

CORPORATE GOVERNANCE

CALLS FOR GOVERNANCE REFORM INCREASE AS PUBLIC SECTOR FOCUSES ON ACCOUNTANTS AND CORPORATIONS

Hank Boerner



Domestic and multinational corporations and their accounting and auditing firms continued to be buffeted by macro forces in the wake of the two major series of events that affected the United States in 2002. The first set of events began with the terrorist attacks of September 11, followed by the anthrax mailings in the weeks that followed the crash of the four airliners. The issues surrounding homeland security quickly became very visible matters for debate by government officials, journalists and commentators, think tank scholars, academics, and analysts, many recommending dramatic increases in domestic security measures that will intimately involve the private sector.

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The second set of events began earlier, with the dramatic collapse of the technology stock market bubble in spring 2000—the "tech wreck"—followed in late-2001 by the financial collapse of Enron Corp. and news of other companies' accounting irregularities or missteps (usually in the form of restatements). The revelations of troubles at many firms, including some of the bluest of the blue chips, at times became a crescendo of bad news that served to dampen investor enthusiasm in the markets.

The terrorist attacks were aimed at the most visible and iconic symbols of American political, business, and financial supremacy. The financial after-effects are being felt in many sectors; for example, the airline industry has since suffered the loss of billions' of dollars in revenues.

Tens of thousands of financial industry employees were dislocated by the attacks on the World Trade Center. The New York Stock Exchange closed for four trading days, opening on the following Monday. Ground Zero was not just

Lower Manhattan, but also the world's financial system.

The terrorist attacks came in the midst of an economic downturn that officially began just months earlier (in March 2000, according to the National Bureau of Economic Research), effectively stalling the longest growth period in U.S. history (120 months), and in the midst of a continuing broad market sell off of technology and other companies.

As the nation began the long recovery from the events of September 11, and as the economy began to show signs of a rapid recovery and return to positive gross domestic product (GDP) growth, the financial collapse of Enron then sent enormous shock waves throughout the corporate, business, financial, government, regulatory, and accounting communities. Institutional and individual investors even began to voice concern publicly about the state of the equities markets and the future of investing in general.

Reaction to both of these series of macro and micro events in the public sector could affect corporate financial officers and capital mar-

kets professionals for months—if not years—to come.

ORGANIZED FEDERAL RESPONSE—PRIVATE SECTOR FOCUS

In reaction to the September 11 attacks, the federal government created the Office of Homeland Security; soon there were proposals of new federal budget allocations totaling \$40 billion to address domestic defense. Proposals were being floated by members of the Congress, think tanks (especially the Brookings Institution), the Bush White House, and others calling for dramatic changes in the way the U.S. public and private sectors handle data and information.

Measures proposed would include mandatory reporting of vital data collected by private sector corporations—such as airline, hotel and car rental companies' transactions—which could be reported in real time to government data collectors in the future. Privacy of such data is a major societal concern, as is the protection of competitive or proprietary information. Corporate financial officers, brokerage houses, investment bankers, commercial bankers, and accountants and auditors could well find themselves as major brokers of information with government negotiators in 2002 and beyond.

AFTERMATH OF ENRON AND OTHER CORPORATE GOVERNANCE FAILURES

President Bush has noted that the economic and financial security of the United States is as important as weapons or the military. Restoring investor confidence in the capital markets is now a major priority for the White House, Congress, Securities and Exchange Commission (SEC), the exchanges and self-regulated organizations (SROs), and the corporate community.

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The front cover headlines of the May 6 issue of *Business Week* framed some of the major issues in the current debate: "*The Crisis in Corporate Governance—Excessive Pay, Weak Leadership, Corrupt Analysts, Complacent Boards, Questionable Accounting!*" These are enduring, populist messages in the growing debate about the problems with corporate America, especially in the view of media and the public sector. The magazine's writers said the present situation is a huge crisis and wondered what it will take to restore the public's faith in the system.

The resolution of these issues are crucial to detecting future directions of the capital market, at least over the next one to two years and perhaps for the rest of this decade. The solutions are being suggested in very public ways, usually tossed into the boiling cauldron of public opinion through proposed legislation or new rules, thought-leaders' speeches, endless media interviews, and a number of public workshops conducted on the suddenly hot topic of corporate governance.

The following are several developments that bear watching by the financial community and corporate finance officers in the search for clues as to where the corporate governance reformation movement may carry the American society.

Executive and Board Compensation

Federal Reserve Chairman Alan Greenspan weighed in on this issue:

The "seemingly narrow issue of option expensing is of critical importance for the accurate representation of economic performance." Translation: Only two firms in the Standard & Poor's (S&P) 500 apparently now expense officer, director, and employee options; the rest should quickly follow the example. Chairman Greenspan, with a careful eye on the faltering stock market, believes that failure to expense options has introduced a significant distortion of reported earnings, and with options as an increasingly prevalent form of executive compensation, the interests of shareholders and management have become seriously misaligned. "It is no more valid, in my judgment," the chairman said in a speech, "to assume that option grant expense is zero than to arbitrarily assume that depreciation charges are zero."

Chairman Greenspan acknowledged the entrenched opposition to change: "To be sure, lower reported earnings as a result of expensing, should it temper stock price increases, could inhibit option issuance. But that inhibition would be appropriate because it would reflect the correction of misinformation." (Note that the average earnings growth rate of the S&P 500 would be reduced by one quarter for the period 1995-2000 if companies reported stock options as expenses.) Treasury Secretary Paul O'Neil is generally in agreement in that he believes options should be charged to earnings when exercised.

Board Structure and Behavior

Directors are becoming more difficult to recruit, according to Thomas Neff, head of executive recruiting firm Spencer Stuart. He told *The New York Times* that where recently he interviewed three or four candi-

dates to fill a post, now he must interview at least six to find a suitable candidate. Many of those who are interviewed apparently express concerns about their personal reputations if things go wrong, and Mr. Neff sees this as an indicator of a trend of fewer CEOs serving on other boards. One silver lining: Mr. Neff is encouraging his corporate clients to look beyond CEOs, to recruit CFOs and COOs, a new level of management for board service and potential CEOs of their own companies.

Post-Enron, what does it take to bring a new director on board? Stock grants and options, donations to a favorite charity, cash compensation (especially for audit committee members, who must devote more time to meetings than other directors), and continuing education for board members (and prospects for board membership).

Public Sector Prosecutions—Beyond the SEC

In the tradition of populist and crusading New York State Attorneys General, the present occupant of the post, Eliot Spitzer, has seized on the current troubles of Wall Street to bring legal actions against high visibility targets—such as venerable Merrill Lynch, the nation's largest brokerage firm. Mr. Spitzer, criticizing the SEC for moving too slowly to protect investors, won a court order requiring Merrill to disclose its investment banking ties in analyst research reports. Plowing through subpoenaed emails, Mr. Spitzer saw enough to broaden his criminal and civil probe to include Goldman Sachs, Lehman, and other firms; he is also considering criminal charges against some firms. Mr. Spitzer demands reforms, such as the formal division of investment banking and research functions. His actions conjured up visions of the 1980s parade

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of handcuffed Wall Street inside traders being escorted to arraignment from their offices!

New Federal Laws—Imposing SEC Regulations

Congress comprises a chorus of critics focused on reforms they believe are needed to restore faith and confidence in the capital markets. A number have advocated adoption of strong corporate governance measures and characterized current financial reporting practices as insufficient. U.S. Senator Carl Levin (D-Michigan), with Senator John McCain (R-Arizona) introduced a "Shareholders' Bill of Rights" package that directs the SEC to issue stricter rules to govern board conduct and compensation. Senator Levin's law would require board audit committees to directly oversee a company's accounting practices. Earlier, the Senator introduced legislation that would end tax deductions [of options] for any company failing to report options as an expense.

This is one of more than two dozen reform measures introduced in the House and Senate since the financial collapse of Enron Corp. Many of the bills introduced address accounting industry issues, but to date, Senator Levin's bill is the most far-reaching, in the view of *The Wall Street Journal*. The Senator has long focused on corporate governance issues; he introduced reform legislation in the early 1990s to address governance practices (including

CEO compensation) and financial disclosure.

Institutional Investor Vigilance

Institutional Shareholder Services (ISS) is launching a new rating service to measure (and advise on) the quality of corporate boards and their corporate governance practices. The Corporate Governance Quotient (CGQ) will initially monitor and rate the 3,000 companies in the Russell 3000 index and will eventually expand to cover 9,500 U.S. publicly trade companies. ISS will include the CGQ rating on each of its proxy analyses for institutional investor clients that subscribe to the service.

Included in the rating are seven core topics:

- Board structure and composition
- Charter and bylaws
- Laws of the state of incorporation
- Executive and director compensation
- Financial performance and other qualitative factors
- Director and officer ownership
- Director education

ISS hopes that CGQ will foster progressive governance practices and policies, and will offer ISS-accredited director education programs in cooperation with National Association of Corporate Directors, Dartmouth University's Center for Corporate Governance, and several other groups. (The full range of rating criteria can be examined at www.iss-cgq.com/ratingcriteria.htm.)

A REINVIGORATED SEC?

SEC Chairman Harvey Pitt, formerly a private sector securities lawyer, assumed his post as the recession deepened, the market sell-off continued, and just four weeks before the September 11

terrorist attacks. Chairman Pitt responded to calls for reform by moving quickly to announce several initiatives and serves as the Bush Administration's lightning rod on financial markets issues. The Enron and Global Crossing financial failures considerably shaped his early agenda for action.

Critics on various sides of the issues—those for dramatic and immediate accounting and financial reporting reforms, and those opposing precipitous emotional reactions that could damage the capital markets—have voiced displeasure with Chairman Pitt on some of the approaches he has taken. One academic characterized Mr. Pitt's short tenure as a "crisis in confidence." Less adversarial and reform-minded than the previous chairman, Arthur Levitt, Chairman Pitt seems to be firm believer in the ability of markets to be self-correcting and more of a consensus builder than Mr. Levitt. The pressure applied by Eliot Spitzer has prodded the SEC to begin an investigation of securities analyst behavior.

Given the mood of the Congress, if the SEC is seen to be moving too slowly, reformers on Capitol Hill may pass legislation to force the SEC to adopt new and, perhaps, more draconian regulations regarding financial disclosure, corporate behavior, securities analyst practices, and transparency of financial reporting. Chairman Pitt came into office suggesting a move to real time financial reporting, and in April announced proposed rules to require accelerated periodic reporting filing dates and Web site postings for material news. Among other things, new regulations would require companies to report 8-K transactions in two business days (for transactions over \$100,000).

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TEN POINTS FOR INVESTOR RELATIONS PROFESSIONALS

The volunteer board of the National Investor Relations Institute (NIRI) adopted a 10-point program to "help restore confidence in the U.S. capital markets." Included in the plan: a two-tier system of disclosure, with a plain English executive summary of information in the Management's Discussion & Analysis (MD&A) of Forms 10-K and 10-Q ahead of the traditional detailed information required by the SEC and Financial Accounting Standards Board (the "second tier" in both documents).

NIRI would like to see generally accepted accounting principles (GAAP) earnings stated before pro-forma. The MD&A portion of quarterly and annual reports should be expanded (the SEC has recommended this). Supporting President Bush's call for senior managers to be held responsible for reporting financial results, NIRI's board said the "Management Responsibility for Financial Reporting" in the 10-K should cover all written disclosure in SEC filed documents.

Off-balance sheet businesses should be disclosed in an aggregated form with details on any special purpose entity (SPE); this information should be put in a news release and posted on the company's Web site. Insider stock transactions should be reported

within 48 hours during normal trading days. Formal window periods should be established to govern when insiders can buy and sell securities—and the dates should be clearly posted for investors.

Companies should be more aggressive in educating employees on the benefits of owning company stock. The company's investor relations officer(s) should be required to meet with an independent committee of the board of directors (preferably the audit committee) to report on feedback and comments from investors and securities analysts. NIRI called on the SEC to urge the SROs (such as the NYSE) to make this a listed-company requirement.

And finally, believing that investors want to know how companies make their money, NIRI suggests companies should disclose information beyond the financial to explain non-financial factors and intangibles that make up a significant portion of a company's market value—especially the so-called "knowledge-based businesses."

Collectively, the events and developments mentioned in this column underscore the revolution underway in corporate board and management accountability, corporate governance practices, financial reporting requirements, and accounting rule-making. No company will be untouched by the accords and decisions reached on these issues in the months ahead. This is not a rhetorical exercise; the reforms being suggested are real and far-reaching.