955 through 1985**, in which the major events were the corporate scandals of the 1960s, the passage of the Foreign Corrupt Practices Act in 1977 (U.S. Congress 1977) to curb payment of foreign bribes, and the New York Stock Exchange's 1978 mandate that companies have audit committees as a condition of corporate listing. This also marked the period of a strong academic voice for private property rights and positive agency theory that viewed managerial power

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⁷ See the Securities and Exchange Commission (SEC) in 1940 in Accounting Series Release (ASR) No. 19 for the SEC's actions that eroded the proxy provisions, culminating in 1954 with shareholders having only the right to sell their stock or launch a proxy contest (Mitchell 2009, 719)
as a subject of market not regulatory control. The period ended with the establishment of a private sector group, the National Commission on Fraudulent Financial Reporting in 1985.

- The period 1986 through 2002 marked the slow dismantling of New Deal financial regulation and the triumph of market ideology with respect to corporate governance. The Treadway Commission (NCFFR 1987), once again, noted the need for greater corporate oversight. Deregulation led to recurrent financial reporting scandals, the failure of gatekeepers, and the financial wreckage culminated in the enactment of the Sarbanes-Oxley Act of 2002. The rhetoric surrounding passage of SOX in 2002 reflected similar concerns about corporate power as those echoed in the 1930s.

Two significant factors are prevalent in each of these periods, increasing managerial power and creating a need for some method of mitigating bad corporate governance: (a) exponential growth of American corporations, both nationally and internationally, and (b) diffusion of ownership of corporate stock, not only nationally and internationally, but also ownership by major institutional shareholders. I therefore address these factors in each of the ensuing chapters.

Corporate Growth and Ownership

Important environmental factors contributed to the phenomenal growth of the U.S. corporation: the industrial revolution and an expansive need for capital. Prior to the industrial revolution most business was carried on by owners of their own companies. As corporations in urban areas grew, offers for employment and greater wealth created a population moving from the farm to the city. Giant corporations
needed far more capital than could be supplied by a handful of owners, even wealthy owners. Understanding that wealth could be amassed by passive means, investors throughout the country provided capital by buying stock in corporations, thus supplying management with fantastic sums of capital over which they had almost dictatorial power. Berle and Means (1933) documented this rapid growth of corporations in their study. They pointed out that corporate relationships had changed so significantly as to undermine traditional justifications for private property.

The traditional corporate form of business was as follows: Shareholder-owners voted for a board of directors to function in their stead as representatives under a fiduciary scenario. Members of the board of directors appointed managers to run the corporation and see to its day-to-day functioning and profitability. Managers hired employees to carry out the purposes of the corporation and perform necessary work tasks within the corporation.

Managers of the giants, seeking to solidify their position of power, nevertheless understood that regulatory requirements within each state dictated that boards of directors would still be elected by the shareholder/owners. To solidify their power, then, these managers hand-picked individuals to be board members. Shareholders received a notification that the annual meeting of the shareholders would be held at the corporate headquarters on a certain date. These owners were encouraged to attend and vote for board members, but, of course, distance precluded most from such attendance. Proxy certificates were therefore sent to shareholders, recommending these hand-picked individuals for election to the board and appointing other hand-picked individuals to vote in the shareholders’ stead. Of course, write-in lines were included on the ballot, but
most of the shareholders had no idea who should be recommended for board membership. Most shareholders dutifully marked their proxy ballot as the manager recommended, and the manager’s power was thereby extended and strengthened.

The giant corporate entities that developed from the burgeoning of ownership and concentration of power in managers created enormous pressure for corporate governance mechanisms to curb managers’ exercise of power. Out of this significant need grew the audit committee concept. Regulatory bodies, aware of “cronyism” on boards, determined that a committee, composed of directors who were not connected to management, would best suit the task of hiring external auditors, assist in setting a proper scope for the audit, and, in general, overseeing the external audit process.

Diffusion of corporate ownership was not only widespread but also of different types of owners. Many were individual owners, but a growing number of corporate shareholders were institutional. Indeed, many individual shareholders, understanding that they lacked sufficient expertise to decipher corporate financial data, turned to institutional groups to invest in corporate shares in their stead. This diffusion is examined in each chapter as to the effect it had on corporate governance and managerial power, because any symbolism in regulatory restraint affected each type of ownership differently and because each type of ownership had its particular effect on managerial power.

Symbolism

One of the major points discussed in this study is whether corporate governance reforms, such as recommending establishment of audit committees as a part of corporate boards, was a real reform, designed to enforce the concept, or a symbolic
reform, designed to placate investors who were worried about their ownership of the
corporation and whether that investment was sound. Edelman (1964) suggests that
political responses to public outrage may result in symbolic regulation, i.e., regulation
that does not significantly change the status quo and does not need implementation to
effectively placate the outrage. He posits that politics (as promulgated by the
government) performs two basic functions: an instrumental function of distributing
material benefits and an expressive function of distributing symbolic assurances. He
contends that a relatively small number of “elite” insiders receive the brunt of benefits
from legislative pronouncements, but that support for the legislation is widespread
because of a placated mass public.

   [M]any business regulation and other law enforcement policies confer tangible
benefits on the regulated businesses while conveying only symbolic reassurance
to their ostensible beneficiaries, the consumers. (Edelman 1964, 4).

He agrees with Harold Lasswell, a member of the Chicago school of sociology, who
argued that democracies needed propaganda and symbolism to keep the uninformed
mass public in agreement with what the elite determined was in their best interests.

   Quite often a [political] solution is a magical solution which changes nothing . . .
and which merely permits the community to distract its attention to another set of
equally irrelevant symbols. The number of statutes which . . . change[s] nothing
in the permanent practices of society is a rough index of [this] role of magic in
politics. (Lasswell 1930, cited in Edelman 1964, 33)

Merino and Neimark (1982) conducted a historical analysis of the conditions
surrounding the passage of the Securities Act of 1933 and the Securities Exchange Act
of 1934 and concluded that these acts had little or no effect on existing relationships.
That is, these acts perpetuated the status quo, i.e., they were symbolic.
Symbolism and symbolic reform, then, play a major part in the evolution of the audit committee and in improvements (or lack thereof) in good corporate governance. I use my historical analysis to assess how and why audit committees were established and used in each of the three time periods. I assess the various demands for audit committees to see if they represented symbolic or real reform. The analysis enables me to identify a pattern to identify symbolic or real reform and apply that pattern to enactment of the Sarbanes-Oxley legislation. This study provides a means to assess implementation of SOX and the nature of this last reform. If symbolic reform has been replaced with real reform because of SOX, I discuss whether the capabilities of audit committees under the “bright line” promulgations of SOX will create problematical difficulties for corporate boards of directors specifically and for the American capitalistic system in general.
CHAPTER II

1920 THROUGH 1954

The period from World War I to the end of World War II was as volatile as any in the nation’s history. Major socioeconomic changes and a global war reshaped the social fabric of the nation. Sometime after 1915 . . . the 1920 census alerted Americans to the urbanization of the nation. The self-reliant, yeoman farmer, the backbone of democracy, had been replaced by a multitude of industrial, urban workers . . . (Previts and Merino 1998, 235)

The reasons both the New York Stock Exchange (NYSE) and the Securities and Exchange Commission (SEC) suggested the formation of audit committees in 1939 are intermingled with the early history of the 20th century. An understanding of this history is important in explaining the audit committee concept, its beginnings under the present-day concept of financial overseer, and the rationale behind considering these committees as key protectors of good corporate governance, not only in the past but also in the present. The history is examined by considering four major factors: (1) the pattern that developed in the early years of the 20th century within the economy of the United States; (2) corporate governance structure, which generally means the methodology with which a company performs its corporate and social responsibilities to stakeholders⁸; (3) the role assumed by the parent of the audit committee – the corporate board of directors; and (4) the duties suggested during this time frame as responsibilities of the audit committee itself.

⁸ The American Bar Association equates corporate governance with “corporate responsibility” and defines that term as “behavior by the executive officers and directors of the corporation that conforms to law and results from the proper exercise of the fiduciary duties of care and loyalty to the corporation and its shareholders. . . . [It] also embraces ethical behavior beyond that demanded by minimum legal requirements” (American Bar Association 2003, 4).
History

Examination of this period of the 20\textsuperscript{th} century must begin with a study of the decades prior to 1929, so patterns are discerned that have a major affect on the events of the 1930s. A pattern of power began to emerge within the economy of the United States in the middle to late 1800s, emanating largely from two major sources: compacting of the nation by the Iron Horse and increased technology in communications. Individuals with keen foresight realized that power could be amassed by controlling the production of items needed by the railroads, as well as the railroad companies themselves and the credit that would be needed to fund the vast expansion. Prominent among these was John Pierpont Morgan.

J. P. Morgan was born in an affluent family in 1837. After an education in Boston and in Europe, Morgan settled in New York City, where he used his family influence and his financial knowledge to begin amassing financial wealth and influence that would place him in a preeminent position in the economy of the United States. Morgan not only acquired major railroad companies, but also holdings in the steel manufacturing that was vital to the westward expansion. His financial support of these railways was instrumental in keeping the lines solvent and prospering.

In 1889 the Morgans’ [father and son] financial power manifested itself in another and more characteristic way. J. P. Morgan had secured control of many important railroads, combining financial power and direct railroad power in a fashion new to American finance. . . . Morgan’s railroad empire, [rather than just being a railroad entrepreneurship,] . . . was the direct product of developing finance assuming new forms and functions. In 1889 the House of Morgan convened a conference of railroad presidents, at which [J. P.] Morgan presided and issued ultimatums – “bankers triumph” and “presidents surrender”, declared the New York Times. “Morganization,” the [absolute] control of finance over industry, and, consequently, the centralization of industry and finance, made its definite appearance.
In 1879 the House of Morgan was essentially an old-style financial institution – dealing in foreign exchange, placing American securities in Europe, gathering together the scattered capital of innumerable investors by selling stocks and bonds, and participating in government financing. By 1889 the House of Morgan still did all these things, but in addition it participated directly in corporate affairs, combining, consolidating, centralizing, imposing the master of finance over industry by the institutionalized control of investment resources and of corporate industry itself. (Corey 1969, 132)

Timmons (2002) describes Morganization somewhat gentler than Corey, but with the same results, as follows:

[J. P. Morgan] often applied a process that was called Morganization. He would take over problem companies, flush out incompetent managers, and appoint people he trusted. Over time, many of the companies would recover and become profitable, keeping capital flowing into other Morgan deals. (Timmons 2002, 124)

By the turn of the 20th century, J. P. Morgan & Co. was the dominant institution in the economy of the United States. It had significant holdings/control in the following companies, among numerous others:

- United States Steel Corporation
- General Electric Company
- New York Central Railway; Great Northern Railway, and New York, New Haven and Hartford Railway
- International Mercantile Marine Company
- The financial institution that was the forerunner of the Chase Manhattan Bank

Morgan and those with whom he allied maintained control of the giant corporations through a device called a “voting trust” (Pujo Committee 1913). Terms under such an agreement generally called for shareholders to relinquish their voting rights to a trustee – Morgan and/or his associates, in this case. These trustees, then,
elected boards of directors for the corporations and, in general, controlled operations of
the company (Pujo Committee 1913, 1018-1020).

A House of Representatives subcommittee was empowered to investigate the
massive financial power accorded to Morgan and his associates. The subcommittee
was headed by a Democrat from Louisiana, Arsène Pujo. Its purpose was to
investigate the concentration of a pattern of financial power that had been accumulating
in a select few New York individuals over the prior two decades (Pujo Committee 1913,
4; Wheeler 1973, 288-289). Chief interrogator for the subcommittee was Samuel
Untermyer, described as "the abrasive initiator, organizer, promoter, and general
ringmaster of the hearings" (Wheeler 1973, 289).

As expressed in the first few pages of its report, the subcommittee was to
investigate a concentration of power that could threaten the economy of the United
States. The concentration had as its pinnacle J. P. Morgan. This power was
demonstrated in the subcommittee's final report, as follows:

The firm members and directors whose [interlocking directorate] affiliations are
thus shown number 180. . . . In the aggregate they hold 385 directorships in 41
banks and trust companies; . . .50 directorships in 11 insurance companies; . . .
155 directorships in 31 railroad systems; . . . 6 directorships in 2 express
companies and 4 directorships in 1 steamship company; . . . 98 directorships in
28 producing and trading corporations; . . . and 48 directorships in 19 public utility
corporations; . . . in all, 746 directorships in 134 corporations having total
resources or capitalization of [over $25 billion]. (Pujo Committee 1913, Exhibit
134C, 2, emphasis added)

J. P. Morgan died within a relatively short time after the Pujo Committee
investigation. Secondary research indicates that Morgan used the power he and his
associates possessed for benevolent purposes, such as alleviating the government's
problem with the Panic of 1907 (Pujo Committee 1913; Corey 1969; Wheeler 1973;
It is suggested, however, that power of this magnitude in the hands of unethical persons has the possibility of collapsing the American economy. It is this power that Berle and Means discussed in *The Modern Corporation and Private Property* (1933). Congress attempted to mitigate this power immediately after the Pujo Committee’s report by enacting two important pieces of legislation: (a) establishing the Federal Reserve Board to control the American banking system in 1913 with the passage of the Federal Reserve Act and (b) passage of the Clayton Antitrust Act of 1914.

This was a period in American history when dramatic major sociological changes occurred. Giant corporations were driving the American capitalistic system and produced a significant amount of war material that had been instrumental in the Allies’ victory in Europe. The population of the United States moved from an agrarian culture in the prior century to a more urbanized culture (Previts and Merino 1998). Major innovations decreased the space and distance between individuals and parts of the country, allowing much faster communication and travel. Soldiers who enlisted and fought in the “War to End All Wars” returned to civilian life and became part of the workforce. After a short recession, caused by this influx, the country experienced a boom in consumerism and prosperity that lasted for most of the 1920s decade. Production capacity of U.S. businesses that had been part of the World War I effort was redirected toward the national economy (Carey 1969a).

The decade prior to the stock market crash and the Great Depression was one of significant growth -- described as a “wave of prosperity” (Carey 1969a, 35), as a booming economy (Adelberg 1975), as “the so-called Golden Age of Business” (Previts
and Merino 1998, 238). A desire for new items on the market existed in all parts of the country; consequently, the decade was aptly described as the “Roaring Twenties.” Victory produced a headiness in America, omnipresent in everything from architecture to music to consumerism. Military personnel re-entering the workforce also wanted to participate in this consumerism (Sage 2006). Accompanying this consumeristic attitude was the desire of many Americans to participate in the significant growth of the economy, but not through ownership of tangible property. Berle and Means (1933) reported that the concept of wealth in property ownership was changing rapidly from material items – land, machinery, buildings – to ownership of passive property, such as stocks and bonds of the growing giant corporations.

Businesses as a group received much of the credit for the effort that had won the war, and the general feeling was that business was no longer to be regarded as an evil. “Many people attributed the Allied victory to the creativity and ingenuity of American business people” (Previts and Merino 1979, 197). “[T]he war had proven that business was ‘moral’” (Previts and Merino 1998, 238), and any thoughts of legislation restricting the power of corporate heads were reduced to insignificance.

World War I had an unsettling effect on those who advocated laissez-faire economic policies. The war effort, enormously successful, showed that government, labor, and business, working together, could increase the nation’s productivity significantly. Cooperation, not competition, had enabled the nation to marshal its economic resources to meet the stringent demands of the war effort. . . . Pragmatists and other reformers hailed the ‘social possibilities of the war,’ arguing that the war effort had shown that coordinated economic planning, not laissez-faire policies, would be of greatest benefit to the nation. (Previts and Merino 1998, 237)

In spite of this assessment, however, administrations during the 1920s – Harding (1921-1923), Coolidge (1923-1929) – continued to espouse laissez-faire policies (Carey 1969b).
Big business had a fairly free hand. High tariffs were enacted, immigration was restricted, and for a time the country enjoyed unparalleled economic well-being. . . . Demands for capital mounted, and new securities were issued on an unprecedented scale.

. . .

In the absence of any regulation of the securities market, abuses were inevitable. . . . Unbridled speculation in the stock market had pushed prices to fantastic heights. Almost everyone thought that ‘a new era’ had dawned, and prosperity would continue forever. (Carey 1969b, 156-157)

This antecedent of events and lifestyle in America precipitated a succession of events and happenings that created the need for a corporate audit committee suggestion by both the NYSE and the SEC.

Berle and Means

Adolf Berle and Gardiner Means reported their perception of a growing problem in the giant corporations: Widespread dispersion of stock ownership in these companies had reduced the ability of individual stockholders to have an active voice in the affairs of the company (Berle and Means 1933). Of course, stockholders were given the right to choose a person to vote for them in electing directors, but the proxy signed by the stockholder gave this right to persons hand-picked by the management of the company (Berle and Means 1933, 86). The result was centralization of power within the management of the corporation, with very little or no actual ownership of the immense amounts of capital contributed by stockholder-owners. Berle and Means (1933) describe this alteration from the concept of individualistic property ownership in entities of the 19th century to passive ownership of a “right” in a corporation as separation of ownership from control. This separation creates a situation, then, where “the management can thus become a self-perpetuating body even though its share in

Berle and Means (1933, 86) state that stockholders have two other options available to them: (1) refrain from voting, or (2) attend the annual meeting of stockholders and cast his/her vote there. Neither option likely represents any improvement in representation or in determining the direction of corporate affairs.
the ownership is negligible. This form of control can properly be called 'management control'” (Berle and Means 1933, 87-88).

Ownership [of corporate property] is so widely scattered that working control can be maintained with but a minority interest [or none at all]. . . . Separation of ownership and control becomes almost complete when not even a substantial minority interest exists. . . . Growing out of this separation are two characteristics, almost as typical of the [giant] corporation as the separation itself — mere size and the public market for its securities. It is precisely this separation of control from ownership which makes possible tremendous aggregations of property. (Berle and Means 1933, 4-5)

Berle and Means reiterated what Senator Robert La Follette had pointed out previously to Congress two decades earlier: through the use of the proxy, corporate managers possessed power that was virtually unchecked. This caveat specifies a main problem — the separation of ownership from control “brought forth princes of industry” (Berle and Means 1933, 2) who created economic empires by use of absolute authority delivered into their managerial hands (Berle and Means 1933, 124). “[The revolution of the quasi-public corporation] has destroyed the unity that we commonly call property — has divided ownership into nominal ownership and the power formerly joined to it” (Berle and Means 1933, 6-7).

Absentee ownership of corporate shares was not new. Theoretically, however, the corporate shareholder was represented by directors who then appointed managers of the company. Also in theory, these directors functioned as representatives of shareholders and saw to their best interests. Blair (1950, 102), however, reports this lack of active participation in corporate affairs was not a major concern of the average stockholder. He states, “[T]he average stockholder is not interested in improving the quality of directors elected as long as the stock of the corporation is providing dividends
and holding its own in the market” (Blair 1950, 102). Berle and Means, too, speak of the “apathy of the small stockholder” (Berle and Means 1933, 81) in proxy matters.

Bricker and Chandar (2000) asserted that the separation of ownership from control in Berle and Means’ book was misplaced. These authors stated that Berle and Means had failed to recognize institutional investors as the owners of large blocks of corporate stock. These institutional investors did not exist in 1933, but Bricker and Chandar suggested that Berle and Means’ theory should be reevaluated, based on Jensen and Meckling’s (1976) principle-agent theory that supplanted Berle and Means’ theory. Bricker and Chandar suggest that Berle and Means should have foreseen the advent of these institutional investors because of the existence of large investment bankers that did exist in 1933, such as the J. P. Morgan investment fund managers who dominated securities sales transactions in this time frame (Seligman 1982, x). These large investment bankers held considerable persuasive force in determining corporate policies.

The correct placement of ownership-control separation, according to Bricker and Chandar, should involve two tiers of investors – one involving managers and the large institutional investors, and one involving the shareholders of the corporation and the large institutional investors. They state, “We observe that excluding significant capital market parties . . . may result in analysis and policy that fails to address the interests of the excluded parties” (Bricker and Chandar 2000, 531).

Stelzer (2003) pointed out that a number of investors were unconcerned about the separation problem.
Many defenders of the capitalist system were and still are unperturbed by the principal-agent problem. Their solution is straight-forward. Principals who are unhappy with the way their managers are performing can [simply] sell their shares. . . . Unfortunately, the presence of substantial market imperfections makes life in the corporate and financial worlds more complex. In order to know whether to exit from an investment, shareholders must have immediate, accurate, and comprehensible information . . . (Stelzer 2003, 22)

This selling of shares, rather than making an attempt at changing the corporate governance methods used by the company, known as the Wall Street Rule, appears to be inapplicable to large institutional investors, however. Such investors do not have the ability simply to sell their shares because of the enormous impact this selling would have on the market.

Indeed, I posit that much of the principle-agent theory is less than satisfactory as applied to managers and stakeholders. Jensen and Meckling (1976) argued that the separation problem was minimized through their contractarian theory of the firm. These authors stated that the separation problem was only a part of the “give and take” of a contract between stockholders and corporate managers and was therefore no longer an important consideration in corporate governance. In effect, Jensen and Meckling almost relegate boards of directors to irrelevancy, along with audit committees of boards. The problem, of course, is that in a contract, each party needs to be on an equal footing. Managers are in a power position that places stakeholders in a significantly subservient position, and that remained unchanged throughout the 20th century.

Power

Perhaps the best descriptive discourse on power is John Scott’s book, Power (2001). Scott’s treatise deals almost exclusively with social power and has a variety of
descriptions of the power one party exercises (or is capable of exercising) over others.

At its simplest, power is a social relation between two agents who may . . . be called the 'principal' and the 'subaltern.' A principal is the paramount agent in a power relationship, while a subaltern is the subordinate agent. The principal has or exercises power, while the subaltern is affected by this power. . . . A power relation, then, involves the intention to produce a particular effect or the desire to see a particular effect occurring. Power is an intended or desired causal effect; it is an effect that realises a purpose. . . . Social power, in its most general sense, then involves the socially significant affecting of one agent by another in the face of possible resistance. (Scott 2001, 2-3)

Power can be effected, then, without being exercised. This conclusion is central to the argument that power is, at root, a capacity. . . . [T]he actor with the potential to exercise power can, at any moment, choose to realise this potential by affecting the actions of others. Power – like knowledge and money – can be held in readiness for use whenever it is needed. The anticipation of its use, furthermore, means that power can have significant social consequences even when there is no explicit and overt intervention by the principal. (Scott 2001, 5)

Scott agrees with Berle and Means’ assessment of corporate managerial power, stating that directional manipulation of large corporate operations can be accomplished “without having to face any significant influence from shareholders” (Scott 2001, 46). Regarding institutional investors, however, Scott states that power on their part can be exerted on management to alter decisions, especially where several institutional investors unite to apply pressure (Scott 2001, 76).

The 1920s decade, then, was one in which the country was immersed in a boom time. Business was felt to be largely responsible for winning the war, and their actions were considered to be moral and in keeping with a prosperous time in which even the smallest of investors could participate. Fortunes were to be made overnight by investors who sank life savings in stockholdings of the burgeoning giant corporations. Widespread stock ownership by the public flourished in this decade (Bratton 2001, 749), creating a significant change in the nature of property from private to passive (Berle and
Means 1933). Because of the general belief that the business world had proven itself to be moral, and because of the widespread economic boom in the 1920s, there was little reason for examination or required oversight of management’s actions. Macintosh (1999) reports on this lack of investor concern:

> The extent of corporate power and the lack of corporate accountability generated little public concern in the period of unprecedented economic growth and stock market activity which took place in the early- to mid-1920s. For example, in 1922 when the President of the New York Stock Exchange advocated full publicity in connection with the issue of securities . . . it fell on deaf ears. (Macintosh 1999, 140)

The amassing of unchecked power by management of these giants, who had little or no actual ownership of the company, created a situation wherein 200 giant corporations in 1929 controlled nearly half of all non-banking wealth. The remaining half was owned by more than 300,000 smaller companies (Berle and Means 1933, 32). Carey (1969b) reports that sporadic attempts at auditing corporations were done in the decade, but that guiding principles were not enunciated by the accounting profession. Further, Merino and Neimark (1982) assert that in studies conducted by the NYSE of publicly-held companies in the 1920s that had audited financial statements, quality was not reflected in these statements.

> The studies are inadequate because the researchers [asserting widespread numbers of audits of financial statements] failed to assess the quality of the accounting numbers – an assessment that would be admittedly extremely difficult since quality itself is an ill-defined concept. Many of the most pernicious practices of the period were buried in traditional accounting formats that came to light only when the companies involved went into receivership, . . . [providing] examples of corporate abuses and manipulative reporting practices during the 1920s. (Merino and Neimark 1982, 43-44)
Fiduciary Concept

In the mid- to late-1920s, “[p]erceptive critics [such as Berle and Means] began to break into print” (Carey 1969b, 161). Chief among those, according to Carey, was William Ripley, who “wrote with zest of ‘the docility of corporate shareholders permitting themselves to be honeyfuggled;’ and about ‘the hoodwinking of the shareholders’” (Ripley 1927, cited in Carey 1969b, 161) in his book entitled *Main Street and Wall Street*. In particular, Ripley addressed the concept of complete disclosure of corporate financial affairs to shareholders as a method of mitigating managerial power (Macintosh 1999, 142).

As stated, a key concept of corporate governance in the 1920s had to do with the corporate business form. Boards of directors, in theory, were the stockholders’ representatives, functioning as overseers of corporate governance and operations. Many (if not most) stockholders believed their corporation’s board was functioning in a fiduciary manner for them. Indeed, a number of authors argued this should have been the board’s job. Dewing (1919) reports that a number of court cases differed on whether boards had fiduciary responsibility or not. The legal point in these cases was one of board liability. If courts determined that the board had fiduciary responsibility, as in a trustor-trustee relationship, then there was no statute of limitations on such liability (Dewing 1919, 77). On the other hand, Dewing (1919, 78) states that legalities cannot reduce the fundamental responsibility of the director to the stockholder – to represent the stockholder’s best interests in corporate dealings.

In this regard, to whom the board should be responsible? Berle (1926, 1931, 1932) argued that corporate boards should be directly responsible for representation of
shareholders. Dodd (1932), however, spoke to the fiduciary responsibilities of corporate boards to society, not just to shareholders. A “debate” between Berle and Dodd, based on two articles by each, ensued. Berle (1932, 1367) stressed that, until legalities permit board fiduciary responsibilities to society, those duties must remain solely to the shareholder.

Either you have a system based on individual ownership of property or you do not. If not . . . it becomes necessary to present a system (none has been presented) of law or government, or both, by which responsibility for control on national wealth and income is so apportioned and enforced that the community as a whole, or at least the great bulk of it, is properly taken care of. (Berle 1932, 1368)

Unchecked by present legal balances, a social-economic absolutism of corporate administrators, even if benevolent [as was apparently the case with J. P. Morgan], might be unsafe; and in any case it hardly affords the soundest base on which to construct the economic commonwealth which industrialism seems to require. (Berle 1932, 1372)

Macintosh (1999) reports Dodd’s contention was that a corporation represented an agency condition on the part of directors, rather than a trustee condition.

Dodd . . . [pointed] out that when the corporation is viewed as a separate legal entity, it is the corporation that enters into contractual relationships with outsiders[,] and the directors are fiduciaries for it [in contractual dealings] and not its stockholders. Consequently, the emphasis of the law should be on ensuring that corporations are accountable to the society in which they operate. (Macintosh 1999, 145)

Merino and Neimark (1982, 34, fn 3) agree with this latter contention, stating that corporate accountability “encompasses accountability for the full range of social costs imposed by corporate activities on all members of society.”

William O. Douglas

William O. Douglas was a strong liberal advocate of regulatory restraint in the years before and just after the Great Depression (Douglas 1934), championing federal
regulatory protection for all shareholders. He argued, as did Berle and Means, that because of the widespread ownership of corporate stock, “managers came to be their own supervisors, and the stockholders were moved into a position of effective subservience to those who by tradition and law were their servants” (Douglas 1934, 1308). Douglas noted several instances wherein the corporate board was not kept informed of managerial decisions or failed to inform stockholders of such decisions detrimental to them. The title of his article in the Harvard Law Review (1934) is descriptive of his contention – “Directors Who Do Not Direct.” Douglas advocated federal regulatory jurisdiction over the capitalistic free enterprise system that would require proper oversight of managerial power. He posits (1934, 1327) that a fiduciary relationship between the board of directors and shareholders must be embodied in the board of directors as an initial contention of proper corporate governance. This necessity emanates from disparate shareholders’ inability to control management or to “act intelligently” (1934, 1316) in matters involving their investments. Government must therefore function as intervenor, regulatorily enforcing the fiduciary relationship and protecting shareholders from rampant managerial power as well as from themselves. Douglas also disagreed with Ripley, who believed that complete disclosure in financial statements provided a mitigating effect on managerial power. Douglas did not believe that the average shareholder had the intelligence to comprehend financial data. Legislating this disclosure would therefore achieve minimal or no effect on managerial power in falsifying financial data.

Douglas was the third chair of the SEC from 1937 to 1939. He was therefore in that position when the SEC investigated the McKesson & Robbins scandal. The audit
committee concept, with its symbolic gesture that lacked any real reform, emanated from that investigation. Merino and Mayper (2001) report on this “turnaround” from a regulatory champion to a conciliatory leader, suggesting that Douglas appears to act in favor of the status quo [restoring the American Dream in a liberal environment] due to his close relations with the accounting profession [and with business] and, in our view, being ‘captured’ by the profession” (Merino and Mayper 2001, 502).

These ties to business and the accounting profession appear to be significant in creating symbolic, rather than real, reform in the late 1930s, vis-à-vis Douglas’ earlier “hard-line” regulatory stance.

Extending this line of thinking, I posit Douglas was not only “captured” by the accounting profession, but was also placed in a precarious and delicate balancing position by circumstances over which he had only partial control. In the early 1930s Douglas was, as stated, a champion of federal regulatory restraint of corporations. He assumed the chair of the SEC after Joseph Kennedy, who resigned after one year (1934-1935), and after James Landis, who headed the SEC for two years (1935-1937). As chair of the SEC from 1937 to 1939, Douglas was directly responsible for the continued existence of the fledgling SEC organization. Pressures were likely applied by several factions: (a) President Roosevelt could ill afford to lose support for his programs from those who opposed federal regulatory restraint of corporations. Douglas, as chair of the SEC, was, of course, ultimately answerable to the President. The SEC needed to provide securities regulations that would support these programs. (b) The NYSE likely felt that the SEC was assuming authority for areas of security dealings that had been the NYSE’s responsibility prior to the SEC’s formation (Seligman 1982). In this position, Douglas needed to assume cooperative leadership in this area without alienating the
NYSE Board of Governors. (c) Powerful CEOs and investment banking institutions represented a very powerful business faction. A lack of conciliation with this group, until the SEC had been established with its own power, might defeat the purposes of the new organization and doom it to obscurity. Conciliatory decisions were likely an important factor in this regard, balancing restraint of managerial power and restitution of fiduciary responsibilities against possible organizational extinction from powerful external pressures. Conciliatory decisions were also very important in “[preserving] the status quo” (Merino 2003, 271). The Securities Acts were not intended to provide so much of a broad regulatory reform as they were designed to rationalize free market capitalism (Kennedy 1999, cited in Merino 2003, 271) and create a “bridge” between those, like Berle and Means, who espoused private property rights, and the new “changing face of capitalism . . . [thereby maintaining] the ideological, social, and economic status quo while restoring confidence in the existing system and its institutions” (Merino and Neimark 1982, 49).

I posit the effect of all this on boards of directors was likely negligible. Boards (and CEOs) understood that the Securities Acts were symbolic, designed to placate worried investors in this time of economic crisis.

The 1929 Crash, the Great Depression, and Corporate Governance

It is virtually impossible to overstate the cataclysmic economic condition of the United States that resulted from the 1929 stock market crash (the “Crash”).

The stock market crash in the fall of 1929 was a catastrophe beyond the worst predictions of the most pessimistic observers. The financial community was in a state of shock. Thirty billion dollars of quoted value of securities vanished in less than a month. . . . Financial paralysis gripped the country. Public reaction was bitter, and a critical review of the processes of the financial market . . . became an obvious political necessity. (Carey 1969a, 38, emphasis added)
The enormity of this free-fall can perhaps be put in better perspective by understanding that new Fords and Chevrolets were selling at the time for less than $1,000. Seligman (1982) reports that the loss over the next three years, measured in real dollars of the period, increased to more than double the thirty billion initial loss. Small investors who had sunk their entire savings in the market lost everything. Large investors – millionaires before the Crash – became little better than wage-earners within the ensuing first month.

Numerous bank failures over the following months created a scenario the Federal Reserve and the large investment houses were incapable of correcting (Seligman 1982). Seligman (1982, 4) discusses actions on the part of the Federal Reserve during the spring and summer of 1929 to curb the rampant speculative loaning of money and mitigate inappropriate comments by President Coolidge, who had assured the nation during that 1929 spring that stocks “were ‘cheap at current prices’” (Coolidge, cited in Seligman 1982, 4). Five days after Black Tuesday (October 29, 1929), a bankers’ pool attempted a stabilization of the market by infusing securities. Shortly thereafter, though, prices fell again (Seligman 1982).

The Crash did not mimic financial calamities of prior experience. So-called “bubbles” (the South Sea Bubble being the best known) “burst with a suddenness” (Seligman 1982, 3). The 1929 Crash, however, began in September of 1929 and came with a kind of surrealistic slowness – so gradually that, on the one hand, it was possible to live through a good part of it without realizing that it was happening, and, on the other hand, it was possible to believe one had experienced and survived it when in fact it had no more than just begun. (Brooks, cited in Seligman 1982, 3).
Indeed, as demonstrated by the loss of more than sixty billion in securities value over the following three years, the American Dream crept close to extinction.

Boards of Directors and Corporate Management

Boards of directors and corporate management, like the rest of America, faced a major crisis. Stock value plummeted, and boards and managers that had been used to an inflow of capital from investors, now faced significant losses in stock value. An obvious realization at this point was that the marketplace could not be depended upon to drive the national economy anymore (Berle 1963). Initially, the government under President Hoover exuded confidence that the American economic system would stabilize – everything would be all right in a few months; let those companies who faced bankruptcy do so; have faith in the capitalistic system (Berle 1963, 80). When things did not stabilize, investors pressured the federal government to step in and mandate reforms that would bring about the stabilization.

Management may have believed that their power was to be mitigated to a relatively large degree because of the ensuing Securities Acts of 1933 and 1934. Previts and Merino (1998, 271) state that the Securities Acts “should have changed relationships between accountants and management.” I extend this concept to include the relationships between management and investors. However,

[the relationship] did not because [one of] the stated objectives of the legislation – to curb managerial power . . . [was] not implemented. By the end of the decade, management continued to have great flexibility [in corporate governance]. . . . In many respects, securities legislation appeared to be symbolic, its primary purpose being to mollify public concern. (Previts and Merino 1998, 271)

I suggest that because of the symbolism of the New Deal concepts, most especially the Securities Acts, managerial power and the “rubber stamping” of
managerial decisions by boards of directors, many of which were interlocking (Bunting and Barbour 1971; Barr 1976; Patton and Baker 1987; Mizruchi 2004) continued unabated in spite of the calamity of the Great Depression. Boards were composed either of hand-picked directors or of entity officers (Douglas 1934) and remained that way in spite of securities regulation.

The old concept that the stockholders elect the board, and the board selects the management, [remained] fiction. . . . The board does not select the management; the management selects the board” (Mace 1972, 43).

A glaring example of this kind of managerial control and power is the empire built by the so-called Match King, Ivar Kreuger, during the 1920s. In all likelihood American shareholders in the Roaring Twenties held more securities of Kreuger & Toll, Inc. than any other single security. The collapse of his economic empire happened in 1932. Kreuger represented a major exception to the marketplace morass for innumerable shareholders. When his empire collapsed, those who had believed in at least one ray of hope in the problematic securities market had their optimism destroyed. When it was discovered that Kreuger was operating what amounted to a giant pyramid scheme (Flesher and Flesher 1986; Clikeman 2003), impetus to Congress’ consideration of federal regulation for corporations intensified considerably.

Kreuger maintained his fraudulent scheme by not allowing auditors to examine books and records of Kreuger & Toll, evidencing his power as manager. The total lack of any effective oversight by his board of directors is evidenced in the following quote:

[I]f an investment banker were to ask for an audited balance sheet, Kreuger would simply refuse to deal with that individual. . . . Thus billions of dollars worth of securities changed hands without reference to financial statements. . . . [E]ven the corporate directors never saw any financial statements, [nor] did the directors attend directors’ meetings. . . . Kreuger apparently prepared by hand every financial statement his companies ever issued without reference to journals or
ledgers. . . . He reputedly then told his few accountants to record the entries necessary to make the books correspond to the already prepared financial statements. (Churchill, cited in Flesher and Flesher 1986, 423)

_Ultramares v. Touche_

An important court decision in 1931 created still more conflict concerning transparent financial reporting and good corporate governance. This was Chief Justice Benjamin Cardozo’s decision in the case of _Ultramares Corporation v. Touche_ (255 NY 170). The New York accounting firm of Touche Niven & Co. was engaged to audit the 1923 financial statements of Fred Stern & Co., Inc. (specifically, “to prepare and certify a balance sheet exhibiting the condition of [Stern’s] business as of December 31, 1923” (Ultramares 1931, 1)). Stern was a rubber importer, and Touche had been engaged for the same purpose in the prior three years (Ultramares 1931).

[Ultramares] was a lending corporation and lent money to Stern Company. . . . Touche knew that the company used the audited accounts in its dealings with lending institutions to secure loans. Accordingly it supplied Stern with 32 numbered copies of the accounts. [Ultramares] lent money based on these accounts. The accounts were subsequently found to have been negligently prepared [Stern declared bankruptcy on January 2, 1925] and the plaintiff suffered loss as a result. (O’Leary 1998, 521)

Justice Cardozo determined that the books and records of Stern had been falsified by employees of Stern and that Touche, through its employee assigned to the job, had been negligent in determining the veracity of the information. In assigning a judgment of negligence, Cardozo stated that

> scrutiny of these [falsified] invoices would have disclosed suspicious features in that they had no shipping number nor a customer’s order number and varied in terms of credit and in other respects from those usual in the business. A mere glance reveals the difference. (Ultramares 1931, 3)

Justice Cardozo found for the accounting firm in the Ultramares case, however. His reasoning was that if liability were to be attached to negligence, given all the facts of
the case, that “[such an] extension, if made, will so expand the field of liability for negligent speech as to make it nearly, if not quite, coterminous with that of liability for fraud” (*Ultramares* 1931, 7).

Fraud includes the pretense of knowledge when knowledge there is none. To creditors and investors to whom [Stern] exhibited the certificate, [Touche] owed a like duty to make it without fraud, since there was notice in the circumstances of its making that [Stern] did not intend to keep it to himself. . . . A different question develops when we ask whether [Touche] owed a duty to these [external parties] to make it without negligence. If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. (*Ultramares* 1931, 3-4)

This finding by Cardozo has been challenged by a number of jurisdictions.

Negligence by accountants today, particularly where the accountant is aware of the use of the external financial statements, will likely result in a judgment against the accountant. Several facts distinguish the *Ultramares* case: (a) the “audit” by Touche Niven & Co. was a balance-sheet-only examination; (b) the preparation of the balance sheet was made by Touche, not Stern, who was therefore ultimately responsible for its contents; and (c) many of the standard audit procedures in effect today, such as confirmation of receivables, were not enforced at this time. Indeed, one of the major suggestions to surface as a result of the McKesson & Robbins investigation in 1939 was this receivable audit step.

The New Deal, the SEC, and Symbolism

A new and energetic President assumed leadership of the United States government in 1932. He promised to deliver democracy from Wall Street money changers back into the hands of the American people. Franklin D. Roosevelt’s inaugural address assured the American people that “the only thing we have to fear is
fear itself – nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance” (Roosevelt 1933, ¶1).

The Securities and Exchange Commission came into existence on June 6, 1934, with the passage of the Securities Exchange Act of 1934. Roosevelt had urged the Congress in February of that year to establish regulatory restraints of stock exchanges as a part of his New Deal and as an extension of the Securities Act of 1933. This 1934 act, in conjunction with the 1933 act, represented a major affront to the business community and to the exchanges. A conglomeration of companies and individuals, representing most of the moneyed “old guard” that had basically controlled the nation’s economy throughout the first part of the 20th century, feared governmental restrictions from politicians who understood little of Wall Street workings and would subject U.S. capitalism to political whims (Maeder 1999). Many, if not most, of the CEOs in this mixture enjoyed immense prestige and power, posing an extreme danger to American capitalism (Berle and Means 1933). Considerable pressure was applied to the fledgling SEC, not only by the NYSE, but by bankers’ associations and the U.S. Chamber of Commerce (Seligman 1982, 91-92), to reduce contemplated regulatory restraints within the initial Securities Act of 1933. As a result the SEC

[used] both . . . acquiescence and compromise strategies in dealing with external constituents and in balancing needs for the appearance of regulation with de facto inaction in regulating audit practice. (Bealing et al. 1996, 317, emphasis added)

Conflicting opinions about the reason for SEC establishment abound throughout the research of these early years. Most of the extant literature supports the idea that the Securities Acts were intended to correct the perceived wrongs in the marketplace
and provide investors with better and more complete financial information. Merino and Neimark, however, posit that the securities legislation in 1933 and 1934 cannot be understood if viewed simply as a response to the alleged abuses in the securities markets in the 1920s; rather . . . the [securities] acts were part of a continuing nineteenth- and twentieth-century effort to reconcile corporate dominance with individualistic eighteenth-century democratic and economic theories without disturbing the existing [20th century] set of social and economic relations. (Merino and Neimark 1982, 34)

These authors conclude, therefore, that the Securities Acts were not designed to be strictly enforced, but rather to be symbolic gestures, placating investors who could perhaps be classed as less than sophisticated. They were not designed to result in “significant changes in distribution of economic resources” (Merino and Mayper 2001, 501). Merino and Mayper further suggest that the Acts were designed to maintain the American Dream in a liberal environment that had secured power within the U.S. government. These authors also suggest that persons responsible for the continued existence of the SEC would necessarily need to compromise, rather than to enforce strict regulatory restraints on the business world and on the exchanges. I posit the impact of this conciliatory stance by the SEC emboldened managers to continue to use their power as they had in the 1920s. Since the “teeth” of the Securities Acts had been reduced (Seligman 1982) to the point that legislation was symbolic only, perception of this symbolism by managers allowed their power to continue virtually unchecked.

Further, I posit the impact of the Securities Acts on boards of directors simply allowed them to continue to rubber stamp managerial decisions and not to be concerned with liability to stockholders or society because of any lack of acceptance of fiduciary responsibility.
Edelman (1964) discusses this concept of symbolism at length. He reports conditions that create feelings of well-being among society, particularly under emotional duress. (1) He states that the more emotional the situation, the greater will be the positive reaction of the person to symbolism. (2) He suggests that a great number of our society cannot decipher ambiguous and/or complex situations, and that, when confronted with these, they “respond chiefly to symbols that oversimplify and distort” (Edelman 1964, 31). He cites Harold Lasswell, a prominent political scientist of the 20th century, as follows:

Quite often a solution is a magical solution which changes nothing . . . and which merely permits the community to distract its attention to another set of equally irrelevant symbols. The number of statutes which pass the legislature, or the number of decrees which are handed down by the executive, but which change nothing in the permanent practices of society, is a rough index of the role of magic in politics. . . . Political symbolization has its catharsis function . . . (Lasswell, cited in Edelman 1964, 33)

Symbolic legislation might, indeed, be sufficient to restore investor confidence in the marketplace and placate worried, angry investors. I suggest, however, this type of legislation was also strongly advocated by corporate CEOs who were perceptive enough to understand the stringent regulatory requirements were not going to be enforced – that they were political symbols of the type discussed by Lasswell. They understood that the status quo would be continued and that their power would be only marginally challenged by this fledgling SEC organization. They also understood that any challenge to their being able to hand-pick boards was also virtually nonexistent.

McKesson & Robbins, Inc. Fraud

On December 5, 1938, a complaint was filed in the United States District Court at Hartford, Connecticut, seeking the appointment of a receiver for McKesson & Robbins, a large, widely known and respected company engaged principally in the drug and chemical business. The complaint alleged that the company’s
officers and directors had fraudulently represented its assets as including inventories and accounts receivable which did not exist. (Carey 1970, 22-23)

The following information is taken from primary source data gathered at the SEC and is a portion of the Report on Investigation by that body into the matter of McKesson & Robbins, Inc. (McKesson) which took place over a four month period in early 1939 (SEC 1940a).

The discovery of the McKesson fraud is somewhat convoluted. Apparently, Julian F. Thompson, the treasurer of McKesson and the first to suspect fraudulent transactions, made those suspicions known to senior members of the McKesson board of directors on or about Friday evening, December 2, 1938. Saturday morning, December 3, 1938, 2,000 shares of McKesson common stock disappeared from the account of Mrs. F. Donald Coster, wife of McKesson’s CEO. These shares were transferred by “a New York Stock Exchange firm” (1940a, 14) to Robert J. Dietrich, head of shipping, receiving, and warehousing for McKesson. Dietrich, whose real name was Robert Musica, was, in reality, the brother of the CEO. These 2,000 shares were not registered in Mrs. Coster’s name but instead were “registered in ‘street names’” (1940a, 14, f/n 5). Apparently Dietrich, in turn, then delivered the 2,000 shares to an attorney, Benjamin Slade (although Slade said he “represented an undisclosed officer of the company” (1940a, 14)). Slade then turned the 2,000 shares over to Thomas J. Spellacy, Mayor of Hartford, Connecticut, who, in turn, gave the stock to Vincent W. Dennis, Corporation Counsel for the City of Hartford. Dennis, now owner of 2,000 shares of McKesson stock and armed with information concerning fraudulent allegations, filed suit against McKesson in District Court on Monday, December 5, 1938.
The complaint was filed in the United States District Court at Hartford, Conn., (USDC, Hartford) on Monday afternoon, December 5, 1938 by . . . Dennis . . . as a stockholder suing on behalf of himself and on behalf of all other stockholders of McKesson & Robbins, Incorporated. (SEC 1940a, 13)

[The suit alleged that] the company, through its officers and directors, for a long time prior to the date hereof had fraudulently represented its assets to be of a substantial character and in its statement to stockholders, security holders and to the general public has included in its inventory and accounts receivable, inventories which do not and have not existed and accounts receivable which do not and have not existed. (SEC 1940a, 13).

The judge for the District Court immediately placed McKesson in receivership and established temporary receivers for the corporation.

On Monday evening, Wilbur L. Cummings, a McKesson director and a partner of the law firm that represented McKesson, made the situation known to the Board of Governors of the NYSE through Sidney Weinberg, a Goldman Sachs partner, a director of McKesson, and a member of the NYSE Board of Governors. All trading in McKesson securities was halted at the opening of the market on the following day, Tuesday, December 6, 1938 (1940a, 14-15). Cummings also called William O. Douglas on Tuesday and “told him we’d welcome an investigation. . . . They [the SEC] have much more power than the auditors or even [the] receivers” (1940a, 16). The SEC conducted an investigation over the next two days.

Although it was impossible to track down all the ramifications in that short period, [SEC investigators] reported a sufficient outline of the situation to impel the Commission on Friday morning, December 9, to refer the matter to the Department of Justice for necessary criminal proceedings. [By] noon of the same day it was announced that the case would be considered by a Federal Grand Jury under the direction of the United States Attorney’s Office in New York. (SEC 1940a, 16).
F. Donald Coster, McKesson’s chief executive officer (CEO), was arrested and fingerprinted. These fingerprints identified him, in reality, as Philip Musica, a convicted felon.

It was at noon of . . . Friday, December 16, after his past career had been exposed and just as the United States Marshal reached his home to rearrest him under [the current] indictment, that Philip Musica, alias F. Donald Coster, committed suicide. (SEC 1940a, 19).

The McKesson board of directors was comprised of the following individuals:

- The executive committee, composed of Weinberg, Cummings, Charles Michaels (executive vice-president), William Murray (first vice-president), and Coster-Musica (CEO)
- Horace Merwin
- Rowley Phillips

Testimony by these directors (with the exception of Coster-Musica) asserted that, with very few exceptions, board members were unaware of the contents of audit report from the company’s auditor, Price Waterhouse & Co. Further, these board members testified they had no part in hiring or overseeing the audit, and that Coster-Musica or the controller, John McGloon, made these arrangements close to the end of the year being audited (SEC 1940a, 4-5). This testimony was not challenged by the SEC in the investigative report, nor were any of the directors indicted in the fraud.

In carrying out the fraud Coster, in the later years [when the brunt of the fictitious assets were recorded on the books and records] was assisted principally by his three brothers: George E. Dietrich, assistant treasurer of the Corporation, who was in reality George Musica; Robert J. Dietrich, head of the shipping, receiving, and warehousing department of McKesson & Robbins at Bridgeport, Connecticut, who was in reality Robert Musica; and George Vernard, who was in reality Arthur Musica and who managed the offices, mailing addresses, bank accounts and other activities of the dummy concerns with whom the McKesson Companies supposedly conducted the fictitious business. (SEC 1940a, 3)
The total consolidated assets reported on the December 31, 1937, McKesson balance sheet were somewhere in excess of $87 million. Approximately $19 million of these assets were nonexistent inventories and accounts receivable of the drug division of the Connecticut subsidiary of McKesson, itself a fictitious entity, and of the Canadian subsidiary of McKesson & Robbins, Inc. (SEC 1940a, 3). No evidence of a board approval of any financial transaction that created the fictitious assets was submitted as evidence in the investigation, further indicating that the board was largely unaware of the fraud and had been “honeyfugged” as much as had McKesson’s shareholders.

Indictments were handed down on the three surviving Musica brothers, Benjamin Simon (who apparently had participated in some of the office management fictitious events early on), John Jenkins and Leonard Jenkins (brothers-in-law of Coster-Musica), and McGloon (SEC 1940a, 20).

The operations of the fraud were therefore almost exclusively under the direction of one person – the CEO, F. Donald Coster. To be sure, the family members abetted the fraud, but it appears from the testimony that they were following the directions of the mastermind CEO. The initial allegation of board complicity was never proven. Although Merwin and Phillips were indicted, they were cleared of the charges by the jury in the case (SEC 1940a, 20).

Carey (1970, 25) asserted “the entire accounting profession was, in effect, on trial.” Twelve expert witnesses, eleven of whom were senior partners from prominent CPA firms and one who was a university professor, gave testimony in the investigation of McKesson (SEC 1940a). Using an identical line of questioning with all witnesses, William W. Werntz, chief accountant of the SEC, basically asked each witness: (1) Why,
in their opinion, had auditors not been able to determine the nonexistence of $19 million of assets fictitiously recorded on McKesson's books, and (2) What needed to be done to improve the independence of audit firms, so that financial information would give investors information they needed to make useful decisions. The conclusions of a preponderance of these witnesses agreed that having a "buffer" between the auditor and the CEO would have alleviated to some degree the inability of the auditor to challenge the power of the CEO.

The witnesses called to testify were as follows:

- Samuel J. Broad, Peat, Marwick, Mitchell & Co., New York
- William H. Bell, Haskins & Sells, New York
- Norman J. Lenhart, Lybrand, Ross Bros. & Montgomery, New York
- John K Mathieson, Mathieson, Aitken & Co., Philadelphia
- Charles B. Couchman, Barrow, Wade, Guthrie & Co., New York
- Hiram T. Scovill, professor of accountancy and head of the department of business organization and operation at the University of Illinois
- Joseph J. Klein, Klein, Hinds, and Finke, New York
- George D. Bailey, Ernst & Ernst, New York
- Charles W. Jones, Arthur Andersen & Co., Chicago

Werntz' line of questioning included a check of each individual's credentials; a determination of the scope of audit each firm used (with particular reference to a
pamphlet recently published by the American Institute of Accountants entitled “Examination of Financial Statements by Independent Public Accountants”); the witness firm’s methodology of staff organization and training for audits; conduct of the audit; review of the audit work by the audit firm; and the type of report rendered to the company and to whom these reports were addressed (SEC 1940a). Fiduciary responsibility was not a part of the investigation of the expert witnesses.

Werntz then asked each witness for any general suggestions and/or comments he might have which would assist in the investigation. These comments concerned such items as auditor rotation, auditor attendance at board meetings, adoption of a natural business year by the corporation, and other concerns that the auditor had about the auditor-corporation connection. Consensus in this last general questioning area was as follows (SEC 1940a):

- Auditors were appointed by the CEO or senior managerial personnel of the corporation.
- Limitations by the client management on the extent of the audit were a reality, with only three of the witnesses dissenting from this opinion.
- Auditor responsibility was to the board of directors in most of the witnesses’ opinion. This testimony differed from actual circumstances, though, as evidenced by most of the witnesses stating that their financial statement reports were rendered to management, not to the board. In cases where copies of the reports were sent to board members, most of the witnesses agreed that the form sent to the board members was a “short form,” rather than a “long form,” implying that financial information was significantly limited in these reports.
• Most importantly, eight of the twelve witnesses said they would strongly favor a committee of the board of directors (which several of the witnesses even called an “audit committee”) as being responsible for appointing the auditor and handling the details of the audit, such as scope and fee. Three of the remaining four said the board itself should be responsible for this task. The remaining witness expressed no opinion on the matter.

This last testimony formed the recommendation of the SEC in Accounting Series Release (ASR) No. 19 (SEC 1940b), which they believed would mitigate much of the familiarity between auditor and auditee. Their intent, of course, was to inject impartiality and distance between the two parties and thereby to strengthen the independence of the external auditor. A perception of independence and distance on the part of the external auditor was vital in restoring investors' confidence in published financial information, according to this thinking.

Reports made at annual meetings of the American Institute of Accountants (AIA) during this period expressed various views about the independence accorded the external auditor by the SEC’s recommendations. In a presentation by J. N. Aitken, Jr., a CPA from Philadelphia, just after the McKesson & Robbins investigation, the independence of the auditor in the U.S. was compared to that of the chartered accountant in Great Britain. Aitken stated that external auditors’ independence there was not the problem it apparently was in the U.S. (Aitken, Jr. 1938). John Haskell, then vice-president of the NYSE, reinforced the suggestion for audit committees at the AIA convention in 1939 (Haskell 1939, 16). Joel Bowlby, a Chicago CPA and member of council of the AIA, quoted one of the expert witnesses at the McKesson & Robbins
investigation as saying, in effect, that any method of auditor selection would not have a bearing on his/her independence if he/she were doing the required task correctly (Bowlby 1941, 34). The chairperson of the AIA Special Committee on Cooperation with the Securities and Exchange Commission agreed with this assessment:

A few months ago we were asked by one of the commissioners [of the SEC] whether appointment of auditors by stockholders, rather than by the management, would make for greater independence on the part of the auditor. We expressed our belief that the auditor's independence did not depend upon the channel of his appointment. (AIA 1940, 160)

Several problems remained, however. First, and most importantly, the SEC used a symbolic gesture in urging, but not requiring, corporations to form audit committees, the majority of which would be composed of nonofficer members. The NYSE, through its vice-president, John Haskell, even made an attempt to follow up this recommendation by writing to all corporations listed on the Exchange. His January 9, 1940, letter reiterated the recommendations made, including the audit committee recommendation, and requested “the results of your consideration in order that we may have a better understanding of their appropriateness to your company” (Anonymous (JA) 1940, 132).

No record of any replies to this letter could be found. The chart at the appendix to this study, however, which reports on 60 large corporations’ board makeup for the four years following the McKesson investigation, shows that none reported an audit committee as part of their board of directors. Email messages and telephone contact with corporate headquarters of these corporations during September and October of

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10 It should be noted that any requirement for reporting board committees in these years was nonexistent. The 60 companies selected were randomly picked, with the only criteria for selection being (a) relative size, (b) name recognition, and (c) perceived existence today. The information was gathered from Moody’s Index at the New York City Public Library.
2009 have revealed very limited response concerning the year in which an audit committee was actually formed. Those that have responded generally indicate their audit committee was formed in the 1970s or later. Only one corporation, Coca-Cola, stated that its audit committee was formed in 1939, presumably in response to Haskell’s letter.

Second, the SEC still needed institutionalization as a legitimate organization, capable of making pronouncements that could be enforced which would create good corporate governance, as well as obtaining necessary funding from the Congress for its continued existence. At this early stage in its life, then, symbolism and conciliation was almost a necessity of the SEC’s continuance.

The Birth of the Audit Committee

The audit committee, then, was primarily a result of a perceived necessity to establish distance between powerful corporate managers of large corporations and those who examined their financial reporting. However, the history of the corporation in the early 20th century, of the accounting profession during that time, of the mentality of the American public during the Roaring Twenties, of circumstances which abetted powerful corporate managers to believe in their own invincibility, of a regulatory institution’s need to establish its authority, and of expressed fears concerning unchecked power, all must be analyzed to understand why audit committees were symbolically recommended as part of good corporate governance. Further, all these provide a starting point for examination of why this error-prone system of symbolic corporate governance was allowed to remain in force throughout most of the 20th century.
Accounting Series Release No. 19, published December 5, 1940, encompasses the SEC’s recommendation, as follows:

While the appointment of Price, Waterhouse & Co. [as McKesson’s external auditors] and the method of determining the scope of the engagement in this case was in accord with generally accepted practice, we do not feel that it insures to the auditor, in all cases, that degree of independence which we deem necessary for the protection of investors. Adoption of the following program, we feel, would aid materially in correcting present conditions:

2. Establishment of a committee to be selected from nonofficer members of the board of directors which shall make all company or management nominations of auditors and shall be charged with the duty of arranging the details of the engagement. (SEC 1940b)

Primary source data from yearbooks of the American Institute of Accountants (AIA) (the forerunner of the AICPA) show the following limited mentions of corporate audit committees or committees that resemble audit committees (AIA Yearbooks 1916-1947):

- **1932** The New York State Chamber of Commerce passed a resolution dealing with auditors being selected by stockholders.

- **1933** A newly-formed special committee of the AIA, the Committee on Appointment of Auditors, reported the State of Connecticut stated that banks, in general, may have auditors “elected by the Board of Directors or a duly authorized committee of such Board” (AIA 1933, 246).

- **1939** The Special Committee on Auditing Procedure report briefly discussed the method of appointment of external auditors. The report states that some corporations are using Boards of Directors to engage the auditor. Others provide that stockholders can ratify a Board of Director selection of auditor, rather than selecting the auditor themselves.
Other than in papers presented at the annual meetings of the AIA, no other mention of a committee such as was recommended in ASR No. 19 could be found, although this is understandable. The AIA was very involved in the war effort during the first half of the 1940s, as was the rest of the United States. What happened historically in the years after World War II created the evolution of the audit committee beyond ASR No. 19 suggestions and ultimately produced the “bright line” regulatory mandates of the Sarbanes-Oxley Act of 2002 (SOX).

Post-World War II

Rampant, unchecked corporate managerial power decried by Berle and Means (1933) did not disappear or become extenuatory in this period because of the SEC’s recommendations issued in 1940 in Accounting Series Release (ASR) No. 19 (SEC 1940b). What happened within the business world, and particularly within those corporations where the CEO held and utilized his/her unrestrained power, was, as the common saying goes, business as usual. CEOs continued to appoint boards, to sit as chairs of boards, and very likely to place cronies on audit committees if one was formed in response to the SEC’s suggestion. Such cronies qualified under the definition of nonofficer but were far from independent.

As was true with the end of World War I, America basked in the headiness of victory. Corporate governance and managerial power over corporations was of small concern to persons who were putting their lives back in order and enjoying the freedom from a repressive threat that had been quelled. Activists were still attempting to promote the status of the corporate shareholder, however.
Mitchell (2009) reports that in the period during and following World War II and continuing through most of the 1950s attempts were made by the SEC to legitimize the rights of the shareholder by passing a shareholder proposal rule on January 15, 1943 (718). Basically, the concept was to allow shareholders to challenge “directors who do not direct” (Douglas 1934). Directors were to function as fiduciaries for shareholders, according to this concept, and shareholders should be given the right to enforce trusteeship. “But the trusteeship idea was never fully endorsed by the courts” (Mitchell 2009, 720). New Deal proponents of the proposal rule believed that shareholders could thereby be given a voice in the functioning of the corporation. Mitchell (2009) states, however,

as much as the New Dealers wanted to enact the shareholder proposal rule, their ideal of shareholder democracy [ironically] was also meant to substantiate the absolute power of management to run the corporation. Subsequent developments brought that aspect to the fore. (2009, 718)

The proposal rule became constricted by rulings, the first being promulgated in 1947 when such proposals were subjected to review by the corporation. A year later the SEC allowed the corporation to remove (“omit”) any proposals that were outside defined boundaries. Further restrictions on the shareholder proposal occurred in the early 1950s, with the result that “[u]ltimately [the restrictions] destroyed any possibility of effective shareholder participation” (Mitchell 2009. 718). Finally, at the close of this first period, “[d]irectors and executives were not only empowered to manage the corporation without interference from the shareholders (or the community), they were also shielded from liability” (Mitchell 2009, 722).

A different mindset ushered in the following period.
CHAPTER III

1955 THROUGH 1986

As was true with the beginning of audit committees in the very late 1930s, a historic explication of the economic tenor after the mid-1950s and of other situations in the decades of this time period are necessary to understand how corporate governance and boards of directors’ actions/inactions affected the evolution of audit committees. This explanation again illustrates problems concerning managerial power and a lack of ethical conduct within certain corporations which, in turn, created rapid growth of the number of audit committees and a proliferation of their responsibilities during the late 1960s and particularly the 1970s.

History

Dalia Tsuk (2005)\textsuperscript{11} reports that legal and academic scholars had abandoned a focus on corporate power in the post-World War II decades, replacing it with a discussion of individual rights of shareholders. Further, concerns engendered by totalitarianism in European countries in the 1940s led to a distrust of governmental powers in general (Mitchell 2009). These factors, among others, resulted in a very different view of the corporation.

Scholarly views of the corporation subsequent to the 1950s abandoned regulatory constraints of managerial power in favor of individual rights. Fears of managerial power dissipated, because individual shareholders could control this power through economic free markets. The contractual relationships in corporations would be sufficient in controlling these so-called agency costs. Tsuk describes the gradual

\textsuperscript{11} Dalia Tsuk and Dalia Tsuk Mitchell are obviously the same person. References to her earlier works are made using her maiden name.
replacement of the Berle and Means legal pluralism with contractarianism during this
time period:

[P]roponents of the new economic theory of the firm sought to refute earlier concerns about corporate power. With deregulation and free markets in mind, they reread *The Modern Corporation and Private Property* to be a book not about corporate power, but about the limited question of the effects of the separation of ownership from control on efficiency and profit maximization. Then, having described Berle and Means and their disciples as concerned with efficiency rather than power, advocates of the new [contractarian] economic theory of the firm announced that the problem, truly, was not a problem. Specifically, they argued that investors *preferred* to remain passive as it allowed them to maximize their profits through diversification, that both the controlling [managerial] group and the shareholders shared the same interest (namely, the maximization of profits), and that the market . . . held the controlling group at bay. (Tsuk 2005, 183, emphasis added)

I assert that Berle and Means' book is, indeed, a discussion of the dangers of unchecked corporate power. Their description of corporate power was inextricably linked to the concept of separation of ownership from control, but the key point in *The Modern Corporation and Private Property* was power, not this separation. These authors forcefully make the point that giant corporations at the time of their writing were a concentration of economic power which can compete on equal terms with [that of] the modern state. . . . The state seeks . . . to regulate the corporation, while the corporation, steadily becoming more powerful, makes every effort to avoid such regulation. Where its own interests are concerned, [the corporation] even attempts to dominate the state. (Berle and Means 1933, 357)

And yet, by the 1950s, even Berle seems to have been caught up in the move to individual rights that was dominating scholarly views of the corporation and of managerial power. In 1952 Berle reported that the great [American] corporation . . . has become increasingly an arm of the state, held to certain of the limitations imposed on the state itself by the Bill of Rights requiring the concentrate to respect certain individual rights and to assure a measure of equal protection of the [individual rights] laws within the scope of its power. (Berle 1952, 643)
Scholars who espoused the new firm theory quickly “[denounced] the concerns about corporate power” (Tsuk 2005, 211), opting instead to point out stock transferability and market maneuvers by shareholders as the major control over corporate managers. Jensen and Meckling’s (1976) theory of the firm perhaps expressed the new concept best. They state,

> It is important to recognize that most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals. . . . [These relationships serve] as a focus for a complex process in which the conflicting objectives of individuals . . . are brought into equilibrium within a framework of contractual relations.” (1976, 311-312)

Jensen and Meckling speak of Pareto optimality that supposedly occurs when both owner and manager have achieved the lowest agency cost incumbent on themselves. The firm “will undertake that level of monitoring which equates the marginal cost of monitoring to the marginal wealth increment from reduced consumption of perquisites by the manager.” (1976, 329)

I suggest that a major fallacy in the new theory of the firm occurs because of an assumption it makes. Specifically, suggesting that shareholders and managers have a “contracting relationship” (Jensen and Meckling 1976, 311) presupposes an equal “footing” for both parties to the contract. Only under this assumption are both parties capable of reducing their part of agency cost to Pareto optimality. This supposition of equal footing between giant corporation managers and shareholders has been disproved any number of times since the theory became paradigmatic. Shareholders may certainly display their disapproval of managerial tactics by selling their stock (thereby presumably affecting the market value of the corporation), but even the largest
shareholders of giant corporations have minimal ability to mitigate corporate managerial power by using this methodology.

As previously noted, the beginning of this time period saw “[d]irectors and executives . . . not only empowered to manage the corporation without interference from the shareholders (or the community), . . . [but] also shielded from liability” (Mitchell 2009, 722). Much changed in the next decade.

Barr (1978, 17) states that the years after the Korean Armistice in 1953 and up to the mid- to late-1960s saw “uninterrupted economic expansion [in the U.S. that] covered up a multitude of business mistakes.” Arora and Buza (2003) concur with this assessment, stating that the period from the mid-1950s to the late 1960s “is called the 'Golden Period' for [the] U.S. economy. . . . Life was good as a series of welfare programs were started . . . [and] inflation as well as unemployment were low” (2003, 108).

As this economic boom turned around in the very late 1960s and early 1970s, “explosive situations” (Barr 1978, 17) became obvious to stakeholders who were becoming increasingly distrustful of corporate accounting. Barr enumerates several cases of bad corporate governance and/or fraud: Penn Central, Equity Funding, Franklin National Bank. He states “[a]ll of a sudden everyone was asking ‘Where were the auditors?’ ‘Where was the audit committee?’ and . . . ‘Where were the directors?’” (1978, 17).

Social Awareness

Society began a great change in the 1960s as long-held norms were challenged by mostly young people. Many became activists in the civil rights and antiwar movements, while others simply “dropped out” and separated themselves from mainstream culture. (Guerra and Huset 2008, 20)
The 1960s, then, marked an era in which not only had “social values became dominant. . . . [but also] corporate power had become a matter of grave concern” (Previts and Merino 1998, 334). The distrust of financial data produced by corporations (Barr 1978) was exacerbated by scandals in the mid- to late-1960s, with the result that directors were increasingly questioned about their fiduciary responsibilities. Faced with increasingly complex business dealings and a lack of time to perform their duties adequately (Mautz and Neumann 1970b), corporate boards of directors began to consider the audit committee concept as one method of mitigating legal liability. Marget (1978, 403) states

Since 1960 various legal decisions have emphasized the responsibility that outside directors must assume in overseeing corporate affairs. Directors’ liability for misleading financial statements and the importance of the autonomy of the independent auditor have been at the forefront of corporate litigation since that time. Renewed interest in audit committees has arisen in response to those concerns.

The Catalysts

In addition to these reasons for renewed interest in the audit committee concept, most researchers discuss two events in connection with this exponential increase: an endorsement of audit committees by the Executive Committee of the AICPA in 1967 and a New York court case involving director liability, Escott v. BarChris Construction Corporation.

AICPA Recommendation

On July 20, 1967, in a short statement the Executive Committee of the American Institute of CPAs recommended
that publicly owned corporations appoint committees composed of outside
directors (those who are not officers or employees) to nominate the independent
auditors of the corporations’ financial statements and to discuss the auditors’
work with them” (AICPA 1967, 10).

The statement sought to improve the objectivity of reports on financial statements and
strengthen the independence of the external auditor in his/her dealings with corporate
management. The Executive Committee outlined three major steps that they believed
should comprise the basis of the audit committee’s responsibilities:

1) Discussing the scope of the audit with the external auditors “with particular
attention to areas where either the committee or the accountants believe
special attention should be directed” (1967, 10),

2) Reviewing the financial statements as contained in the auditor’s report
after the audit is completed, making sure that the auditors received all
information they sought in the course of their audit, and

3) Seeking the external auditors’ thoughts and recommendations about the
effectiveness of the corporation’s internal controls. (1967, 10)

The statement also recommended that the audit committee meet with the auditing firm’s
representatives, excluding management, and with management of the corporation,
excluding the auditing firm’s representatives.

A review of archive data of the Executive Committee through December 31,
1966, did not reveal any reasoning in discussions or minutes as to why the
recommendation for audit committee concept was made.\textsuperscript{12} Nest (1969, 72), the director
of technical services at the AICPA, however, alludes to the reason for establishing audit

\textsuperscript{12} It should be noted, however, that at the time of the Executive Committee statement, its executive
director was John L. Carey, the person who had authored the editorial about the audit committee concept
14 years previously.
committees as “[contributing] to greater efficiency in the work of the company’s independent auditors” (1969, 72), meaning that the committee was viewed as an aid in reducing and/or easing auditor workload, rather than as a fiduciary representative for stakeholders or functioning in an oversight capacity.

There was an obvious problem of symbolic reform from merely establishing audit committees. Klock and Bellas (1976) correctly note that this amounts to nothing more than a placebo. Major auditing firms within the United States also began to support the concept by suggesting the specific duties that the audit committee should perform to become proactive (Marjett 1978). Neumann, however, notes that “the [AICPA suggestion] was ignored by many, was challenged as a self-serving notion by some, and was opposed by others – especially those within management” (Neumann 1980, 62).

The symbolism of simply forming an audit committee in response to the AICPA recommendation, then, allowed powerful corporate managers to display acquiescence and placate shareholders while maintaining a status quo. Klock and Bellas (1976, 38) cite a number of corporate managers whose boards had no audit committees as believing there was “no perception of a [director] liability exposure” as a result of not having one. Formation of an audit committee was duly noted in the annual report to the SEC and to shareholders, while in actuality nothing changed in the company’s corporate governance.

Audit committees that were formed to maintain the status quo, then, had questionable effectiveness in promoting good corporate governance and ethical financial reporting. Kalbers and Fogarty (1993) suggest that effectiveness of an audit committee depends to a large extent on the power that members of the committee have
within the organization. If members of the committee have (1) the support of management, (2) the support of the board, and (3) sufficient time to accomplish their responsibilities, then these authors assert the committee will be able to perform effectively. Symbolic audit committees, of course, lacked these attributes.

*Escott v. BarChris Construction Corporation* (BarChris)

The second catalyst directly concerned board liability and fiduciary responsibility. In 1961 a company constructing bowling alleys overextended its ability to remain solvent and issued a prospectus for debentures to provide working capital, which prospectus contained materially misleading statements (Escott 1968). When the corporation declared bankruptcy in 1962, the bondholders sued both its directors and Peat, Marwick, Mitchell & Co. (PMM), BarChris’ auditors.

BarChris directors claimed “due diligence” as their defense (Escott 1968). Each director maintained that he had relied on “experts” (PMM) for the correctness of the financial data, and that this reliance was all that was necessary for him to prove due diligence. This defense came from the Securities Act of 1933 (Davis 1968; Escott 1968), and basically stated that individuals (board members in this case) cannot be held responsible for material misstatements where the data was made “on the authority of an expert (other than himself)” and the person “had no reasonable ground to believe . . . the statements were [false]” (Escott 1968, 682-683). Part of the financial data contained in the prospectus had not been audited, however. The financial data for the first quarter of 1961 was presented to the board of directors by management as being correctly stated, when, in fact, it contained the false financial data. The directors (some of whom knew of the falsities) allowed the data to be presented in the registration prospectus.
BarChris pointed heavily to the use of unethical managerial power. The court determined that all corporate directors were responsible for the veracity of financial data which they approved. It stated directors could use due diligence defense only in cases where they had relied on qualified experts, and that reliance on management did not qualify as experts (Escott 1968).

The BarChris decision shocked many corporate directors (Colegrove 1976, 17; Mautz and Neumann 1970a, 58). As previously stated, directors were faced with increasing complexities and time constraints (Mautz and Neumann 1970b; Baruch 1980). Barr (1976, 18) also points out that many directors were CEOs of other publicly-held companies and needed to devote most of their time to their own corporations. Now, because of the BarChris decision, directors – both inside and outside – were faced with pecuniary liability for not performing their fiduciary responsibilities satisfactorily. Giving a select few directors who had financial expertise the task of advising the board concerning financial matters seemed to make sense. Thus the BarChris case became "a significant impetus for the formation of audit committees" (Turtle 1977, 93) and for mitigating potential legal liability problems. DeZoort agrees with this assessment, stating that

\[\text{[h]eightened awareness of audit committees resulted from increased demands for corporate governance and accountability related to boards of directors. In particular, increased legal exposure for corporate boards resulted from a series of lawsuits and investigations during the period.}\]

(DeZoort 1997, 211)

BarChris is the first of several lawsuits that DeZoort cites (1997, 211, fn 1).

One further point pertaining to the BarChris case: Director fiduciary responsibility had presented a legal enigma up to 1968. In the early part of the 20th century, if directors were held to a fiducial standard by courts, then any liability they incurred by
not living up to those responsibilities would create an indefinite legal statute of
limitations (Dewing 1919; Dodd 1932). Stakeholders could then seek recompense for
malpractice on the part of directors at any point in time. Courts were reluctant to assign
that much liability to boards. In 1968, BarChris appeared to abrogate this protection
given to board members.

The Beginning of the NYSE Mandate

Response to the suggestion in ASR No. 19 concerning audit committees varied
considerably, as shown by responses to a letter sent by NYSE Chairman and CEO
William M. Batten on September 3, 1976, to all CEOs of listed companies (Batten
1976a). Several of the responses are indicative of corporations’ ignoring, or even
repudiating, the SEC’s suggestion during this time period after World War II and through
the late 1960s.

Mr. Batten’s letter expressed the NYSE’s intent to make the formation of audit
committees a listing condition and asked for comments from the CEOs. Based on
replies to this initial letter, insignificant changes were made to the wording (but no
correction to the letter’s substance), and a revised letter was sent again to NYSE-listed
corporations’ CEOs (Batten 1976b). The letter was accompanied by a short note
describing an audit committee of independent directors and including definitions of
“independent director” and “outside director.” The cursory information request
accompanying the letter asked the following questions of the CEO:

1. Do you agree that the Exchange should adopt a requirement regarding the
   Establishment of an Audit Committee?
2. Do you agree that such committees should be composed of a minimum of three independent directors of which a majority must be outside directors?

3. Do you agree with the deadline of December 31, 1977?

4. Does your company already have an Audit Committee that meets the proposed requirements or do you have plans to appoint such a committee?

5. If not,

Will you, as Chief Executive Officer, implement the policy if it is adopted by the Exchange?

or

Will you recommend action by your board if that is required?

6. Other comments or suggestions:

A search of the archives of the NYSE revealed 68 response letters from various corporations, 25 of which reported having an audit committee in place, and 43 of which either made no mention of having an audit committee or stated none was a part of the corporation’s board makeup (NYSE 1977a). Of the 25 companies stating they had audit committees, 11 stated in broad, general terms that they had had an audit committee formed “for years,” one company formed its audit committee in 1908, one in 1939, one in 1966, three in 1973, and eight did not specify a formation date (NYSE 1977a).

Amsted Industries reported it “has had an Audit Committee consisting of outside directors since 1908” (Amsted 1976, 1). Amsted, however, challenged the definition of “independent director,” stating that the corporation had included bankers with whom
Amsted had relations on its audit committee (Amsted 1976) and felt that this practice was perfectly acceptable.

What we have already said concerning commercial bankers is equally applicable to many other individuals who have traditionally been thought of as “outside” or “independent” directors. For example, an executive officer of Company who is a director of Company A ought not to be excluded from the class of “independent” directors of Company A merely because Company A buys or sells goods or services to Company B in the regular course of business. (Amsted 1976, 2)

I suggest that Amsted’s audit committee therefore does not meet standards of independence required by the definitions promulgated in Batten’s proposal.

Comments in the replies included a belief that the definitions of “independent” and “outside” were too restrictive (Eli Lilly 1976; Federated 1976; Flintkote 1976; Norton Simon 1976; Olin 1977) and a belief that consultants should be allowed to participate on the audit committee (Dean Witter 1976; Tracor 1976; White and Case 1976; Xerox 1976), among others. Repudiation came from a number of companies (Detroit Edison 1976; Gable Industries 1976; Greyhound Corporation 1976; Northwest Airlines 1976; Helene Curtis Industries 1977+), generally stating that the NYSE had no right to dictate internal affairs to corporations.

The reply from A.G. Edwards & Sons, Inc. is insightful. Benjamin Edwards, the president of A.G. Edwards, pointed out limitations of simply forming audit committees, stating that the most an audit committee would be able to accomplish is to “satisfy itself as to the independence of the company’s auditors” (Edwards 1976, 1).

The [proposal of the NYSE] does not define or even indicate the purpose and mission of the Audit Committee. At best, such a body would be working after-the-fact. Much more important would be the exercising by the “independent” [director] and all other directors of their responsibilities as general board members representing public shareholders.

...
I think an Audit Committee is a good idea, and it may be constructive for the NYSE to require it. And I think a majority of “outside” members makes sense. But the purpose and function of such a Committee should be clearly defined and understood. (Edwards 1976, 1-2)

Making a judgment about good or bad corporate governance because a corporation formed or did not form an audit committee in response to ASR No. 19 is problematical. The SEC suggestion was for either the board or its audit committee to nominate the auditing firm and generally arrange for the auditing engagement (SEC 1940b). Formation of an audit committee affords the auditor a direct channel to the board in case of problems with managerial power in establishing the scope of the audit (Edwards 1976), and this direct channel should strengthen the independence of the external auditor (Carey 1953). In this regard the audit committee contributes to good corporate governance. I posit determining that a corporation has bad corporate governance because it did not form an audit committee in response to the SEC suggestion, however, is an inappropriate conclusion.

As previously stated, CEOs continued to wield power, with boards of directors being little more than rubber stamps for managerial decisions. Mace surveyed presidents and CEOs of companies and reported several telling comments to questions about the functions of the board of directors:

We get a little advice from the outside board members, but the management runs the company. . . . Naturally, we consult with them if we are making a major change in direction. . . . But they are in no position to challenge what we propose to do. . . . The old concept that the stockholders elect the board, and the board selects the management is fiction. It just doesn’t apply to today’s large corporations. The board does not select the management; the management selects the board” (Mace 1972, 39, 41, 43).
Encompassed within these attitudes are arrogance and self-serving that has a real potential for bad corporate governance, and for which boards had little or no ability, or desire, to correct.

**Audit Committee Formation Prior to 1967**

Mautz and Neumann (1970b) cite Loomis in their extensive research into the formation of audit committees, pointing out the problem faced by boards with increasing frequency in this period.

On the one hand, the director is increasingly the target of lawsuits that seek to hold him to higher standards of accountability for his decisions and his actions. On the other hand, he inhabits a world in which the decisions are bigger and more complex, and the action faster – a world in which even the most conscientious and resourceful men necessarily can have only limited comprehension of some decisions for which they are held accountable. (Loomis, cited in Mautz and Neumann 1970b, 3)

Blair (1950, 110) points out a remedy to this problem that board members, particularly outside board members, employed. He asserts that through the use of active committees, the board can effectively subdivide the complexities and alleviate the limited amount of comprehension. “One idea which would appear to mitigate some of these difficulties of directors is the corporate audit committee” (Mautz and Neumann 1970b, 7).

In spite of the reasonableness of this approach, the audit committee concept was not implemented in large numbers prior to the AICPA’s Executive Committee endorsement in 1967 (Marget 1978). Percentages of corporations with audit committees in this time frame varied widely. Apostolou and Jeffords (1990, 1) cite unspecified surveys conducted “prior to 1970” as indicating that “fewer than half of the public organizations” within the United States had formed audit committees. Carey
(1953, 681) states that “about 25 per cent” of an unidentified accounting firm’s clients “appoint the firm as auditors either by action of the boards of directors or of audit committees of the boards.” Mautz and Neary (1979) report that 1960 research showed that only slightly over 30 percent of the Fortune 500 and equivalent companies had audit committees, that in many cases these met infrequently, . . . that their most common and most important assignment was to receive the audit report from the independent auditors and that, except for a variety of other relatively unimportant duties, many audit committees did little else. (1979, 83)

Other researchers are more specific. Mautz and Neumann (1970b) reported 32% of the corporations they surveyed (121 corporations out of 385) responded that their corporation had formed an audit committee. Mautz and Neumann (1970b) sent 1,732 questionnaires to CEOs and received 420 replies (24.2%), 385 of which had usable data (22.2%).

13 Other researchers are more specific. Mautz and Neumann (1970b) reported 32% of the corporations they surveyed (121 corporations out of 385) responded that their corporation had formed an audit committee. 39 of these (32%) reported that their audit committee was in existence since 1950, 35 committees (29%) were formed between 1950 and 1965, and 47 committees (39%) were formed between 1965 and 1970. If these figures are indicative of all publicly-held corporations, the research shows that approximately 19 to 20 percent of such corporations formed audit committees prior to the mid-1960s, presumably in response to the SEC’s suggestion. Colegrove (1976, 17) cites a Coopers & Lybrand survey that reported 17% of its clients had audit committees in 1967. Lehr (1978, 153) cites a Peat, Marwick, Mitchell & Co. survey that showed 18% of its clients on the NYSE and three percent of its clients on the American Stock Exchange in 1967 had audit committees.

With the exception of the research conducted by Mautz and Neumann (1970b), very little has been explicated about audit committees in the period after World War II and before 1967. As previously stated in Chapter 3, Appendix A lists 60 NYSE companies, none of which show an audit committee as a part of their board makeup in
annual reports submitted to the SEC. The only confirmation of an audit committee apparently formed in response to ASR No. 19 was Coca-Cola, Inc.  

I suggest the lack of audit committee formation during this time stems from three factors: (1) The initial suggestion by the SEC and NYSE specified that the committee, composed of directors who were not officers of the company, had the duties of hiring the auditor and arranging for the details of the audit – only. Managerial oversight and fiduciary responsibilities were board responsibilities and not yet considered a part of the audit committee concept. The committee was therefore not a necessity. (2) The ASR No. 19 suggestion was symbolic. It was made to placate investors who were concerned with the fraud perpetrated by management of McKesson & Robbins. It was not intended to be a mandate, and corporations believed they could therefore safely ignore it.

(3) [S]election of auditors by directors [or audit committees] has not increased perceptibly in recent years . . . simply because the matter has received little publicity recently, and has been overshadowed by other, newer problems. (Carey 1953, 680)

Reasoning as to why some companies formed audit committees after ASR No. 19 is conjecture, since data is limited. Auerbach (1973, 97), a Coopers & Lybrand associate managing partner at the time of his writing, reports the reason for establishing an audit committee, based on a 1972 Coopers & Lybrand survey of its clients, was due to a CPA suggestion (20 %), a management suggestion (16%), or an outside director suggestion (11%), among other reasons. It is likely that any of these reasons partially

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14 Delineation of board committees in annual reports was not required during the time frame covered by Appendix A.  
15 41 of the 60 corporations listed in Appendix A (or their successors) were contacted by email and/or telephone and asked to furnish information about the formation date for their audit committee. As of this writing, 24 of the companies have not responded, 11 of the companies refused to give information, and six of the companies responded positively. Of the six, five audit committees were formed after 1967.
represent why the committee was established in the period in and around World War II, although Auerbach does not specify any formation dates. It is also likely that some corporations formed their audit committee simply because of the wording of ASR No. 19. Boards of directors tended to be an average size of 9 to 11 members, and that large a group “borders on a size making unwieldy an in-depth discussion with the auditors about audit results. Inevitably, this situation suggests the use of [audit] committees” (Mautz and Neumann 1970b, 7).

Mace found the relationship between the CEO and the board of directors, in general, to be that of master and servant (Mace 1972). By extension, any audit committee formed under this configuration would also be subservient. Mace describes the condition in several of the companies he interviewed: One director commented “The only decision which we as directors will ever make in that company will be to fire the [CEO], and things have to get pretty awful before we would ever do that” (Mace 1972, 38-39). A CEO stated “The board rubber-stamps the action of management, and the board members are there to mollify the outside stockholders” (Mace 1972, 39). This conception of boards that functioned as a rubber stamp for managerial decisions is reinforced by others, including earlier research by Douglas (1934), and research by DeMarco (1976), Patton and Baker (1987), and Petra (2005).

I posit that an audit committee functioning under these circumstances would be ineffectual at best. Williams agrees, stating that “[f]or the most part, the committees that were formed [in this time frame] were weak, ineffective, and existed in name only” (Williams 1980, 43). I suggest audit committees thus formed during this period were, in
general, symbolic and designed to placate investors, rather than provide meaningful, proactive support for good corporate governance.

Because one of the original intents of the audit committee was to strengthen the independence of the external auditor and increase his/her ability to determine the scope of the audit rather than having the audit scope dictated to him/her by management (SEC 1940a), CPAs logically would be a primary beneficiary of audit committee implementation. A review of AIA/AICPA archive data in Durham, North Carolina, for the period prior to 1967 was therefore undertaken. The AIA appointed a one-man audit committee on February 4, 1955, “to review the scope of the [AIA] audit [conducted by] independent CPAs elected to audit the accounts of the Institute” (AIA 1955, 108), and this internal procedure of the Institute was repeated each year thereafter. Nothing in the data reviewed through December 31, 1966, however, indicated any study or comment by the AIA on the use of audit committees by publicly-held corporations. I suggest a possible reason for this lack of comment about audit committees of publicly-held companies may have been because the provisions of ASR No. 19 suggested use of the committee to hire the external auditor and to supervise his/her work. The Institute may not have wanted it to appear that they were taking any stance in the hiring or paying or supervising of external auditors. Indeed, when a special committee was later formed (in 1978) to determine if the AICPA should require the existence of an audit committee as a condition of company auditability, one of their conclusions was that the AICPA could not legally sustain the Institute’s imposition in corporate governance issues of client companies (AICPA 1978, 5).
On the other hand, suggestions of audit committees, primarily in the banking industry, were at least a part of the literature of this period. The committee on technical research and information of the National Association of Bank Auditors and Comptrollers (NABAC) made a suggestion that the use of audit committees in bank examinations would “preserve the time of the main Board” (Anonymous (JA) 1942, 450). A survey of American banks by a subcommittee of the NABAC in 1949 revealed that “[a] typical bank by-law . . . provides that ‘the comptroller shall be responsible to the president and, through . . . the audit committee, to the board of directors” (Ed. Staff (JA) 1951, 588).

The editor of the Journal of Accountancy that compiled this 1951 article, John L. Carey, understood that the audit committee concept not only could be applied to publicly-held companies, but also that external auditors could use the committee to strengthen their independence. He addressed the situation in an editorial comment (Carey 1953). The NYSE and SEC, according to Carey, had made strong inferences that boards of directors, rather than management, should be the corporate intermediary with external auditors. He wrote “[t]here seems to be general agreement, however, that selection of auditors by directors has not increased perceptibly in [the intervening] years” (1953, 680). Carey then underscores the importance of this lack of connection between the board and the external auditor:

This problem, however, remains an important one. . . . If the board of directors has no knowledge of the circumstances under which the auditors are appointed, or of any limitations that may be placed on their work, or of questions they may raise about internal control of accounting, or of major problems that may arise about disclosure of unusual transactions in the financial statements, [then] the board [will not] have discharged its [fiduciary] responsibilities reasonably. (1953, 680)
Carey’s mention of “internal control of accounting” in connection with the audit committee concept is visionary. Mautz and Neumann state

In the [National Industrial Conference Board's] 1958 study of Corporate Directorship Practices [five years after Carey’s editorial], for the first time, four purposes of a corporate audit committee were identified and continued in subsequent studies: selection of auditors, specifications of audit, review of audit results, and review of internal accounting procedure. (Mautz and Neumann 1970b, 20)

It is from this point forward that responsibilities within the audit committee concept began to proliferate.

Steps to Audit Committee’s Mandate

The expansion of audit committee formation, then, something that Neumann (1980, 62) calls “one of the most irrepressible phenomena in the history of corporate governance,” followed these two catalysts – the 1967 AICPA Executive Committee statement and the BarChris court case. Many researchers who have studied the expansion in the late 1960s and early 1970s ascribe the expansion to one or both of these catalysts (Mautz and Neumann 1970b; Auerbach 1973; Turtle 1977; Marget 1978; Williams 1980; Birkett 1986; DeZoort 1997). Still others state investor distrust and a protracted buildup of accounting problems, including major accounting frauds and misstatement of financial data, caused the increase in audit committee formation (Barr 1978; Lehr 1978; Apostolou and Jeffords 1990). Chazen and Landis (1976, 33) note that the heightened directors’ awareness of their responsibilities “resulted from . . . the more active role of the Securities and Exchange Commission and the courts.” For these reasons, and because of a perceived need on the part of corporate management for the symbolic placation of worried stakeholders, the formation of audit committees increased rapidly during the very late 1960s and particularly the early 1970s.
By the middle 1970s the percentage of corporations reporting boards with audit committees had changed to approximately 70–75% (Mautz and Neumann 1977), with some researchers reporting as high as 85–90% (Chazen and Landis 1976; Birkett 1986; Kalbers and Fogarty 1993).

Research suggests that a preponderance of corporations that had not formed audit committees in response to ASR No. 19 but did so in the very late 1960s and early 1970s in response to the two catalysts had no intention of allowing an audit committee to be anything other than an imposture. This suggestion is based on the following:

1. All publicly-held corporations were contacted by NYS vice-president Haskell in 1940 after the issuance of ASR No. 19, specifically urging that the suggestions contained therein be implemented (Anonymous (JA) 1940). Primary research in the archives of the NYSE did not reveal any replies from corporations to Vice-President Haskell. Corporations’ failure to form audit committees is testimony to the corporate CEOs’ belief that action on their part in response to the SEC’s suggestion for audit committee formation was unnecessary. That is, the CEOs considered the ASR to be a symbolic gesture to a worried public.

2. Public outrage in the late 1960s and early 1970s as a response to frauds and scandals pressured CEOs into forming symbolic committees, so that they could dissuade their shareholders’ concerns.

3. As stated, BarChris was perceived by many boards of directors as a threat of pecuniary culpability. Forming audit committees, even ones without any real power, provided partial mitigation of this threat.
Barr (1976) reports that the composition of outside members of boards of directors, and by extension, audit committees, is “usually [either] the chief executive officer of another publicly held corporation or a very busy professional” (1976, 18). Although the SEC’s recommendation in ASR No. 19 called for directors on the audit committee who were not “inside” directors, Collier and Gregory (1999) found use of management on at least some audit committees that were formed. They reported audit committees that were chaired by CEOs and stated these managers “have a strong negative influence on [audit committee] activity” (1999, 329). Hayes (1981) points out that even if the audit committee members are regarded as “outside” directors, their independence is to be questioned. “[Such] directors often move in the same social circles as the [CEO] and share directorships in other companies” (1981, 1). Further, Hayes cites the head of the Luce Foundation and a member of four audit committees among her six directorships as stating, “It’s sinful to say, but [audit committees] really don’t make much difference. If someone wants to lie to the auditors, they still can and get bad practices approved” (Wallace, cited in Hayes 1981, 1).

Harrison (1987) notes that “the existence of a board committee projects an image of responsible activity to the external environment, regardless of what, if anything, the committee actually does” (113, emphasis added), but he also warns that

[c]reating such committees to project a favorable image may serve a strategic purpose of legitimacy maintenance [for the corporation], but if the committees are not active, it runs the risk of legal repercussions as well as shortchanging shareholders and being unethical. (1987, 114).

An institutional theory explaining why audit committees were formed quickly at this time is one of two theories discussed by Kalbers and Fogarty (1998). The
instituational theory says that punitive or mimetic mentality produces a desire to have something that outsiders perceive as important. The theory suggests that organizational structures [like an audit committee] in such an environment [of herd mentality or coercive forces] become symbolic displays of conformity and social accountability. (Kalbers and Fogarty 1998, 131, emphasis added).

These authors assert that employment of structures, such as an audit committee, “fails to be directly related to the production of expected outcomes” (1998, 132). The formation of an audit committee, in other words, will not, of itself, give anything other than lip service to corporate governance, simply because the corporate board has utilized a protective cover to mitigate liability.

The proliferation of audit committees in the 1970s was done, according to the institutional theory, because outsiders were looking for them and expecting corporations to have them for shareholder “protection,” not because of any desire on the part of the corporation or the board to strengthen corporate governance. I would also assert that they were primarily formed because of fear of liability and litigation on the part of the board. It was a symbolic step, and Kalbers and Fogarty’s research backs this notion.

This study suggests that changes in the structure of corporate governance may be primarily symbolic. . . . The results strongly suggest the corporations will not naturally invest in a level of board oversight that provides the appropriate degree of protection to constituents. . . . [T]hose interested in effective governance must realize that it cannot be done by mandate or fiat. (Kalbers and Fogarty 1998, 145-146)

The spate of audit committee formations did little to stem the corporate governance problems engendered by unchecked corporate power. The SEC, mindful of these problems and wanting to create assertive audit committees, again suggested that corporations consider their proactive formation in ASR No. 123 (SEC 1972a). This
short document (1) traces the history of the audit committee back to McKesson & Robbins, (2) notes that the SEC suggested such committees in 1940, (3) implies that its suggestion met with little success, and (4) notes that the AICPA added its influence in 1967. In what appears to be an attempt at more forcefully recommending audit committees’ use without actually mandating them, the SEC stated that

[t]he Commission has a statutory duty to satisfy itself that the consolidated financial statements filed with it by publicly-held companies of increasingly sophisticated and interlocking affiliations satisfy [statutory] requirements. . . . To this end, the Commission . . . endorses the establishment by all publicly-held companies of audit committees composed of outside directors and urges the business and financial communities and all shareholders of such publicly-held companies to lend their full and continuing support to the effective implementation of the above-cited recommendations in order to assist in affording the greatest possible protection to investors who rely upon such financial statements. (SEC 1972a, 2)

Again that same year, the SEC sought to dissuade distrusting investors concerning audited financial statements by issuing ASR No. 126 (SEC 1972b), entitled Independence of Accountants. In it, the SEC stated

[t]he concept of independence, as it relates to the accountant, is fundamental to this purpose [adequate and accurate disclosure of all material facts to the public], because it implies an objective analysis of the situation by a disinterested third party” (1972b, 1).

The SEC connected this external auditor independence to the corporate audit committee by suggesting that the audit committee would strengthen and increase the auditors’ independence, “particularly [when the committee is] composed of outside directors” (1972b, 3). Directors have a responsibility, according to ASR No. 126, to determine when advice to corporate management by the auditor becomes an impediment to independence. The SEC states that the board of directors, through its audit committee, needs to assume separational responsibility at that point – “when the
[auditor] becomes, or appears to become, so identified with the client’s management as to be indistinguishable from it” (1972b, 4). The ASR then describes a number of situations in which auditor independence may become impaired.

A Wall Street Journal article in May of 1972 reported an increasing number of audit committees were being formed in response to ASR No. 123, the collapse of the Penn Central, and the impending threat of lawsuits against outside directors and auditors for inaccurate or misleading financial reports. The article characterized the audit committee as an “‘early warning system’ to detect corporate problems before they develop into crises.” (Hyatt 1972, cited in Lehr 1978, 143)

In these years, the SEC believed investors needed to be informed that corporations had developed audit committees. ASR No. 165, issued on December 20, 1974 (SEC 1974), required corporations to report information about audit committees in shareholders’ proxy statements.

The corporate proxy had been decried by researchers since the beginning of the 20th century as a tool that allowed corporate management to hand-pick directors who would function only to accede to management’s wishes and dictates (Berle 1931; Berle and Means 1933; Douglas 1934; Dale 1960; Mace 1972; DeMarco 1976; Baruch 1980; Patton and Baker 1987; Scott 2001; Oliver 2003; Mizruchi 2004). ASR No. 165 at least sought to inform skeptical shareholders that their corporation had formed a committee designed to assist in producing accurate financial data, to ensure auditor independence, and to oversee management’s running of the corporation. Among a profusion of changes to the proxy, the SEC included the following:
Disclosure is required of the existence and composition of the audit committee of the Board of Directors. The Commission has already expressed its judgment that audit committees made up of outside directors have significant benefits for a company and its shareholders (Accounting Series Release No. 123). This disclosure will make stockholders aware of the existence and composition of the committee. If no audit or similar committee exists, the disclosure of that fact is expected to highlight its absence. (SEC 1974, 5)

A shareholder receiving this information ostensibly could determine that he/she was being represented by directors who were looking out for the shareholder’s interests, who were reining in unchecked managerial power where ethical bounds were being overstepped, and who were ensuring a presentation of transparent and factual financial data in quarterly and yearly reports. In actuality, corporate “business as usual” continued.

The NYSE was keenly aware of a necessity for some sort of major overhaul of corporate financial matters and addressed the problem with its White Paper in December, 1973 (NYSE 1973). As stated, a number of corporate frauds and bankruptcies had occurred in the 1960s and early 1970s, creating distrust for any information produced by corporations in their annual reports to the SEC. In its White Paper the NYSE stated “[t]here appears to be widespread concern that financial communications generally do not provide investors with enough meaningful information for making [sound] investment decisions” (NYSE 1973, 3).

The urgent need for constructive action is underscored by a recent statement from the Opinion Research Corporation that big corporations “face the worst attitude climate in a decade.” Clearly, financial reporting is not the only factor in the widespread loss of business prestige. It is, however, an obvious starting point for a turnaround – and one which demands the serious attention of responsible corporate managements and directors.

The recommendations in this White Paper can be viewed as a call – and in some instances, perhaps, as a challenge – to the capability of corporate management to develop new levels of excellence in financial reporting. (NYSE 1973, 3)
The NYSE pointedly reminded corporate management that if they did not improve their financial reporting and corporate governance, “government stands ready to do for us what we [will not] do for ourselves” (1973, 4).

As part of the White Paper, the NYSE strongly recommended that all publicly-held companies establish audit committees and use them properly in the maintenance of good corporate governance. They also suggested that corporations list the names and affiliations of all audit committee directors. They stated

[s]uch Committees are usually and preferably composed exclusively of outside directors. . . . A vigorous Audit Committee can stimulate improvements in financial reporting and control and strengthen the creditability of corporate reports.

The [NYSE] first suggested the concept of an Audit Committee back in 1940. The Securities and Exchange Commission and the AICPA subsequently added their support. The [NYSE] believes that the idea no longer represents a corporate luxury but has become a necessity. (NYSE 1973, 6)

A survey of NYSE-listed companies was sent in the spring of 1974, requesting responses to the points brought out in the White Paper. 72% of the companies responded (NYSE 1974, 16), although only 69% of the companies (1,083 companies) responded to the questions concerning the audit committee. 80% reported formation of an audit committee, while 13% reported that they planned to formulate the committee “in the future” (NYSE 1974, 3). 66% had not identified audit committee directors in their annual report to the SEC (1974, 3), although this may have been because of a lack of time. If the corporation was a calendar year corporation, its annual report was due only two months after the White Paper was issued.

An examination of the U.S. Congressional mindset during the time from the McKesson & Robbins scandal in 1939 to the 1970s is necessary to understanding how
audit committees gained rapid support from a number of regulatory bodies. The Congress in these middle decades of the 20\textsuperscript{th} century, and most particularly the House of Representatives, reflected a metamorphosis of thought. Polsby (2004) describes the tenor of the House from approximately 1937 to the late 1950s as strongly conservative.

There is a general consensus among observers that by 1940 and for the previous few years the House had been in the grip of a conservative, anti-New Deal alliance of southern Democrats and Republicans who constituted the real majority of the House, notwithstanding the nominal Democratic majorities that elected [conservative House Speaker Sam Rayburn] and determined [which] Democrats would chair committees.

By 1937, most of the elements of conservative coalition power that became familiar over the next two decades had emerged: (1) entrenchment of the coalition in the House Rules Committee, which provided an all-important strategic bottleneck; (2) the enfeeblement of the caucus as a device to mobilize the majority of the majority party; and (3) the cloak of seniority that protected conservative committee chairmen . . . who opposed New Deal programs. (Polsby 2004, 9-10)

Conditions in the House would continue in this manner, with conservative Republicans and Southern Democrats able to control legislation passed through the House, in spite of Democratic majorities throughout these years ranging from a low of 1\% to a high of 26\% (with only the 80\textsuperscript{th} Congress in 1946 and the 83\textsuperscript{rd} Congress in 1952 being slim Republican majorities) (Polsby 2004, 5).

The 1958 Congressional election was markedly different: “[C]hange was in the air. The signs were plentiful. . . . [I]n the 1958 [C]ongressional election itself, the country had produced a massive Democratic landslide” (Polsby 2004, 21). Gradually, the liberal faction that was the bulwark of the Democratic Party weaned the powerful committee heads from the conservative bloc. The liberal movement was abetted by the election of President Kennedy in 1960, and the liberal Democratic faction in Congress became dominant in the next two decades.
There was a general movement of the country away from earlier conservative tenets, however, and toward a more socially responsible composure. Congress was predisposed toward governmental control of the economic system in general and of the accounting profession in particular at the time. Since it appeared to investors that the accounting profession was less than trustworthy and corporations were not willing to accept suggestions from the SEC as anything but symbolic, this mindset is understandable. Two Congressional committees, the Moss Committee and the Metcalf Committee, held hearings to determine what was needed to regulate and enforce ethics, morality, and good corporate governance within the U.S. capitalistic system. The Financial Accounting Standards Board (FASB) replaced the Accounting Principles Board (APB) in 1972, because the accounting profession recognized that the APB was not providing standards and principles that were proactive and capable of dealing with uncharted problems. A liberal Congress, however, did not believe this was enough.

The SEC, as well as the NYSE, believed that the audit committee was a move in a positive direction to solve the crisis and avert federal legislation of the accounting profession, which appeared to be the intent of Congress. A number of enforcement proceedings and investigations were initiated by the SEC during the 1970s, requiring audit committee establishment as a condition of acceptance:

- **SEC v. Lum’s, Inc.** [365 F.Supp. 1046 (S.D.N.Y. 1973)]\(^{16}\)
- **SEC v. Mattel, Inc.**[(No. 74 Civ. 1185, (DDC October 1, 1974))]\(^{16}\)

\(^{16}\) Cited in Birkett 1986.
\(^{17}\) Cited in Lehr 1978.
- **SEC v. Allegheny Beverage Corporation** [Civil Action 932-73 (DDC January 8, 1976)]\(^{18}\)
- **SEC v. General Telephone & Electronics Corporation** [Civil Action 77 - (DDC January 26, 1977)]\(^{18}\)
- **SEC v. Killearn Properties, Inc.** [Civil Action No. TCA-75-67 (N.D. Fla May 1977)]\(^{16}\)
- **SEC v. Sharon Steel Corporation** [Civil Action 77-1631 (DDC September 20, 1977)]\(^{18}\)
- **SEC v. Charles Jaquin et Cie., Inc.** [Civil Action 77- (DDC October 11, 1977)]\(^{18}\)

The wording of the consent agreements in each of these cases and investigations is virtually identical. The SEC and/or the courts pointed out to each of the corporations that a functioning, independent audit committee likely would have precluded any necessity for action against the corporation. In all cases establishment of an audit committee was mandated, with functions and prescriptions for audit committee

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\(^{18}\) Cited in Borowski 1978.
\(^{19}\) Cited in Marget 1978.
makeup (i.e., outside director members) being an integral part of the decisions. In the investigation of National Telephone the SEC pointed out that, although the corporation had an audit committee, it had never had any meetings. Also, General Telephone (GTE) had an audit committee that failed to inquire about questionable payments to foreign governments. GTE agreed to strengthen its committee as part of the consent decree. Finally, the Stirling Homex investigation involved inside directors and management who had intentionally deceived outside directors as to the accuracy of financial data. The SEC stated that an audit committee would have “strengthened the position of the outside directors” (Marget 1978, 411-412).

A report on questionable and illegal corporate payments and practices was submitted to the Metcalf Committee on May 12, 1976, by the SEC. In its report the SEC stated its position on audit committees:

The legislation we have proposed [requiring the establishment of audit committees in the above cases] should remedy the most pervasive characteristic of the cases brought to the Commission’s attention in this area, namely, the deliberate falsification of corporate books and records and other methods of disguising the source or disbursement of corporate funds. Action to further enhance the creation by public corporations of audit committees composed of independent directors to work with outside auditors would, however, serve as a valuable adjunct to these legislative proposals.

Significantly, in some of these cases, no audit committee existed. In the others, with a single exception, audit committees either operated only during a portion of the time when the questionable payments were alleged to have been made, or were not wholly independent of management. (SEC 1976, 67-68)

On the day before the SEC’s report was published, SEC Chair Hills addressed a letter to NYSE Chair Batten, asking that the NYSE establish a requirement for all companies whose stock was listed on the Exchange to have an audit committee established for initial and/or continued listing (Hills 1976). After due consideration of
this request by the NYSE Board of Directors (NYSE 1976a, 6385), Batten sent his letter to all listed companies, as discussed at the first of this chapter.

The NYSE, in spite of the negative replies some companies submitted in response to Batten’s letter, perceived that a significant majority of the listed companies did not have objection to the requirement, or even welcomed it as a significant step toward proper corporate governance. At the meeting of the NYSE Board of Directors on October 7, 1976, one of the board members reported that of the 1,035 companies replying to the audit committee questionnaire, 819 companies, or 79%, agreed with the requirement (NYSE 1976b, 6440). On January 6, 1977, the NYSE Board of Directors adopted an Audit Committee Policy (the “Policy”) for all publicly-held companies, as a condition of listing on the NYSE, to have formed an audit committee composed of outside directors (NYSE 1976b, 6504). The Policy stated as follows:

Each domestic company with common stock listed on the Exchange, as a condition of listing and continued listing of its securities on the Exchange, shall establish no later than June 30, 1978 and maintain thereafter an Audit Committee comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries would not be qualified for Audit Committee membership. (1976b, 6504)

Further, the Policy gave guidelines for audit committee membership qualifications, such as (1) former officers of the corporation who are receiving pensions or deferred compensation, (2) partners, officers, or directors of banking or underwriting relationships with the corporation, and (3) consultants to the corporation. In these cases, the corporation’s Board of Directors would have the right to determine if the person in question possessed sufficient independence from management to be able to
exercise independent judgment concerning corporate matters. The Policy was submitted to the SEC for approval on February 1, 1977, and approved by that body on March 9, 1977 (SEC 1977).

Mandate Aftermath

Patton and Baker (1987) determined that

The chief executive has by far the strongest voice in determining who’s on the board. It may take a little time, but eventually the board is almost totally of the CEO’s making. . . . In our experience [stated one executive], the really strong chief executives don’t want strong boards. . . . In discussing board performance with our experts, they often used the word ‘incestuous’ to describe the process of choosing new directors for large companies. (1987, 12)

Two further occurrences in the last part of the 1970s decade had a major effect on audit committees, their responsibilities, and requirements for their formation:

- The Foreign Corrupt Practices Act (FCPA) was signed into law in December of 1977. Although this act concentrated specifically on prohibition of bribery payments made to foreign governments by corporations seeking concessions from them, it also contained a section that dealt with a corporation’s internal control. No mention is made of audit committees in the FCPA, but it was an easy progression to assign oversight of a corporation’s internal control to the oversight audit committee. In response to this assignment, a number of researchers warned that too many duties and responsibilities were being assigned to audit committees (Mautz and Neumann 1977; Mautz and Neary 1979; Smith 1991; Abdolmohammadi and Levy 1992; Zaman 2001; George 2003), resulting in a significant lack of time to perform these duties satisfactorily.20

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20 Board members (and therefore members of audit committees) who are CEOs or executive officers of other corporations are obviously going to spend the preponderance of their time with those companies.
The Metcalf Committee (the Senate Subcommittee on Reports, Accounting, and Management), in their report on improving accounting, strongly suggested that the accounting profession require publicly-listed companies have an audit committee as part of their board of directors’ makeup to be considered auditable (U.S. Senate 1977, 13). Additionally, Harold Williams, the new chair of the SEC, also called on the AICPA to require audit committees (SEC 1978, 9). The AICPA had made several strong recommendations that corporate clients have audit committees as part of their boards, but no requirement for this had been promulgated. After due consideration of the Metcalf Committee’s and the SEC’s recommendations, the AICPA submitted an answering report in 1979, stating “that while it continues to support the concept of audit committees for publicly owned corporations, it has found no reasonable basis for issuing a technical standard requiring their establishment” (Anonymous (JA) 1979, 14,16) as a condition for auditability.

I suggest that the NYSE mandatory policy should have produced audit committees that were proactive and seeking good corporate governance through cooperation with management and with outside auditors. Oversight by independent directors elected to audit committees should have been a benefit to both auditors who sought total independence from management in the performance of their job and to management who would receive helpful guidance in internal control matters and financial transparency. Instead, as shown by some of the letters received by the SEC in response to their Policy proposal, a number of companies were sharply critical of any variance to the power held by their management. Still other companies had formed audit committees in response to the catalysts and the mandate but were unsure what
the audit committee’s responsibilities should be, other than meeting with the external auditor and approving the scope of his/her audit (Colegrove 1976; Fram 1978; Baruch 1980; Abdolmohammadi and Levy 1992). The situation resulted again in symbolic reform, rather than real reform.

Mitigation of this dilemma did not occur until the Sarbanes-Oxley Act of 2002. Even with that regulatory pronouncement, real reform may not have occurred. As Arthur Levitt observed in his seminal speech at the New York University Center for Law and Business in 1998, “This is a financial community problem. It can’t be solved by a government mandate: it demands a financial community response” (Levitt 1998b, 2).
Concern about corporate governance after 1987 encompassed both makeup and functioning of the corporate board of directors, as well as its audit committee that now had been mandated for NYSE companies. Investors’ distrust of audited financial statements echoed in the Congress and the SEC. Instead of believing that an external auditor’s production of data was substantially sound and that the corporation had been thoroughly examined by the auditors, investors began to look to the board of directors – and more specifically, the audit committee of the board – as insurant of proper oversight of the corporation and its management.

As previously defined, corporate governance means the methodology with which a company performs its corporate and social responsibilities to stakeholders. The American Bar Association’s (ABA) task force on corporate responsibility defines that term as

behavior by the executive officers and directors of the corporation that conforms to law and results from the proper exercise of the fiduciary duties of care and loyalty to the corporation and its shareholders. . . . [It] also embraces ethical behavior beyond that demanded by minimum legal requirements. (ABA 2003, 4).

It is apparent, because of the continuing problems with aggressive accounting and fraudulent reporting of data, that many investors believed this responsibility was not being properly overseen by corporate external auditors. The ABA asserted that this oversight of management and establishment of good corporate governance principles logically belonged to an independent board of directors, thereby “[eliminating] disabling conflicts of interest and undue influence or control [of the board] by the senior management of the corporation” (ABA 2003, 31).
The ABA report was written after the Sarbanes-Oxley Act of 2002 (SOX) had been enacted. Their comments therefore have a perception of the continuing problem after the major frauds and unethical reporting practices of Enron, WorldCom, Tyco, Xerox, and others occurred. Their perception from that vantage point suggests that accountants within and without the corporation were the main perpetrators of the fraudulent and aggressive financial reporting, rather than management (ABA 2003). The ABA report acknowledges that financial reports are the responsibility of management, but SOX attempts mitigation of bad corporate governance by regulating accountants, as well as providing significant responsibilities for audit committees.

History

Although this time frame in general deals with events happening after 1986, a number of events occurred in the mid to late 1970s that had a significant effect on the evolution of the audit committee in this time period, on the acceptance of fiduciary responsibilities by boards of directors, and on legislation designed to create good corporate governance. Such data provide a bridge between the spate of audit committee formation in the very early 1970s and SOX. A discussion of these earlier data, therefore, is important in understanding how audit committees evolved in the last two decades of the 20th century.

By 1978 the evolution of the audit committee had significantly changed. Congress now considered the audit committee to be a vital part of good corporate governance. An investigative action taken by the SEC, two Congressional subcommittees, and a major piece of legislation – all taking place prior to 1980 – had significant impacts on the evolution of the audit committee. These actions and/or rules
were mostly directed at the audit committees themselves, but they also addressed responsibilities of the board in general.

Perhaps the most important piece of legislation affecting audit committees and good corporate governance was passed in December of 1977 – the Foreign Corrupt Practices Act (FCPA). Neumann (1980) establishes the beginnings of this legislation, as follows:

The Foreign Corrupt Practices Act had its beginnings in the aftermath of the Watergate hearings [in the 1973-1974 time frame]. As Congressional investigations extended their scope, it became apparent that political contributions and foreign bribery were not isolated occurrences but a way of doing business in a good many large corporations. (Neumann 1980, 63)

The Act was ostensibly to curtail these payments of foreign bribery,

although many business executives say, quite correctly, that the payments made to other nations’ officials by American firms are entirely consistent with the way business is done in those countries.21 . . . [However,] the Act . . . went a step further: most publicly traded companies are also required to devise and maintain systems of internal accounting controls” (Bennett 1981, 46-47).

Corporate internal control procedures were not new. External auditors had been evaluating the corporation’s internal controls for years, determining the extent of testing necessary on the audit. Neumann (1980) reports what the FCPA changed:

The Act has not altered the concept of internal control nor management’s primary responsibility for it or for basic record keeping. Subjecting public companies and their officers and employees to civil liability and criminal prosecution under federal securities laws for weaknesses in their internal control, [however], is a change. . . . [The internal control part of the Act] applies to all transactions, not just those related to illegal foreign payments. . . . This Act exposes internal record keeping and control, previously management’s domain, to the SEC’s qualitative judgment. (1980, 65)

21 A multinational company for which I worked in the early 1970s was required to make such payments to move inventory across international borders.
Given this regulatory mandate of good corporate governance through adequate internal controls, Congress indicated that the audit committee’s role should be expanded to include oversight of the corporate internal control function.

Neumann (1980) reports that the audit committees of a number of corporations, even though they had been in existence for only a few years, had accepted responsibilities that included oversight of corporate internal control and of management. In other words, these audit committees were proactive, rather than simply waiting for regulatory agencies to tell them what their duties were. More than 300 of the largest U.S. corporations complied with an SEC edict that required disclosure of questionable payments, largely due to the proactivity of these audit committees (Neumann 1980).

Two Congressional committee reports were a part of this compliance. The first of these, the Moss Committee (the Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce of the U.S. House of Representatives), issued its report in 1976. The impact of its report was on boards of directors. Members of the Moss Committee were highly critical of the general lackluster performance of boards of directors in general. The committee said, in effect, that boards had not devoted sufficient time to the performance of their responsibilities, an assertion echoed by researchers during this time (Baruch 1980; Hayes 1981; Harrison 1987; Patton and Baker 1987). The Committee also recommended that the SEC “promulgate rules concerning . . . a requirement for audit committees” (Neumann 1980, 64).

Since the audit committee is a subcommittee of the board, and since the audit committee’s duties and responsibilities should be set by the board itself, the connection between responsible boards and effective audit committees is obvious. Baruch (1980,
makes this connection clear: “It should never be forgotten that the duties assigned to the audit committee are ultimately duties of all of the directors, which they have chosen to delegate.”

On April 29, 1977, the U.S. District Court of the Northern District of Florida (the Tallahassee Division) issued a ruling in the case of SEC v. Killearn Properties, Inc. (Civil Action No. TCA-75-67). As reported earlier, this case was similar to several other cases or investigations by the SEC wherein audit committees became a requirement for the plaintiff. The Killearn case, however, was significant, in that the consent agreement specified specific duties and responsibilities for the committee:

The [Killearn Audit] Committee shall assume . . . the following duties, functions and responsibilities:

i. It should review the engagement of the independent accountants, including the scope and general extent of their review, the audit procedures which will be utilized, and the compensation to be paid.

ii. It should review [with the appropriate personnel] the general policies and procedures utilized by the company with respect to internal auditing, accounting and financial controls.

iii. It should review [the financial reports] with the independent accountants, upon completion of their audit . . .

iv. It should inquire of the appropriate company personnel and the independent auditors as to any instances of deviations from established codes of conduct . . .

v. It should meet with the company’s financial staff at least twice a year to review and discuss with them the scope of internal accounting and auditing procedures then in effect . . .

vi. It should prepare and present to the company’s board of directors a report summarizing its recommendations with respect to the retention (or discharge) of the independent accountants for the ensuing year.

vii. It should have the power to [investigate] . . . any matter brought to its attention within the scope of its duties . . .
viii. [It should] review . . . all [media and shareholder] releases . . . of Killearn which concern disclosure of financial conditions of and projections of financial conditions of Killearn . . .

ix. [It should] review . . . the activities of the officers and directors of Killearn . . . and take any action the Committee may deem appropriate . . .

x. [It should] approve any settlement or disposition of any claims or actions from causes of action . . . now pending which Killearn may have against . . . officers, directors, employees, or controlling persons. (SEC v. Killearn Properties, Inc. (U.S.D.C. Northern Dist. Fla., 4-6))

The significance of this specific litany of duties meant that the SEC had crystallized more than just what heretofore had been assumed to be audit committee duties – oversight of the external audit, including hiring, firing, and paying the external auditor and assisting in setting the scope of the examination. The responsibilities of the audit committee were now greatly expanded. Further, Killearn’s consent decree established legal precedent that other courts would quickly follow in similar cases.

“The Federal government was so pleased with the results that it could not stop there” (Neumann 1980, 64). The second of the Congressional committees went even further in its attempt to mandate and federally control the accounting profession, both within corporations and in independent audits. The Metcalf Committee (the Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs of the United States Senate) endorsed the findings of the AICPA’s Commission on Auditors’ Responsibilities – the Cohen Commission – which recommended the formation of audit committees “as a means for enhancing the independence of auditors” (U.S. Senate 1977, 14). The Metcalf Committee, however, extended this endorsement in its recommendations. It stated, “The subcommittee strongly believes that the accounting profession or the SEC should immediately require
that publicly owned corporations establish audit committees composed of outside
directors as a condition for being accepted as a client by an independent auditor” (U.S.
Senate 1977, 13, emphasis added).

There were many generalities concerning the accounting profession in the
Metcalf Committee’s report, mostly concerning the external auditor’s opinion and
responsibilities. Their major concerns, however, were the professionalism and
independence of the external auditor. It was this latter concern which generated the
comments about the corporate audit committee. These comments directly attributed
good corporate governance to the presence of an audit committee within the corporate
board of directors. Given this attribution, corporations without audit committees could
be assumed to have questionable corporate governance at best. External audits of
such corporations, therefore, would not be able to find financial statements that fairly
reflected the condition of the company.

The SEC immediately applied pressure on the AICPA to mandate audit
committees as an audit requirement (AICPA 1978). Harold M. Williams was chair of the
SEC from 1977 to 1981. Earlier, Williams had made comments that vilified the
accounting profession. His statement before the Metcalf Committee on June 13, 1977,
was as follows:

[A]s these hearings draw to a close, it is clear that there is dissatisfaction with the
performance of the accounting profession, and [the] time is running out for the
profession to reform itself. The public debate and discussion generated by these
hearings, and the staff study which preceded them, have highlighted the
profession’s failure to come to grips with the responsibilities which the Congress,
the [SEC], and the public expect it to shoulder in today’s business climate. . . .
[The] Commission recommends that the profession be given some fixed period of
time, probably one year, to initiate positive and effective action. At that time,
Congress should review . . . whether legislative action is necessary. (Williams
1977, 1)
On January 4, 1978, at the AICPA Fifth National Conference on Current SEC Developments, Williams stated

> The [accounting] profession must take whatever steps are reasonably available to it – such as insisting that their clients maintain audit committees [as an audit condition] – to insure and enhance its independence. If the profession is reluctant to take steps of that nature voluntarily and of its own accord, the Commission will need to understand why and how that reluctance can be reconciled with a profession which desires to maintain the initiative for self-regulation and self-discipline. (Williams 1978, cited in AICPA 1978, 5; cited in Birkett 1986, 114)

Williams’ attitude toward the AICPA can be construed as a quasi-veiled threat to subject the accounting profession to federal regulatory takeover if it did not require clients to have audit committees as an audit condition. In this regard, Williams appears to be reiterating the thinking of William O. Douglas, in that the only solution to the problems engendered by the capitalistic system must be federal regulation (Douglas 1934). Williams did not comment on the accounting profession’s inability to “act intelligently” (Douglas 1934, 1316), as Douglas stated about average shareholders. The conviction that federal intervention and regulation of the situation is necessary, however, is the same.

Given the pressure from both the Congress and the SEC, the AICPA immediately formed a special committee, the Special Committee on Audit Committees (AICPA 1978). This committee’s analysis in March of 1978 categorized the evolution of the corporate audit committee, from the McKesson & Robbins fraud and ASR 19 to the assertions of the Metcalf Committee. The AICPA Committee report noted that voluntary formation of audit committees had been urged by the AICPA since its Executive Committee report of 1967 (AICPA 1978, 3). The report also correctly noted
that the Cohen Commission had not only urged the formation of audit committees as a means of enhancing auditors’ independence, but also had stated that “audit committees should be formed if appropriate to the size and circumstances of the corporation” (AICPA 1978, 3, emphasis added). That is, the Cohen Commission report specifically avoided stating that audit committees were appropriate in all cases. The report noted that the SEC had mandated audit committees in certain enforcement proceedings, but that its requirement for audit committees for all publicly held corporations (or perhaps even for all corporations) had not been forthcoming (AICPA 1978).

After considering relevant issues such as

- Is an audit committee necessary for the independent auditor to fulfill his/her audit responsibilities?
- Is an audit committee essential for an auditor to maintain his/her independence?
- Should an audit committee requirement as a condition of auditability be applied to all corporations?

the AICPA committee concluded that

it was not possible to sustain the considerable burden of identifying the necessity of an audit committee requirement [as an audit condition]. The AICPA reported to the Securities and Exchange Commission that while it continues to support the concept of audit committees for public owned corporations, it has found no reasonable basis for issuing a technical standard requiring their establishment. The [AICPA] committee [also] pointed out that it does not find audit committees necessary for the maintenance of auditor independence or for performance of an audit in accordance with generally accepted auditing standards. (Birkett 1986, 117-118)

Interestingly, and in spite of the strong statements of its chair, the SEC itself did not mandate audit committees after this report was made to them. Abdolmohammadi and Levy (1992, 55) report that a major reason for this was the SEC’s reluctance to
“place a large burden on small companies.” As a result, while virtually all professional and regulatory bodies concerned with corporate governance and audits of corporations had expressed strong recommendations that corporations establish audit committees, only the NYSE actually mandated them for corporations within their jurisdiction.

Further,

[w]hile the composition of audit committees has been addressed by the SEC, the NYSE, the AICPA and Congress, only the SEC has issued any specific duties to be performed by audit committees, and this has only been done in specific cases for individual companies. (Birkett 1986, 123).

One other point should be mentioned about the few years preceding the time frame for this chapter. As noted, the NYSE mandated audit committees for all so-called Big Board companies as a condition of listing. The edict stated that the committee would be

composed solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member. (NYSE 1977a, 6504).

I suggest that if boards of directors are handpicked by company management, this “opinion” clause weakens the intent of the NYSE pronouncement and thereby makes any such audit committee less than independent from CEOs. The mandate is thereby reduced to symbolism.

Some researchers had listed their concept of what the audit committee should be doing even before the Killearn investigation by the SEC and the NYSE mandate (Solomon 1972; Auerbach 1976; Chazen and Landis 1976). Although responsibilities of the audit committee were enumerated by the SEC in the Killearn consent agreement, researchers still reported that audit committees remained confused as to what they
were supposed to be accomplishing. Baruch (1980, 174) argues that “while the responsibilities of corporate directors [and thereby of audit committees] have significantly increased in the past decade, neither the proper role of the audit committee nor the duties and liabilities of its members have yet been defined.” Bennett (1981) reports that the regulations and court decisions concerning audit committees have not only left audit committees confused about their function, but also left internal auditors confused about the performance of their duties.

The Treadway Commission

In October 1985 a six-man commission was formed that was independent of Congress, of the NYSE, and of the SEC, although members of the commission were former members of the SEC and of the NYSE. The purpose of the Commission’s study was “to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence” (NCFFR 1987, 1). The National Commission on Fraudulent Financial Reporting, known as the Treadway Commission (the “Commission”), carefully defined fraudulent financial reporting, identified the scope of its deliberations as “companies owned by public investors” (NCFFR 1987, 2), and delineated three major objectives of the study. Relevant to this paper are objectives one and three.

1. Consider the extent to which acts of fraudulent financial reporting undermine the integrity of financial reporting; the forces and the opportunities, environmental, institutional, or individual, that may contribute to these acts; the extent to which fraudulent financial reporting

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22 Chair of the Commission was James C. Treadway, Jr., executive vice-president of Paine Webber, Inc. and a former commissioner of the SEC. Members of the Commission were William M. Batten, immediate past president of the NYSE; William S. Kanaga, chair of the advisory board of Arthur Young & Company and former chair of the AICPA; Hugh L. Marsh, internal staff director for ALCOA and former chair of the IIA; Thomas I. Storrs, immediate past chair of NCNB Corporation; and Donald H. Trautlein, immediate chair and CEO of Bethlehem Steel. The Commission was jointly sponsored and funded by the AICPA, the AAA, the FEI, the IIA, and the NAA (now the IMA) (NCFFR 1987).
can be prevented or deterred and to which it can be detected sooner after occurrence; the extent, if any, to which incidents of this type of fraud may be the product of a decline in professionalism of corporate financial officers and internal auditors; and the extent, if any, to which the regulatory and law enforcement environment unwittingly may have tolerated or contributed to the occurrence of this type of fraud.

3. Identify attributes of corporate structure that may contribute to acts of fraudulent financial reporting or to the failure to detect such acts promptly. (NCFFR 1987, 2)

The Commission deliberated for the following two years, issuing its comprehensive report in October of 1987.

As part of its study, the Commission employed external research studies which were used in determining its recommendations. At least one of the research studies specifically recommended a regulatory requirement for corporate audit committees (NCFFR 1987, 107). Others point to the criticality of audit committee participation in the deterrence of fraud (NCFFR 1987, 96, 98, 100). One researcher states, “The audit committee has the potential for playing the most critical role in assuring that mechanisms are in place to deter, detect, and report fraudulent financial reporting” (Bishop and White, cited in NCFFR 1987, 100).

Distrust of financial data emanating from publicly held corporations had been widespread for a number of years. As discussed, Congress had directly attacked the accounting profession, both within corporations and external to them, for such reporting. I suggest the Commission was formed and sponsored by the accounting profession to determine what part or parts of the capitalistic system were responsible for fraudulent financial reporting. In this respect the Commission appeared to be designed to answer Congressional regulators by discovering and discussing the locus of fault for fraudulent financial reporting and to present accountants' conception of the problem. The
Commission asserted there were other perpetrators of fraudulent financial reporting besides the accounting profession. They stated that the possibility of fraud existed throughout the business world, regardless of company size or industry (NCFFR 1987).

In particular, three assertions demonstrated that the Committee correctly assigned responsibility for fraud in its deliberations, rather than simply assuming that accountants were the only cause. First, the Commission stated that "[t]he responsibility for reliable financial reporting resides first and foremost at the corporate level" (NCFFR 1987, 6), meaning that corporate management and boards were ultimately responsible for published information concerning their organization. Second, the Commission asserted that at least a part of the reason for fraud was due to financial analysts.

Financial analysts, through myopic notions of profitability and other indicators of company financial health, may pressure top management to focus all their efforts on achieving short-term gains. Through such conduct, legal, financial, and other advisors become part of the problem of fraudulent financial reporting. (NCFFR 1987, 7)

Third, the Commission stated the public needed to be aware that if a company failed, it should not be assumed that fraud was present in the failure (NCFFR 1987, 8-9), an assumption that seemed to be prima facie in many investors’ minds. Rather, investors needed to ascertain whether “intentional or reckless conduct [amounting] to fraud” (NCFFR 1987, 9) was a part of the failure.

Audit committees were noted as critical to good corporate governance by the Commission, who, therefore, recommended that publicly held companies be required to form them and populate them with only independent directors (1987, 12). An audit committee charter was also recommended, with the board of directors delineating its duties and responsibilities. Reducing responsibilities and procedures to writing solidifies
the concept of oversight within the corporation. It limits or eliminates any managerial attempt to sway the audit committee to accept questionable practices or decisions. Finally, it conditions management to expect oversight and perhaps avoid aggressive accounting.

The Commission’s studies revealed that fraudulent reporting usually occurs as the result of certain environmental, institutional, or individual forces and opportunities. These forces and opportunities add pressures and incentives [which the audit committee must be aware of and mitigate] that encourage individuals and companies to engage in fraudulent financial reporting and are present to some degree in all companies. . . . A frequent incentive for fraudulent financial reporting that improves the company’s financial appearance is the desire to obtain a higher price from a stock or debt offering or to meet the expectations of investors [because of financial analyst forecasts]. . . . In a large majority of the cases the Commission studied . . . the company’s top management, such as the CEO, the president, and the CFO, were the perpetrators. (NCFFR 1987, 23-24)

These opportunities are more prevalent when audit committees and/or boards of directors are dominated by these top management persons.

The Commission cited two examples of changes within this time frame that have key possibilities of affecting fraud – the Tax Reform Act of 1986 and rapid advancement in information technology (1987, 27). The 1986 Act exerted additional pressure on management to avoid the corporate alternative minimum tax (1987, 27). Information technology knowledge can cause manipulation of earnings by “placing vast quantities of data within easy reach” (1987, 28) of perpetrators.

In regard to audit committees, the Commission made six specific recommendations:

1. Audit committees, composed solely of independent directors, . . . should be required by SEC rule [for] all public companies.
2. Audit committees should be . . . overseers of the financial reporting process and the company’s internal controls.

3. All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee.

4. Audit committees should have adequate resources and authority to discharge their responsibilities.

5. The audit committee should review management’s evaluation of factors related to the independence of the company’s public accountant.

6. Before the beginning of each year, the audit committee should review management’s plans for engaging the company’s independent public accountant to perform management advisory services during the coming year. (NCFFR 1987, 40-43)

This latter recommendation, of course, is moot because of the Sarbanes-Oxley Act of 2002 (SOX). In addition, the Commission asserted that quarterly financial reports should be reviewed by the audit committee and that the audit committee chair be required (by SEC rule) to submit a letter describing its activities to stockholders in the annual report (1987, 46-47).

Finally, the Commission included an appendix to its report in which guidelines for the audit committee were delineated. These included, among others, such general items as the size and term of appointment, frequency of meetings, and reports to the board of directors (1987, 182-183) and the responsibility that was initially suggested as the reason for establishment of the audit committee by ASR 19 – selection and payment of the company’s external auditor (1987, 183-184).
Two points should be made about audit committee makeup, its duties and responsibilities and the confusion generated by regulatory and other pronouncements. First, a number of audit committees had strong leadership within the committee itself. These committees tended to function in a manner that permitted good corporate governance in dealings concerning external audits, management oversight, financial reporting, and internal control. They were also viewed as having sufficient power within the committee itself to effect good corporate governance (Kalbers and Fogarty 1993). These authors suggest that, based on their empirical study,

the fundamental types of power needed by audit committees to perform effectively are (1) institutional support [the CEO and all of the top management must support the concept of the AC responsibilities and cooperate with their oversight], (2) actual authority (written and implied) [from the board itself, giving the AC full rein to accomplish what its charter specifies it is responsible for], and (3) diligence [AC members devote the time and effort to accomplish their responsibilities in an exemplary manner]. (Kalbers and Fogarty 1993, 45)

Katz agrees with this assessment, further stating that the audit committee should elect a strong chairperson. He states, “There is nothing more important to a properly functioning audit committee than a strong, skilled and sensible chairperson” (Katz 1998, 22). Spangler and Braiotta (1990) point out that, because the audit committee chairperson lacks any sort of punitive authority over members of the committee, transformational leadership by the chairperson is an essential leadership trait. I suggest that audit committee leadership of this type alleviates much, if not all, of the concern chief executives may have about audit committees intruding in day-to-day activities of the corporation or developing an adversarial position vis-à-vis management.

Second, I suggest that those audit committees functioning effectively within their corporation are proactive. They do not wait to be given specifics by regulatory agencies
concerning the duties they understand need to be performed. They apply judgment to the general terms given in edicts, regulations and court cases and effect proper corporate governance within their organization. That is, they do not wait for “bright lines” to be established, similar to the exacting rules promulgated by the Internal Revenue Code to determine corporate tax liability. I suggest that if an audit committee is confused about its duties and responsibilities, it is because the committee is reactive to a significant degree. In conjunction with their board of directors, these committees very likely need to lay out a charter that is applicable to the situation within their organization and review it periodically for necessary corrections and updating.

A number of researchers express concern that too much was being expected of the corporate audit committee. One survey of members of audit committees reported a number of them expressing concern about the extent of the assigned duties, particularly where specifics have not been “clearly spelled out” (Abdolmohammadi and Levy 1992, 54). Smith (1991) cites a Canadian professor about the perception of excessive responsibilities:

Recent proposals and the evolution [of the audit committee] of the past few years do not serve the best interests of companies because they give extensive responsibilities to outsiders who work for the company only a few hours a week. . . . The proposals put external members of the [audit committee] in a position of responsibility out of all proportion to their competence or the income related to such services: they simply call for the impossible. (1991, 37)

Mautz and Neary (1979), writing immediately after the FCPA enactment and the subsequent perception by regulatory agents of the audit committee as overseer of the company’s internal control, question whether audit committees can “meet those expectations in any realistic fashion” (1979, 83). “We fear that an increasing tendency to demand more of corporate audit committees than many of them can provide may
lead to a *decrease* in their effectiveness" (1979, 84, emphasis added). Patton and Baker (1987) point out that CEOs of other companies are the persons being asked to bear these increasing audit committee duties and responsibilities, while still being asked to function effectively within their own company. Writing from a post-SOX perspective, Terrell and Reed caution that audit committees can lose focus on basics of their responsibility if they become overly concerned with compliance with regulations.

“The string of audit committee-related changes begun in 1999 [and before] has snowballed into a cascade of reforms, threading through all facets of corporate governance. In view of the stark demands for compliance with these ever-unfolding rules, audit committees are faced with the mounting challenge of maintaining focus on effective oversight of their companies’ accounting and financial reporting processes. . . . As they deal with the many implications of the reforms, audit committees should beware one distinct danger: that they will become swamped by – and inordinately focused on – compliance for compliance’s sake, rather than focusing on activities to enhance the effectiveness of their oversight function. (Terrell and Reed 2003, 7-8)

I suggest that these authors, and others, are correct in their contentions that audit committee members are faced with a multiplicity of responsibilities that require an inordinate amount of time. They are also correct in stating that liabilities attached to membership on audit committees may mean that fewer qualified persons will accept these positions. What is also correct, however, is that proactive audit committees represent a deterrent, albeit imperfect, to fraudulent financial reporting, something that must exist for our capitalistic system to survive.

The Numbers Game

After the Treadway Commission report was issued and before the turn of the 21st century, the American economy performed better. The U.S. had survived the recession of the early 1990s, commonly attributed to the savings and loan crisis of the late 1980s, wherein over 700 savings and loan associations failed. A period of
prosperity ensued, and aggressive accounting again became prevalent within corporate America. Accounting data was being reported which was less than transparent, and auditing, both within the corporation and external, was still distrusted by investors.

On September 28, 1998, Arthur Levitt, then chair of the SEC, made his well-known speech, which he called The Numbers Game, to students and faculty at the New York University Pollack Center for Law and Business (Levitt 1998b). In his speech Levitt specifically attacked what he considered the major cause of bad corporate governance and fraudulent financial reporting: earnings management. He stated he had “become concerned that the motivation to meet Wall Street earnings may be overriding common sense business practices” (Levitt 1998b, 1), a concept that echoed data in the Treadway Commission report a decade earlier. Levitt spoke of a gray area wherein the financial figures reflected managerial wishes “rather than the underlying financial performance of the company” (1998b, 1). Five “gimmicks” were cited in the speech (Levitt 1998b, 3-5) which were alleged to be in common use to meet financial analyst forecasts:

- “Big Bath” charges to expense as restructuring charges;
- Creative acquisition accounting that classifies a large portion of the purchase price as in-process research and development (to be expensed in the year of acquisition);
- “Cookie Jar” reserves, wherein unrealistically high estimates of liabilities are made during profitable years and used to reduce expenses in bad years;
- Abuse of materiality, where questionable errors are recorded within a ceiling determined to be unimportant to the financial statements as a whole; and
Manipulation of revenue recognition to record revenue before it is realized or realizable.

Levitt concluded

As part . . . of this comprehensive effort to address earnings management, the New York Stock Exchange and the National Association of Securities Dealers have agreed to sponsor a “blue-ribbon” panel. . . . Within the next 90 days, this distinguished group will develop a series of far-ranging recommendations intended to empower audit committees and [allow them to] function as the ultimate guardian of investor interests and corporate accountability. (Levitt 1998b, 7)

Blue Ribbon Committee

The Blue Ribbon Committee (BRC) asked for by Chairman Levitt was formed almost immediately following his address. An SEC news release dated September 28, 1998, was published for immediate dissemination (BRC 1999, 46), stating that the committee was being formed by joint effort of the NYSE and the NASD. This likely indicates that advance notice of Levitt’s remarks was provided to the SEC. The committee was “drawn from the various constituencies of the financial community” (1999, 46) and was co-chaired by John Whitehead and Ira Millstein. The full panel consisted of eleven persons, each of whom was distinguished in American financial circles (1999, 48).

From its inception the BRC was focused on a different aspect of financial reporting. Whereas most of the prior literature and regulatory pronouncements concerning audit committees had concentrated specifically on fraudulent financial reporting and prevention methodology, the BRC stated that its focus would be “on the large grey area where discretion and subjective judgments bear on the quality of financial reporting” (1999, 2). That is, the BRC’s concept that audit committees need to
be concerned with the quality of its oversight responsibilities in total, rather than on fraud alone, is correct. Of course, prevention of fraudulent financial reporting was a major part of audit committees’ responsibilities, but the BRC addressed the audit committee situation from more of an overall perspective.

In addressing improvement of the effectiveness of audit committees, the BRC asserted that three groups needed to work in tandem to bring about good corporate governance: (1) management, including the internal auditors, (2) external auditors, and (3) the full board of directors, including the audit committee. “However, in the view of the [BRC], the audit committee must be ‘first among equals’ in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process” (1999, 7).

Concerned almost exclusively with proper disclosure, transparency of financial information, and accountability for stakeholders of the organization (1999, 8), the BRC made ten recommendations for improving audit committee oversight effectiveness (1999, 10-16). Six of the recommendations were directed at the NYSE and NASD:

- Numbers one through four, dealing with (1) a clear definition of audit committee member independence (the BRC believed the NYSE definition “[allowed] for too much discretion and should be fortified” (1999, 23)); (2) committee establishment and independence of members; (3) committee composition, including financial literacy and expertise requirements; and (4) formal written charter adoption, including an annual reassessment of its provisions.

- Numbers six and seven, (6) specifying, in the audit committee charter, ultimate accountability of the external auditor to the board of directors and the audit
committee; and (7) specifying the independence of the external auditor from the audit committee in the charter.

Three recommendations were directed at the SEC:

- Number five, dealing with disclosure in the proxy statement of adoption of a written charter by the audit committee and how that committee has satisfied the charter’s requirements in the prior year.
- Number nine, recommending that the SEC require a written letter from the audit committee in the annual report of the company, specifying how its oversight has engendered good corporate governance in the prior year.
- Number ten, recommending a requirement that outside auditors to perform a SAS 71 review of the corporation’s quarterly reports to the SEC.

Recommendation number eight was directed at the AICPA. It sought an addition to GAAS that required the company’s external auditor to “discuss with the audit committee the auditor’s judgments about the quality, not just the acceptability, of the company’s accounting principles as applied in its financial reporting” (1999, 15) – its internal control.

Each of the recommendations, with the exception of the first, contained the word, “require.” The BRC, in other words, intended that the specified organization to which the recommendation had been directed implement it by directive or regulation. Further, the BRC expressed urgency in implementation (1999, 19). It also emphasized the connection of good corporate governance, which “holds management accountable to the board and the board accountable to shareholders” (1999, 20), with a properly functioning audit committee by stating
One of the issues that has taken on increasing importance in the search for good [corporate] governance is how best to harness the oversight process to achieve more fully the goal of quality corporate financial reporting. This important search leads immediately to the audit committee of the board of directors – the entity at the core of the corporate financial reporting process. (1999, 17)

Blue Ribbon Committee Aftermath

I suggest the BRC recommendations and report represent what should have been the culmination of the audit committee evolution. Embodied in the BRC’s recommendations were thoughtful and far-reaching concepts that would have allowed transparent financial reporting, effective oversight of corporate internal control, and a significant increase in good corporate governance in the U.S. capitalistic system. Application of these concepts represented completion of an evolution which was born in fraud and which went from dealing almost exclusively with external auditor independence to effectively enforcing good corporate governance through managerial and internal control oversight. Application by proactive audit committees should have mitigated a considerable amount of the investor distrust of corporate financial reporting.

Within two years of the BRC’s report, however, the U.S. capitalistic system was once again shocked by two major corporate failures. The first, Enron, represented unethical omission of liabilities through the use of special purpose entities but was not a case of fraud. The second, WorldCom, was an instance of flagrant fraud, perpetrated by the company’s top management (Cooper 2004).

Researchers have noted that audit committees were functioning in both of these instances and were eminently qualified as to financial literacy and expertise (Benston and Hartgraves 2002; George 2003; Petra 2005). I suggest that regardless of composition or expertise, a passive audit committee that does not assume its
responsibilities with serious intent can easily be overpowered by persons who are intent on committing fraud and who have the immense power accorded to corporate managers.

Jacobs observed the following about the Enron scandal:

There’s no way that criminal law, government regulation, or auditor independence will ever ensure a just and fair society or a squeaky-clean stock market. Any tax expert, investment banker, ambitious exec or teenager will, given enough time, find loopholes in any rules big enough to drive an SUV through. Things work out pretty well, though. We plug the biggest holes in the ship, and watch and wait while the rats gnaw other ones. . . . There will always be rats. Given enough motivation, any one of us can become a rat. (Jacobs 2002, 1)

The SEC implemented the recommendations of the BRC within a short time after the issuance of that committee’s report (SEC 2000), but both the Enron and WorldCom scandals had begun. After WorldCom, the Congress of the United States swiftly passed the most comprehensive accounting act since the Securities Acts of the early 1930s – the Sarbanes-Oxley Act of 2002.

The duties and responsibilities of the audit committee were no longer a matter of proactivity and accepting responsibilities to instill good corporate governance and transparency within corporate financial reporting. Those duties and responsibilities were now defined by fiat. The audit committee concept had evolved from a suggestion as an aftermath of a fraud to a mandated set of regulations. The former was largely treated as a symbolic reform by corporate America, intended to accomplish only placation of investors. The passage of time should determine if the latter comprises real reform.
CHAPTER V

SUMMARY AND CONCLUSIONS

When scandals occurred throughout the time periods of my study, demands were generated for better corporate governance and more transparency of financial data. Audit committees were identified as the primary method of achieving these ends. My study, however, indicates that audit committees have remained a symbolic solution to corporate governance and mitigation of unchecked corporate power.

Audit committees evolved with additional duties and responsibilities because of factors both within the corporation and external to it. Each factor is important in explaining audit committee growth, from oversight of the external audit to oversight of both corporate internal control and corporate governance, as well as the external audit. These factors interlock, in that their combination exacerbates the need for audit committees’ additional duties. They must be considered together in examining audit committee evolution from simply dealing with external auditors to playing the key role in a corporation’s governance methodology. I list five that have affected audit committee increase in responsibilities.

Power

I posit the primary factor precipitating a necessity for audit committees was unchecked power accorded managers of giant corporations in the early part of the 20th century. The rapid expansion of these corporations with nationwide (and worldwide) ownership created, in the words of Berle and Means, “princes of industry” (Berle and Means 1933, 2). These two authors are perhaps best remembered for their description of a separation of ownership from control and for the transformation of property
ownership from tangible to passive. Unchecked power in the hands of CEOs, however, is the main theme of their study.

Scott (2001) agrees with Berle and Means. He writes

[T]hose who can legally determine the composition of the board of directors and who, therefore, [should] have the ultimate powers of command are a large and anonymous mass of small shareholders who have no effective control. . . . [Management] becomes a self-recruiting management team that can run the corporation without having to face any significant influence from [the actual owners of the corporation]. (Scott 2001, 45-46)

The power extended to key managers, CEOs of large corporations, allowed them to hand-pick their own board of directors. The boards would then approve whatever the CEO decided without questioning his/her motives. This also meant that external auditors were forced to deal with management that could dictate the scope of the audit. Expert accounting witnesses during the McKesson & Robbins, Inc. investigation corroborated this fact. They stated that, in most cases, the auditor was hired and fired by management (SEC 1940a).

CEOs, then, became used to having their way, deciding how the corporation would be operated and controlled. Eventually, in several glaring examples of financial misstatements and fraudulent reporting, they used manipulative accounting to achieve their goals. These CEOs also understood that audit committees could be symbolic, and that these attempts at mitigation of power were made to placate worried investors only. Even after the NYSE mandated audit committees as a condition of listing and the SEC mandated the Blue Ribbon Committee’s recommendations, some corporate managers continued to use power to enforce their decisions, regardless of consequences.

The initial call for regulatory restraint of managerial power was championed by William O. Douglas (Douglas 1934) and was also a part of the thinking of Berle and
Means (1932), as well as of Dodd (1932, 1935). However, the initial call for audit committees from the SEC and the NYSE was symbolic, so managers continued to operate their companies with little or no regulatory interference. Boards of directors also continued to “rubber stamp” management’s actions. Shareholders were left without fiduciary representation, and societal ramifications were of little or no concern to these managers.

As pointed out in Chapter 2, conciliatory decisions were necessary for the fledgling SEC and for its chairmen, with pressure on the organization from a number of different sources. Those sources included Congress, the President, the NYSE, and a powerful group of business leaders who resented the organization interfering with the capitalistic system. It also, of course, included worried investors who in many cases had lost a significant amount of life savings. Douglas, as chair when the McKesson & Robbins fraud was investigated, was very likely forced to adopt an approach that offered conciliations to each of these groups. The SEC abandoned a hard line regulatory approach to keep the organization intact and to promulgate the policies sought by President Roosevelt. These conciliatory pronouncements were made in the form of suggestions, which I assert were viewed by corporate managers and business leaders as symbolic that could be safely ignored or downplayed.

Merino and Mayper (2001) state this turnabout by Douglas amounted to his being “captured by the [accounting] profession” (Merino and Mayper 2001, 502). I posit Douglas was not so much captured by the accounting profession as he was put into a position wherein his chair of the SEC and his political future could have been placed in jeopardy by taking a hard line regulatory stance.
I posit managerial acquisitive instincts for power have existed throughout the 20th century up to present day. WorldCom, for example, is a glaring example of deliberate falsification of accounting data (Cooper 2008). Enron, while not participating in any conduct that was illegal, certainly used unethical methods to deceive its shareholders. These two scandals were the direct cause of the very specific delineation of audit committee duties and responsibilities that are now mandated in SOX.

Karmel (2005) asserts that SOX reoriented the thinking of boards of directors (and thereby, of course, of audit committees) to an adversarial orientation, vis-à-vis management. She states, "Whether Sarbanes-Oxley will result in better corporate governance and greater sensitivity by corporate officers and directors to investor interests remains to be seen" (2005, 79). I concur with this assessment. SOX has placed significant requirements on audit committees and on corporate management and boards, something that perhaps should have been mandated earlier than 2002. It is possible that an adversarial role for the audit committee, accentuated by SOX, may have caused more harm to manager-board-audit committee relationships than good.

Whether corporate power has now been curtailed or mitigated cannot be determined yet. If corporate managers’ history throughout the 20th century is followed, CEOs will continue to seek methods to circumvent any “bright line” pronouncements that attempt to remove their power. For example, several researchers point out that functioning and correctly formed audit committees at both Enron and WorldCom failed to stop those scandals (George 2003; Klein 2003; Petra 2005).
Ethics

The second factor concerns unethical behavior by persons in key positions within the corporation. Douglas asserted this in his 1934 article, demonstrating insight into a root cause for audit committee formation. He was speaking of directors who do not function as fiduciaries for shareholders, but his point pertains to a main reason why audit committees became a necessity and why their duties and responsibilities have increased significantly over the years. He states:

All of these [suggested regulatory] measures, of course, merely check or control rather than cure a fundamental condition which underlies the whole problem. That condition has been reflected by the amazing absence of social consciousness on the part of directors and business executives and by their lack of any awareness of the implications and results of many practices which flourished in recent years. (1934, 1328-1329)

This lack of social consciousness, demonstrated in many cases by fraudulent financial reporting, also reflects a total absence of concern for legal owners of corporations.

George concurs with this conclusion. She correctly states that ethicality is central to good corporate governance, with the result being that audit committees cannot create good corporate governance absent ethics at the top of the corporate chain of command (George 2003). Hanson (1978) provided an early vision in this root cause. He predicted that if the corporations do not take ethical conduct upon themselves, no choice is left for the government except to increase regulation and, eventually, to take over the private sector. Hanson (1978, 82) states, “The only proven way to enforce the norms of ethical conduct is by ensuring, to the best of our ability, that those who violate the norms will be found out and dealt with.” He asserts that businesses themselves must deal with non-ethical managers to avoid governmental
intervention. Uzun et al. (2004) also support the contention that ingrained corporate ethical behavior cannot be underestimated when dealing with corporate governance.

The history of audit committees from 1939 forward to the mandates of SOX demonstrates an ever-increasing number of duties and responsibilities for audit committees because unethical top executive officers refuse to set standards in managing their organization. The culmination of these increased duties and responsibilities is embodied in SOX. SOX, however, is oriented toward financial controls. Corporate fraud, however, has not necessarily emanated from a lack of these controls. In case after case controls were in place but were overridden by senior management, who then surreptitiously covered up what they had overridden.

**Symbolism**

A third factor which had a key effect on the growth of the audit committee’s responsibilities was the use of symbolic reform, as opposed to real reform. Indeed, as Fried and Schiff (1976) point out, audit committees were formed specifically as a part of symbolism to placate investors. I posit the major increase in audit committee establishment in the 1970s was due solely to this reasoning by corporate managers and boards. Worried stakeholders believed such a committee within their board of directors would solve corporate mismanagement and return honesty as well as fair play to corporate financial reporting. It was not at all important to these stakeholders that the audit committee be composed of experts, or ask tough questions of managers at annual meetings, or be responsible for internal control oversight. The symbolic gesture of formation was sufficient to allay the stakeholders’ fears.
Regulatory bodies did not share this view. When audit committees did not function as purveyors of good corporate governance and proper corporate internal control, regulations ensued. When “bright line” regulations are established, unethical managers seek ways to circumvent them (Where does it say I cannot do that?).

The U.S. model allows – even encourages – corporate officers to view accounting requirements as if they were specified in a tax code. For taxes, avoidance of a tax liability by any legally permissible means not only is acceptable, but is an obligation of corporations acting in the interests of their shareholders. Enron [managers appear] to have taken the same approach to accounting. (Benston and Hartgraves 2002, 126)

I suggest this same approach, combined with a belief that SOX is symbolic only, may be a part of corporate attempts to circumvent the provisions of SOX. This, of course, creates a continuing problematical situation in regard to transparency of financial data, properly functioning internal controls, and good corporate governance.

Financial Analysts

A fourth factor, financial analyst forecasts, is posited to be a major reason that corporate managers attempt aggressive accounting measures and falsify financial data, necessitating audit committee oversight. Financial analysts create a scenario that investors accept and expect of corporations by announcing what the company’s earnings per share (EPS) should be for the following quarter. Managers understand that the market price of their company’s stock will likely be reduced by a considerable amount if this EPS forecast is “missed” by as little as one cent. If the corporation is approaching the end of the forecasted quarter and is below this target EPS, management may attempt to boost earnings for that quarter by any means. The thought process is that the company will be able to correct misstatements in the following quarter and to “make up” for prematurely recognized EPS. This misstating of
earnings and financial data to “make” the forecast is precisely what caused the fraud and subsequent bankruptcy at WorldCom (Cooper 2008). Baker and Owsen suggest this gives financial analysts considerable power in manipulating corporate data. They state

Evidence indicates that investment decisions are made on the basis of unaudited interim earnings announcements, financial analysts’ forecasts, and privately obtained information. Large multinational companies, and the financial analysts and institutional investors who follow them, operate in an environment where audited financial statements are essentially irrelevant to their decision making processes. (Baker and Owsen 2002, 789)

Lindsell (1992) also notes the considerable pressure put on corporate managers to meet or beat forecasted numbers.

This forecasting process can propagate bad corporate governance and foster manipulated financial data. When this perceived necessity for aggressive accounting occurs, and when corporate managers possess unchecked power, fraud results. Audit committee responsibilities, of course, now include oversight of managerial reporting and should reduce this fraud to a minimum. As stated earlier, however, concealment of fraud, especially where collusion is involved, is exceedingly difficult to detect, even by persons with accounting expertise.

Reactive Audit Committees

Reactivity, the fifth factor creating additional duties for audit committees, may be generally defined as passivity or mental inertness or torpidity. In a speech at Tulane University that was a precursor to his profoundly influential 1998 NYU address, Arthur Levitt noted

[t]here are too many boards [and audit committees] that overlook more than they oversee. Too many that substitute CEO directives for independent initiative. Too many that are re-active instead of pro-active (Levitt 1998a, 3).
Heier et al. (2005) note that changes to internal control procedures over the past century have resulted from weaknesses in internal control, and that the evolution of internal control displays a reactive process to those weaknesses. So also does the evolution of audit committees.

As applied to audit committees, reactivity can be considered to indicate ones that wait to be told how to function, rather than accepting responsibility for positive actions within a general frame of responsibilities. A number of researchers have delineated their concept of a general framework for audit committees (e.g., Palmer 1977; Baruch 1980; Terrell and Reed 2003; Backman and Salan (Eds.) 2004; Walker 2004), all of which contain comparable general descriptions of audit committee duties and responsibilities. Despite these, both Baruch (1980) and Walker (2004) assert many audit committees profess not to understand what is required of them. In other words, I suggest that these audit committees wait for bright line requirements, so that they may fulfill the letter, rather than the spirit, of the law. By doing so, they supposedly avoid legal liability, rather than providing good corporate governance and managerial oversight.

It is difficult to overstate a necessity for proactivity on the part of audit committees, particularly since the passage of SOX. This acceptance of responsibilities and willingness to commit to oversight of good internal control and good corporate governance may be the only solution for maintenance of the U.S. capitalistic system to remain free of total governmental control. Hanson’s (1978) warning of this willingness of government to assume control of the U.S. economy if business does not become
self-regulating should be a clarion call. Passivity on the part of audit committees should no longer be an option.

Audit Committee Timing and Expansion

Three questions need to be considered in discussing the evolution of audit committees. The first two are interconnected, so that either could be considered a corollary of the other.

1. What precipitated the need for audit committees in 1939?
2. Why did audit committee formation not occur earlier than the 1939 SEC/NYSE suggestion?
3. Why have the duties and responsibilities of the corporate audit committee proliferated during the 20th century, to the point that a number of authors (Barr 1976, Palmer 1977, Mautz and Neary 1979, Patton and Baker 1987, Smith 1991, Abdolmohammadi and Levy 1992, George 2003, Terrell and Reed 2003) have expressed concern about the ability of audit committee members to fulfill these duties responsibly?

1939 Audit Committee Need

I suggest that all of the major factors discussed in Chapter 2 of this study created a need for better corporate governance and control of an economy that had become alarming. These major factors were:

- managers of giant corporations with unchecked power,
- an accounting profession in what may be described as disarray,
- the Crash and continuing Great Depression, and
three significant frauds disclosed within the 1930 decade, at least one of which – the Whitney embezzlement – was minimized significantly by regulatory authorities.

The McKesson & Robbins fraud was the prime impetus for audit committees. The SEC investigation into the fraud disclosed that auditors, in many cases, were hamstrung in their attempts to report on the financial condition of corporations because of limitations placed on data availability by corporate managers. 12 expert witnesses called to testify before the SEC reported that these same managers, or their hand-picked board of directors, were responsible for hiring the audit firm and for setting the scope of the audit. A majority of those witnesses testified that, in their opinion, a buffer was needed between corporate management and auditors (SEC 1940a).

The culmination was recorded in ASR No. 19 as a suggestion to corporate boards of directors and management. Even though a followup letter from the president of the NYSE was sent that strongly urged corporations to form audit committees, the interruption and strain on the American economy from our entrance in to World War II, coupled with a perception that the audit committee suggestion in ASR No. 19 was symbolic and lacking in any real reform, signaled to corporate managers that the suggestion could be safely ignored.

Why Not Earlier Than 1939?

I suggest that three main reasons created an economic climate prior to 1939 in which audit committees were not even considered to be necessary. The first, of course, was the spectacular growth of giant corporations that accounted for over one-half of the American economy. This growth created powerful managers with little or no oversight.
and threatened the foundation of the capitalistic system, because it had been used in any number of cases without regard for what was best for stakeholders of the corporation. In some cases managers disregarded stakeholder and societal expectations in favor of personal gain. In other cases managers did not necessarily achieve personal gain (except for the prestige accorded his/her position atop the giant), but nevertheless used that power inappropriately to strengthen their position or their corporation’s stature without regard to ethicality or morality. A corruptive virus was allowed to fester within the capitalistic system, exacerbated by the second factor.

Second, in the 1920s – the Roaring Twenties – America was experiencing a headiness that created apathetic owners of the giants’ stock. Persons from all across the country sank life savings into a robust economy they perceived as continuous. There was no need for oversight of corporate management, because World War I had proved business to be “moral” (Previts and Merino 1998). The apathy seemed unbounded; persons were totally unconcerned about how the corporation was managed as long as the price of their stock increased. Given these conditions, the stock market crash in 1929 was cataclysmic beyond belief (Carey 1969a).

Third, American business had a very powerful voice in economic affairs. I suggest this strong lobby had significant influence on members of the Congress of the United States. An energetic man had been placed in the White House by a worried and angered electorate. He had promised to rid the economy of the Wall Street money changers (Roosevelt 1933) and return democracy to the economy. One of Roosevelt’s first creations was the SEC, and it is very likely that the electorate perceived this as the start of a cure for the economic problems plaguing the country. Roosevelt and the
persons he placed in charge of the fledgling organization were acutely aware of the business lobby, however. Immediate strident regulatory pronouncements might doom the SEC to obscurity. I suggest a conciliatory posture in regard to corporate governance was obligatory, not only to placate American investors, but also to reconcile corporate dominance with individualistic eighteenth-century democratic and economic theories without disturbing the existing [20th century] set of social and economic relations. (Merino and Neimark 1982, 34).

Proliferation of Duties and Responsibilities

Even though the marked increase in audit committee formation has been ascribed by researchers to the 1967 recommendation of the Executive Committee of the AICPA (e.g., Mautz and Neumann 1970b, 1977) and to the case of *Escott v. BarChris Construction Corporation* (e.g., Klock and Bellas 1976), I suggest the proliferation of its duties and responsibilities occurred primarily because of the passage of the FCPA in 1977. Congress and the SEC had been faced with a number of frauds within corporate America in the late 1960s and 1970s and had determined that the audit committee, in its role as overseer of management, was the best answer for cleaning up corporate governance and allowing financial data transparency. The main thrust of the Act was to curtail bribery of foreign governments and officials by American corporations. It also required corporations to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect" the corporation's financial condition (U.S. Congress 1977, §78m(b)(2)(A)), in addition to prescribing certain minimum internal control standards. Since the SEC had already adjudicated audit committee oversight of corporate governance in its investigations of the 1970s corporate frauds, I suggest it
has been a logical step to assign further duties and responsibilities to the committee, producing, in effect, an auditor within the corporation itself.

Limitations and Future Research

My study is limited to studying the history of audit committee evolution from 1939 to the passage of SOX in 2002. Because of this constraint, several limitations are inherent in the study. Each of these limitations contains topics for possible future research and study. They are as follows:

- Although audit committees have been reported in the 19th century, particularly in connection with the growth of railroad companies, my study is limited to the birth of the audit committee as it is recognized and established within corporate America during the last century and forward to the 21st century. This type of audit committee is not involved with auditing of an organization per se, as were the audit committees connected with the railroad companies. Rather, the audit committee concept examined in my study is used in an oversight role. Its primary purpose from its inception has been mitigation of unchecked power and establishing a valid oversight of corporate financial data.

- Closely connected to this last limitation, my study does not extend beyond the passage of SOX. It does not attempt to predict whether SOX will eliminate corporate misdeeds through use of audit committees. I briefly discuss the problem of fraud in spite of fully functioning audit committees after the passage of SOX, but I do not make estimates of whether SOX will alleviate corporate fraud to the point that further governmental regulatory action will not be necessary. History has shown that if mandations are perceived as symbolic and not intended
to be enforced with any strength or concerted action, managers have a tendency to regress into “business as usual” after a period of time. I contend enough time to assess this tendency after SOX passage has not elapsed yet.

- I have not used examinations of audit committee makeup, expertise, composition, meeting frequency, independence, etc. to prove or disprove whether audit committees are functioning properly or to examine correlations among these data and good versus bad corporate governance. Researchers have already made numerous such studies, particularly in the last two decades. It is likely that this type of study will be more useful after the provisions of SOX are fully functioning and after any perpetrators of post-SOX fraud are brought to justice.

The evolution of audit committees has burdened this committee of the board with significant responsibilities. Investors and regulators are expecting transparency, honesty, and ethicality to result from their functioning. Proactive audit committees that are supported by ethical managers will be able to achieve these results. Whether other audit committees that have been reactive and that are easily overpowered by a domineering management will cause further damage to the capitalistic economic system in the U.S. remains to be seen.
APPENDIX

SAMPLE MAKEUP OF CORPORATE BOARDS OF DIRECTORS
REPORTED TO THE SECURITIES AND EXCHANGE COMMISSION
YEARS 1940-1943
<table>
<thead>
<tr>
<th>Company</th>
<th>1940 Inside Directors</th>
<th>1941 Outside Directors</th>
<th>1942 Inside Directors</th>
<th>1943 Outside Directors</th>
<th>1944 Inside Directors</th>
<th>1945 Outside Directors</th>
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<td>1940 Outside Directors</td>
<td>1941 Inside Directors</td>
<td>1941 Outside Directors</td>
<td>1942 Inside Directors</td>
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<td>Warner Bros Pictures</td>
<td>6</td>
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<td>FW Woolworth Co</td>
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</tr>
</tbody>
</table>

NOTES:
1. United States Rubber Company listed directors on its finance committee.
2. Great Northern, Monsanto, and U S Rubber Company listed directors on their executive committees.
COMPREHENSIVE REFERENCE LIST


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