THE CHANGED ENVIRONMENT: CHALLENGES AND OPPORTUNITIES IN 2004

The snowball is rolling down the hill, gathering speed now, growing larger in size, finally noticeable from a distance, a thing of major proportions and momentum, and seen in its entirety as a potential threat to those in its path.

The snowball may be an apt metaphor for the aggregated chain of events that in 2004 will create challenges for corporate financial executives, chief executive officers, and members of boards of directors. Experts are projecting important and far-reaching changes in corporate financial reporting, accounting, disclosure, and financial engineering that will also have direct effects in the capital markets. The combined effect throughout the year might well be compared in one's imagination to that metaphoric snowball barreling down the steep mountainside toward the villagers below. But at least the alarms have been clearly sounding for finance executives!

Sarbanes Oxley and SEC rules

The powerful package of federal statutes known familiarly now as Sarbanes-Oxley (or the shorthand SOX) signed into law in July 2002 has been well documented for its chapters and verses—11 comprehensive titles in all, most updating the 1933 and 1934 securities protection laws, and in total comprising the most stringent statutes to attempt to govern corporate behavior in 70 years.

Lawyers and accounting firms have been busily churning out loose-leaf book guides, memos, and advisory letters to clients, and conducting seminars to help corporate executives and legal counsel adjust to the dozens of new requirements and operating rules of the road. SOX directed the Securities and Exchange Commission (SEC), Internal Revenue Service, U.S. Sentencing Commission, U.S. General Accounting Office, and other public sector agencies to implement rules, conduct studies that would lead to additional rules, and promulgate other follow-on measures that have increased the complexity of SOX statutes, which were plainly written and straightforward when Congress completed its work.

Beyond continued federal implementation of these sweeping securities protection laws, other forces are at work reshaping activities in which corporate finance executives play a major role, including the relationship between the board and management.

Tougher exchange rules for listed companies

The board of directors of the New York Stock Exchange—under fire for its own corporate governance failures—nevertheless kept a package of new listed company corporate governance rules moving through the public process toward implementation. The SEC approved the new rules in October 2003, after separating one key provision for more urgent (early) action—the requirement that all employee stock options programs be approved by shareholders (approved earlier in 2003).

The board of directors of the NASDAQ Stock Exchange passed a similar package, also approved by the SEC in October 2003, that observers say could stress small-cap and mid-cap firms and impose financial burdens as they attempt to implement the rules. Both exchanges address board independence and attempt to define the test of whether a board member is independent; directors who fail the test will have to leave their boards.

State investigations continue

Another force exerting pressure on the capital markets—providing great momentum for change—is the continuing oversight of the equity markets by New York State Attorney General Eliot Spitzer. Mr. Spitzer and 10 major investment banking houses reached agreement in 2003 on the methodology for providing independent financial analyst

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THE NEW PRACTICES COULD SOON CREATE FUNDAMENTAL CHANGES IN THE WAY BANKERS AND BROKERAGES CONDUCT FINANCIAL ANALYSIS AND RESEARCH.

reports to investors (their customers). The new practices could soon create fundamental changes in the way bankers and brokerages conduct financial analysis and research. One result: A number of houses have begun dropping companies from analyst coverage.

The coming disclosures by researchers with no ties to investment banking or brokerages could be accurate and not so accurate, informed or less informed, depending on analyst skill. Conflicting analyses could create communication challenges for internal finance officers who attempt to publicly address facts or opinions as stated in the reports. A concern is that less qualified researchers may be encouraged by the availability of Mr. Spitzer's settlement money to generate new business for themselves—the pool of research money is almost $400 million over a multi-year period.

Analyst change of behavior

Corporate finance managers could also find themselves dealing with more penetrating questions and a greater degree of skepticism on the part of experienced sell-side analysts. Each major investment house now covering a public company—say, General Electric—will have to purchase research on GE from up to three independent research firms (as recruited by an equally independent outside monitor) and then make their analyses and recommendations available to the customer receiving their own sell-side analyst's GM report. (Here is an absurd projection: 10 houses covering GE could have to provide as many as 30 separate reports, on a combined basis.) Is this a recipe for investor confusion? Some on Wall Street think so. Note that institutional investors can opt out of the scheme if they notify the banker.

The terms of the negotiated settlement to achieve independence for analysts could pose new challenges for CFOs and investor relations officers attempting to provide the company's story to brokerage and investment banking customers. Here is where a stated disclosure policy could be helpful to both board and executives, to avoid pitfalls as communication with analysts becomes more complex.

Greater mutual fund disclosure

Mr. Spitzer and several other state attorneys general have moved on to perhaps an even larger target: the $7 trillion (assets) mutual fund industry, now embroiled in scandal. Complicating life for funds is the fact that new SEC rules adopted in 2003 will require that mutual fund advisors publish their internal guidelines on corporate governance voting (for companies in which they have invested) and to publish the record of the proxy vote for every company in the portfolio (for shareholders to examine if they have an interest).

What new revelations may be found as shareholders dig through fund publications? How will these affect public corporations? The answers to these questions are more unknowns for CFOs in 2004.

As SOX provisions are implemented, and as SEC responds to revelations of more scandals and the demand for more rigorous enforcement of securities regulations, accountants and their corporate clients are, of course, devoting many hours to understanding the new requirements for financial reporting.

The view from the board room

The question that is often raised as recent corporate scandals are publicly examined: Where was the board? The nation's estimated corps of 15,000 directors has taken notice of the attention and is responding. The National Association of Corporate Directors, arguably the most prestigious of board associations, recently conducted its annual corporate governance conference; the theme was looking ahead to the challenges of 2004—"Redefining Directorship: Balance Compliance with Performance."

Charles Elson, director of the new Center for Corporate Governance at the University of Delaware, declared to the directors in attendance that a sea change has definitely occurred, with many new demands being imposed on individual board members. "You will be operating under more stringent laws and regulations, some of which will create personal liabilities for you," Professor Elson advised. "You will be devoting many more hours to board room duties, including committee assignments. Serving on nominating, compensation and audit committees will now mean extraordinary time demands for members.

"Boards of directors," he counseled, "will have to increase their level of collective and individual professionalism, to come into compliance with the mandates of Sarbanes-Oxley, New York Stock Exchange and NASDAQ listing rules ... and to meet rising shareholder expectations. The key adjustment will be that CEOs will work for the board . . . not the reverse, which has been the case at some companies."

Strong culture needed to address challenges

John (Jack) Krol, former CEO of DuPont and now the Lead Director of the new Tyco International Board, said that from his perspective, most boards and senior executives really try to do the right thing, for shareholders, employees, and their organizations. "Whether there are new accounting, reporting or governance rules to comply with or not, boards will encourage development of a strong corporate culture, one with honesty and integrity, committed to full disclosure, and a culture that sets high standards for its senior managers."

Here are his thoughts on important changes taking place in the nation's boardrooms, which will have direct impact on corporate officers:

- More proactive boards are evolving, with more independence of decisionmaking, separate of the CEO and corporate management;
- Many boards are adopting written charters to spell out accountability for the board, and senior corporate officers, especially including the CEO and CFO;
- More executive sessions are scheduled, without the CEO or CFO present;
- Some boards are scheduling sessions with the CFO and not the CEO present;
- Nomination of board members is considered one of the most important responsibilities of the board; a ratio of soliciting 10 prospects for one successful recruitment may be the new norm, given the higher standards evolving;
- Financial experts are eagerly sought for board membership; the requirement for board audit committees to hire, supervise, and liaise directly with the outside auditing firm, and to change auditors when necessary, creates higher standards for audit committees;
- At Tyco, the head of internal auditing now reports directly to the board (to the audit committee, not to senior management); this could become a trend at other companies; and
- Risk assessment is becoming a critical board responsibility; outside consultants are being recruited to assist boards. (At Tyco, an outside consultant is helping assess risk for some 2,100 operating units of various kinds that make up the organization.)

Richard Breeden, former Chairman of the SEC and a federal court-appointed monitor to the troubled WorldCom, recently stirred up public interest when he issued a comprehensive package of 78 recommendations for improving corporate governance at WorldCom , which is recovering from the largest bankruptcy in corporate history. This maybe a form of Magna Carta,he believes, for U.S. corporations as they move into a new era of greater responsibility to shareholders and stakeholders.

Board audit committee has a key role

Former SEC Commissioner Cynthia Glassman, who was also a Federal Reserve System economist, underscored the critical role of the board audit committee in the life of the corporation. The new protocol for the audit committee, and for the committee's relationship with internal finance officers, is that the committee be fully independent, able to hire and fire auditors without interference, able to receive complaints about financial reporting or accounting irregularities, able to recruit only qualified financial experts as committee members, and able to hire outside experts to help probe internal finances when the committee has questions or issues—a sea change in the environment, indeed.

"The bar is raised very high now for audit committees," she observed,"and it could become harder to find qualified financial experts for boards. They will probably serve on fewer boards, and shift from being friends of the CEO to being board members who add value and do a real job of monitoring finances inside the company."

The revolution in disclosure and SEC enforcement

Meeting separately in New York City, a non-profit organization, The Directors Roundtable, conducted an educational program to help directors and advisors look ahead to 2004, focusing on the revolution in SEC disclosure and enforcement and how it will affect board members and senior corporate officers.

Under the direction of Jack Friedman, The Directors Roundtable is a worldwide civic-minded group of directors and advisors that has conducted as many as 500 educational programs over the years. The group's "Governance Series" was conducted in 33 major U.S. cities and traveled to Milan, London, Frankfurt, and Paris in late 2003. The Roundtable's focus is on internal compliance systems, accounting, financial reporting, ethics, and corporate governance issues.

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New levels of oversight

Terry Iannaconi, an executive at KPMG, shared his observation that new levels of board oversight include making sure outside auditors go beyond bread and butter issues, including, as an example, making a search for potential fraud a part of the audit process.

The SEC is expected to issue new rules and opinions addressing critical accounting policies in 2004, posing additional challenges for companies, and effective corporate disclosure will become even more important. On the subject of revenue recognition, the SEC is expected to adopt more conservative views and a more intense regulatory focus (in the wake of the corporate scandals of 2001, 2002, and 2003).

Also expected is greater focus on accounting restatements, which are now epidemic, said Mr. Iannaconi, citing recent restatements by the dozen, though most are minor."The majority are human error, not fraud," he suggested. But he noted that the SEC tracks all restatements and this could trigger an investigation of a company, creating headline risk.

"Restatements draw public attention," he said,"and there will be other issues evolving in 2004 that could draw public attention, such as changes in audit standards, especially with new standards being issued by the Public Company Accounting Oversight Board. Adoption of new standards could trigger situations where a company would be unable to attest, as it must under federal regulations, that controls are in place to deter financial shenanigans. A company's disclosure of sufficient deficiencies in internal audit and financial control systems could trigger immediate public scrutiny.

"And many companies have weaknesses they are now addressing," KPMG's Mr. Iannaconi said. Skepticism is high, and "we could even see statements of positive opinions that controls are in place at a company generating skepticism at the SEC." The risks are high that companies required to attest that there is reasonable assurance that financial statements are in accordance with generally accepted accounting principles (GAAP) may not be able to. "There are no absolutes here and no company is going to be perfect. These are developments to watch in 2004," he suggested.

Disclosure—how much is too much?

Recalling our snowball gathering size and speed, one might ask, how much of all this pending disclosure could be too much? As Wall Street and corporate America work to restore investor trust on Main Street and in the capital markets, could too much news, information, and revelations about corporate finances, accounting policies, board activism, and other factors create higher levels of distrust, lack of confidence, and other uneasiness for investors?

Professor David Beim of the Columbia University School of Business suggested at The Directors Roundtable that this could be the most challenging issue now facing executives and boards. He suggested,"Should we think in terms of setting absolute standards for board and management behaviors, as the media continue to ratchet up interest in corporate affairs, or do we set intelligent benchmarks for management and have the board enforce behavior as the fiduciaries for shareholders?" As board best practices emerge in 2004, many more questions will be raised and concerns addressed, in a public dialogue.

Some questions will also be raised internally by employees, he believes, and the rank and file will be looking to talk with someone in charge, and that may be the board or senior management. Running a tighter corporate ship has never been more important, it would appear. "Internal controls will be critical to ensure that financial information at all levels is accurate," he advises,"because the penalties for violations are so much higher for board and management."

The individual and combined forces for change in corporate accounting, disclosure, financial processes, auditing, and regulatory compliance seem destined to bring a higher level of risk for boards, CEOs, corporate finance officers, and also could create opportunity for bringing about positive change to strengthen the body corporate. At both conferences cited, there was an abundance of optimism expressed by presenters even as the nation's experts on corporate finance, accounting, and governance described the new environment in which companies will be operating.

As the metaphoric snowball comes into sharper detail, the alarms have been sounded—we are all on alert—there is time to take action. •