"GOVERNANCE AND SCANDALS: ROLE OF THE BOARD, AUDITORS, AND THE SEC"

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The US system of corporate governance is based on a regime of checks and balances. Management runs the company. The shareholders own the company. And the board -- composed of a majority of independent directors -- is responsible for policy and direction and represents the interests of the shareholders.

But that poses an interesting question: who are the shareholders directors are to represent? Shareholders are not a monolithic group. There are large institutions and individual investors. Some are willing to stay with the company for a long time, others stay invested only for the short term. Today hedge funds are the ones thought to be in and out of a company's stock most quickly.

There are also stakeholders, for example, employees, customers, and communities. I personally take them into account, too, but the shareholder interest comes first under most state incorporation statutes.

Also under the US system, corporations are incorporated under state statutes. But the regulatory scheme, mainly under the Securities and Exchange Commission (SEC), is federal. The SEC came into being in reaction to the stock market crash of 1929 and is an independent agency, headed by 5 commissioners appointed by the President with the consent of the Senate. One of the commissioners is designated chairman by the President. The SEC has a budget of over $800 million and has 3,500 people. It has jurisdiction over "registrants" (public companies selling securities) and the stock markets and their activity. It is empowered to require disclosure, investigate, and enforce.

The stock exchanges have listing requirements and operate under the aegis of the SEC.

I appreciate that your culture and your business establishment has traditionally worked differently from ours. I'm not here to tell you how to run things, but to relate how the US system works in the hope that some of my experience will be useful.

The US has had a rash of recent scandals, triggered by the collapse of Enron and the accounting firm, Arthur Andersen. This was followed by World Com and various others. I know you have had a major scandal recently too.

At Enron, dishonesty in management caused the reporting of misleading and fraudulent financial results. The auditor, Arthur Andersen, did not provide the proper check. The board seemed asleep. When the truth became known, the company

collapsed, investors suffered big losses. So did the employees -- one of the stakeholders -- many of whom were heavily invested in the stock. Meanwhile the top people at the company walked away with millions of dollars. That caused corporate governance to become a political issue, exacerbated by the scandals which followed. Trust in corporate managements, directors, auditors, and stock market research analysts fell to a new low.

The President and the Congress stepped in quickly. The result was the Sarbanes-Oxley Act (2002), new regulations by the SEC, and new listing requirements by the stock exchanges. All of this was aimed at fixing the situation by causing more accountability, more transparency, and a stronger system of checks and balances. The basic thrust of the reforms is good and seems to be working.

There are a variety of reforms, but I'll discuss the five that I think are the most meaningful.

(1) Director independence standards are higher.

All directors are to be people of accomplishment, good judgment, and high integrity. But, in order to list on the NYSE and NASDAQ stock exchanges, a majority of directors must be independent. And standards for independence have been raised by SOX, the SEC, and the stock exchanges. This promotes vigilance in challenging management when necessary – it is one of the checks. (The ultimate check within the purview of the board is to choose the CEO and when necessary, change the CEO.)

But the real value of independent directors is that they bring other viewpoints and relevant experience to deliberations about strategy and performance. Obviously, they must also understand what makes for success and profitability in the business.

So, today US boards are constructed to have a mix of expertise and experience. For example, Aetna, Inc, which is in the health care insurance business, has: two CEOs from other companies, two CEOs from the financial services arena, a Harvard professor who is the country's expert in health care economics, a physician who has regulatory experience, a former government Cabinet officer who brings public policy experience and expertise in audit and corporate governance.

I can say absolutely that the perspective of independent directors sharpens management's strategy and operational excellence and in some cases, makes an absolutely crucial difference between success and failure.

There are now a variety of criteria mainly designed to ensure that the director does not have a financial relationship with the company that is sizeable. For example, a director is not independent if he/she or a family member is a part of another enterprise which makes or receives payments from the company that exceed the greater of $1 million or 2% of the other company's revenues during the past 3 years. A director cannot have been an employee or worked for the company's auditor for 3 years.

But independence is also a mindset. A director must be willing to question management and not just agree because he/she is a friend of the CEO.

I think this is working – directors have become more vigilant and more intellectually engaged in board matters. This does not mean that they are attempting to micro-manage company affairs. It means that they are far more active in doing their job of oversight, challenge, and advice. It also means that there is increased emphasis on ascertaining the culture of ethics in the company, the "tone at the top."

(2) Board Executive Sessions are required.

There is a new requirement that the board hold executive sessions of the independent directors regularly without management present. There must be a presiding director or it can be a chairman of the board who is not also the CEO. These sessions are scheduled into the agenda of the meeting and are designed to give the opportunity for candid discussion.

The presiding director presides over these executive sessions and relates any relevant consensus back to the CEO afterward. This is one of the best reforms, as I see it. It reinforces the independence of the board as well as helping it work together as a group. And this is an important point: a board functions as a group, so the group must work well together to be effective. Members must respect and trust each other. That is why the reform has created a leader of the board -- as differentiated from the leadership of the management.

Example: I was in two executive sessions last week. One of them discussed the CEO's compensation. The other dealt with an aspect of company strategy that the board found rather risky.

(3) SOX requires that the CEO and CFO certify quarterly to the truthfulness of the financial statements.

In order for them to certify, there are sub-certifications required from business unit heads, the controller, internal auditor, functional heads, and others. In other words, the process is pushed down in the company. The sub-certifications come up, and that gives comfort to the two at the top who must certify.

The audit committee, which must review each quarterly earnings release, financial statement, and filing to the SEC, also reviews the certifications. If a certification was missing or was qualified (meaning hedged) in some way, that would be a red flag. In other words, there is much more discipline in the assessment and reporting of financial results. And there is meant to be accountability.

SOX has also spelled out stiff penalties in case of fraud later….if the CEO and CFO certifies wrongly, there is a maximum of $1 million and/or 10 years in jail. If the certification is found to be willfully misleading, the maximum penalty is $5 million and/or 20 years in prison.

This has gotten everyone's attention.

(4) The Audit Committee's responsibility has been increased.
It is the only board committee which monitors what management does all the time – part of the system of checks and balances. The work of other board committees ebbs and flows – but eternal vigilance is demanded of the audit committee all the time. Audit committees must be composed of independent directors. Independent auditors also are important to the system of checks and balances.

In SOX, the audit committee is responsible for the appointment, compensation, and oversight of the work of the outside auditor.

This strengthens the reporting relationship of the outside auditor to the committee and is an important reform. The audit firm does not report to management. It did not before but often acted though it did. This is a change. So, now the audit committee selects the lead engagement partner on the audit.

The audit committee, especially the chairman, must carefully and wisely use the checks and balances built into the audit committee system. There is inherent tension among the roles of those who are around the table – management, the outside auditor and internal auditor. The latter two are checks on management. The audit committee plays one off against the other – gently, not confrontationally -- to get the most insight and information. And the purpose is to become aware of problems before they become crises and to head them off.

The audit committee also ensures that the management has a process in place to manage risks to the company. That is a new requirement in the stock exchange listing requirements. I have long felt that audit committees should set the agenda for their work according to the areas where there are the biggest risks to the company. Generally now, we have enterprise risk management. That entails identifying a comprehensive list of risks. Each one has an "owner", a person in management is responsible for managing that risk area. There is also designated a board committee (or the full board) to oversee the risk management process.

(5) The Public Company Accounting Oversight Board (PCAOB) to regulate the accounting profession has been created.
The new requirement is that each public accounting firm which audits public companies must register with the PCAOB and the PCAOB periodically inspects the firm's work. Previously this review was done by the American Institute of CPA's, a professional association in the private sector. The PCAOB is a private sector regulatory body, but it is under the jurisdiction of the SEC. In addition to the work described above, it also writes the standards by which auditors are to do their work. This new regulatory apparatus is aimed at causing the auditors to be more independent, to be more accountable, and to rebuild trust in our accounting firms with the public, investors and capital markets.

I believe the PCAOB is doing a commendable job. However, there is an outstanding issue…and it relates to the auditing standard which implements section 404 of SOX. This requires management to represent that the system of internal controls is effective, and then the auditor must attest to this. This requirement has caused a lot of complaints and many in corporate America believe it is costing too much and not providing enough benefit to justify the cost. New guidance to ease the requirement was given about a year ago by the SEC and PCAOB and the situation is about to be reviewed by the regulators once again.

The Bottom Line

I continue to believe that most corporate managers, directors and auditors are honest. But if some people in management work together to deceive the board and the investment community, it is difficult for the board to know. However, I think the reforms make it more difficult today to do what those at Enron, World Com, and Fannie Mae did.

I also believe that the US corporate governance system is working reasonably well and that trust in the system is returning. But if one is a director, as I am, I believe in the old adage, "Eternal vigilance is the price of liberty. In this case, eternal vigilance is the price profitability."

The Vision

Our capital markets are already global and moneys move around the world with lightening speed. What happens in one market can have ripple effects in others, as the financial crisis of 1998 has demonstrated. So, to one degree or another, we are all in the same boat. Therefore, the vision for the future is that we must have a truly global system of capital markets, so that an investor in one country can trust the financial statements provided by a company in another country. With this must come international accounting standards that all countries will adopt and enforce the same way. We need to be assured that auditors in all countries are truly independent. We need a more common global regulatory system or at least, an effective regulatory regime in each country. And we need a more common system of best practices in corporate governance.

This may be a pipe dream but I prefer to think it's a vision of a truly international financial world.