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Reforming corporate governance post Enron: Shareholders' Board of Trustees and the auditor

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Abstract

One potentially positive outcome of Enron's demise could be improving the process by which auditors are selected, retained and compensated. A proposal to reform this aspect of corporate governance is outlined in this essay. In addition, this editorial accomplishes two goals: (a) identification of the problem of audit independence as an outcome of vesting the authority to make auditor-related decisions with corporate boards of directors, and (b) proposing a structure to allow shareholders a direct path for deciding on auditor choice and compensation. This structure calls for establishing a Shareholders' Board of Trustees (SBT) independent of the Board of Directors and vest it with the responsibility of selecting, retaining and compensating external auditors. As a side benefit, allowing SBT to participate in the choice of corporate audit committee members could only enhance that committee's independence and effectiveness.

To function as an independent agent of shareholders, administering the election process for the SBT has to lie outside the corporation; it could be, for example, administered by the *stock exchange* for a fee. It is evident that the administrative and procedural matters of implementation need to be developed and need not be binding to give this concept serious consideration.

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1. The issue at hand

In theory, auditors are "agents" of the shareholders, but in practice we speak of the management as the audit "client." Moreover, the letter of engagement is exchanged between the management and the auditor. Yet, the entire present institutional arrangement is built on the premise that shareholders elect and appoint the auditor, which, I believe, is the biggest fallacy in corporate governance today. In today's global economy, corporate ownership is widely dispersed and shareholders, through proxy votes or sheer indifference, have effectively handed over the control of auditor-related decisions (hiring, retention and compensation) to corporate management. That same management will also decide on consulting engagements.

Critics often assert that auditor independence may be impaired when the chosen audit firm is also retained to perform consulting services. Contrary to these assertions, I would argue that any such potential threat to audit independence arises from vesting *de facto* authority for hiring auditors in the hands of the same management that also hires consultants. Audit independence can be achieved by removing from the management's domain such *de facto* authority to hire and compensate the auditor. When vesting the decision making process in the hands of different organizational units (shareholders choose the auditor, and the management chooses the consultant), audit independence will be attained (even if the same audit firm is retained to perform consulting functions). A possible structure to achieve this goal is developed below.

2. Enron and agency cost

In the short period since October 2001, when the Enron affair started unraveling, a plethora of reports have been written about Enron' s collapse. The enormity of that failure has led some writers to rush into assigning blame often confusing assumptions with facts to the point that suggested causes are mere speculation. Although much remains to be uncovered, the larger picture of the Enron debacle appears to reveal a disturbing phenomenon: the conflict of interest between shareholders and management has been allowed to prosper exclusively in favor of corporate management, the party in possession of information.

In academia, professors take pride in teaching ways to mitigate the conflict of interest inherent in the separation of corporate ownership and corporate control. Failing to at least mitigate that conflict of interest will give rise to high agency cost to the residual claimants, the shareholders. Indeed, in the case of Enron, the agency cost will be higher than any one had feared.

In academia, we also teach that one of the most direct ways of reducing the conflict of interest in a corporate setting is to offer managers incentive plans