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*Corporate Governance in the Wake of Enron: An Examination
of the Audit Committee Solution to Corporate Fraud*

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Abstract by Caroline Katz

Sarbanes-Oxley's solution regarding corporate governance is to place the audit committee in charge of monitoring a system of internal controls. The author argues that the implementation of internal financial control systems, monitored by an audit committee of independent directors, will prove to be ineffective in deterring and preventing corporate misconduct. She focuses on the importance of considering the cognitive perspective in relation to these internal controls and small group decisions.

The author suggests that there is little evidence that these internal controls programs prevent misconduct, mainly because a truly effective compliance program brings along with it the risk of uncovering incriminating information, creating disincentives for compliance. Sarbanes-Oxley internal controls solution ignores the context of the decision process. First, the context where monitoring counts is where a firm is experiencing conditions of relative loss. This is where, because of the risky shift, corporate cover-ups are predictable. Second, boards of directors are relational teams that act by consensus. Group dynamics may intensify individual biases such as self-servicing, overconfidence, over optimism, and cognitive dissonance (ignoring contrary information). Thus, the group's decisionmaking becomes less reliable, especially in situations of relative loss. Last, the difficulties of achieving accountability in relational teams suggest the internal controls system is less reliable than it appears. Group processes are not necessarily ideal when dealing with problems of a complex nature. The phenomena of group polarization, group biases, and cognitive dissonance affect a group's ability to make impartial judgments.

Accountability was the primary congressional goal in enacting disclosure regulations under the securities laws, as it can improve the quality of some kinds of judgment under certain conditions. These conditions are not often met in the context of audit committee/director decisionmaking. Additionally, accountability can increase the effects of certain biases and cognitive dissonance.

In conclusion, the author argues that Sarbanes-Oxley will have little effect on deterring or preventing corporate misconduct because it ignores the complexities of group decisionmaking. Thus, corporations should be permitted to devise the type of internal controls programs suitable for their own circumstances.