THE CONFERENCE BOARD

The Conference Board

Commission on Public Trust and Private Enterprise

EXECUTIVE SUMMARY

Findings and Recommendations

SR-03-04-ES

The Conference Board Commission on Public Trust and Private Enterprise was convened in June 2002 to address the circumstances which led to the corporate scandals that were widely reported during 2001 – 2002 and the subsequent decline of public and investor confidence in companies, their leaders, and American capital markets.

The Commission's work articulates a series of principles and "best practice suggestions" in three major areas–executive compensation, corporate governance, and audit and accounting issues–as they relate to publicly held[*] corporations. This Executive Summary contains highlights of the Commission's reports[**] and summarizes principles that companies can adopt to improve their corporate governance.

The 12-member Commission–co-chaired by Peter G. Peterson, Chairman of The Blackstone Group and Chairman of the Federal Reserve Bank of New York; and John W. Snow, Chairman and CEO of CSX Corporation and former Chairman of The Business Roundtable–included prominent leaders from business, finance, public service, and academia. Although the Commission was sponsored and supported by The Conference Board, it enjoyed absolute independence and authority in its findings and recommendations, and was financially supported by The Pew Charitable Trusts.

The full text of the Commission's reports and recommendations can be found on The Conference Board's Web site at www.conference-board.org/knowledge/governCommission.cfm

* While these issues are also of concern to privately held companies, such companies are often financed through a sophisticated investor base. Use of money from the general public, however, necessarily subjects publicly held companies to higher scrutiny and, therefore, to the attention of this Commission.

** The Commission issued its first set of findings and recommendations, Part I: Executive Compensation, on September 17, 2002. Subsequently, Part 2: Corporate Governance and Part 3: Audit and Accounting were released on January 9, 2003.

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Acknowledgments

The Commission wishes to thank Simpson Thacher & Bartlett, which served as special counsel to the Commission; Towers Perrin for providing background information related to executive compensation; and KPMG LLP, which provided the background for and a customized analysis of their survey data.

An Overview

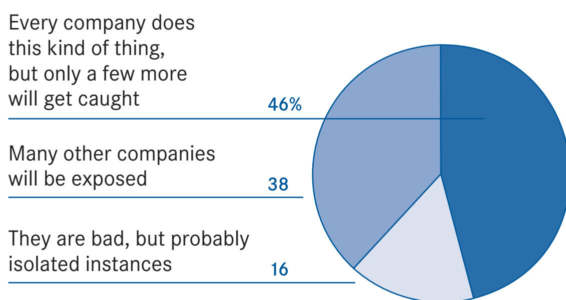
The egregious failures at Enron, WorldCom, and other companies evidence a clear breach of the basic compact that underlies corporate capitalism—which is that investors entrust their assets to management while boards of directors oversee management so that the potential for conflict of interest between owners and managers is minimized. Furthermore, various professional advisors of companies, such as public auditors, compensation consultants, and, in some cases, law firms failed to provide truly independent advice and professional judgment as they came to view management, instead of the corporation, as the "client."

Events of the last two years suggest that, in many instances, this compact among shareowners, boards, and management has been significantly weakened, diminishing the trust that investors and the general public have in our system of corporate governance. Recent survey data suggest that large numbers of people believe executives are willing to take improper actions to enrich themselves at the expense of the corporation and that CEOs of major corporations are not trustworthy.

For example, surveys of the prevalence of corporate wrongdoing show that 46 percent of the public believes: "Every company does this kind of thing, but only a few more will get caught" (Chart 1). In another survey, when asked if corporate executives take improper actions to benefit themselves at the expense of their corporation, 79 percent responded that this practice was either "very" or "somewhat" widespread (Chart 2). Finally, when asked who could be trusted, CEOs of large corporations fared very poorly (Table 1).

Chart 1

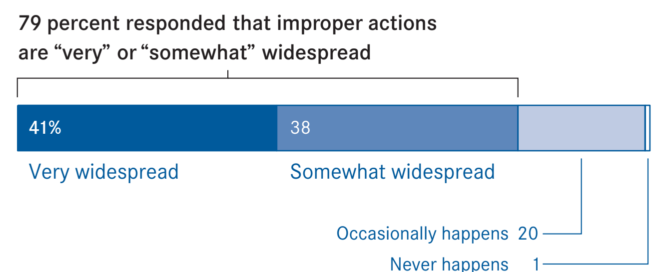
Public thoughts on the prevalence of incidents of corporate wrongdoing



Source: The American Survey, July 2002

Chart 2

Do top executives of a large corporation take improper actions to help themselves at the expense of the corporation?



Source: CNN/USA Today/Gallup Poll, July 2002

Table 1

People Who Can Be Trusted

	Most can be trusted	Can't be too careful with them
People who run small businesses	75%	22%
Military officers	73	24
CEOs of large corporations	23	73
Car dealers	15	81

Source: CNN/USA Today/Gallup Poll, July 2002

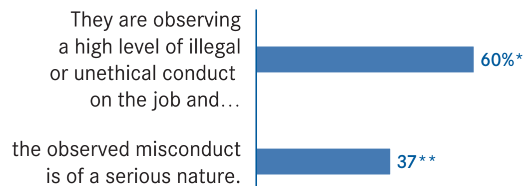
In the area of executive compensation, the Commission shares the public's anger over excessive compensation, especially to executives of failed or failing companies who may have garnered substantial compensation even as their companies and the retirement savings of their employees have collapsed.[1] The additional collapse of the dot.com market and the abrupt halt of the raging bull market of the 1990s (with its unsustainable growth and unrealistic price/earnings ratios) have also contributed to an unprecedented loss of confidence in the stock market and in corporate America.

Another major challenge to corporations and their leaders is to create a "tone at the top" and a corporate culture that promotes ethical conduct on the part of the organization and its employees. Empirical studies suggest that a large percentage of employees are aware of inappropriate conduct in their companies. A recent survey covering selected U.S. industries found that 37 percent of employees had in the previous year observed misconduct that they believed could result in a

1 An article in *Fortune* ("You Bought, They Sold," Sept 2, 2002, p. 64) calculates that, since 1999, executives at 25 companies whose stock price declined 75 percent or more from their peak in the period January 1999 through May 2002 "walked away" with $23 billion.

Chart 3

Employees' observations of any violation of law or company standards



* Percent of employees who observed violations of law or company standards at least "sometimes" in previous 12 months.

** Percent of employees who observed misconduct that they believed could result in a significant loss of public trust if known.

Source: Customized analysis provided by KPMG LLP, based on its *2000 Organizational Integrity Survey*

significant loss of public trust if it were to become known (Chart 3).[2] Finally, employees report a variety of types of misconduct (Chart 4), and they believe this misconduct is caused most often by factors such as indifference and cynicism; pressure to meet schedules; pressure to hit unrealistic earnings goals; a desire to succeed or advance careers; and a lack of knowledge of standards (Chart 5).

Improvements in systems of corporate governance alone will not restore the public's trust. Corporations should work to support responsible behavior and build environments in which employees are encouraged and feel safe to take the initiative to address misconduct rather than waiting until after the damage is done. Leaders must also put in place appropriate management systems and processes to achieve and monitor this result. Poorly designed compensation systems, for example, can provide strong incentives for misbehavior that undercut even explicit statements on ethics.

2 KPMG, Integrity Management Services, "2000 Organizational Integrity Survey: A Summary," KPMG U.S. Web page (2000) at www.us.kpmg.com/search/index.asp?cid=718 (November 18, 2002).

A strengthened ethics stance by the board, CEO, and other senior management can help companies minimize the costs of misconduct, enhance their reputations, and preserve the public's trust in business. Besides developing a code of conduct, the Commission believes that the board and the CEO should take steps to ensure that all employees understand and abide by the corporation's ethical principles and rules of conduct. Ethical conduct should be encouraged and reinforced by including it as an important and explicit part of each employee's annual review.

The Commission believes that managing for short-term earnings and stock price results has led to many of the behaviors and manipulations that have resulted in the recent corporate crises and loss of investor confidence. Therefore, a strong focus on the corporation's long-term economic growth and viability is essential to restoring trust in public corporations.

Chart 4

What kinds of misconduct do employees observe?

Source: KPMG LLP, *2000 Organizational Integrity Survey*

Chart 5

Companies are sending the wrong messages to employees on how to meet business goals

Employees believe misconduct is caused by…

Source: KPMG LLP, *2000 Organizational Integrity Survey*

Executive Compensation

The Commission believes that in the executive compensation area there has been a "perfect storm"—a confluence of events that created an environment ripe for abuse. The excessive use of stock options—especially fixed-price options—was encouraged by the fact that they did not result in a charge to earnings while providing substantial tax deductions. In the unprecedented bull market of the 1990s, the substantial use of stock options[3] and other equity-based incentives resulted in an enormous incentive to manage companies for short-term stock price gains and led to massive unanticipated gains in options unrelated to management's operating performance. In sum, executive compensation has become too "de-linked" from long-term performance goals in many corporations. There is an imbalance between unprecedented levels of executive compensation, with little apparent financial downside risk or relationship of this compensation to long-term company performance. Finally, there is a widespread public perception of unfairness associated with the perceived ability of corporate executives to cash in stock even as their companies and the retirement savings of their employees have collapsed.

The Commission's recommendations are based on perceptions of lax board and compensation committee oversight, skewed relationships between consultants and compensation committees, failure to effectively tie compensation to long-term corporate growth and success, and excessive use of fixed-price stock options whose value related more to short-term stock price gains than to long-term performance goals.

The Commission endorses the principle of having a level playing field with respect to forms of executive compensation. It rejects the kind of solutions which resulted from legislation enacting Section 162(m) of the Internal Revenue Code (which limited the tax deductibility of cash compensation over $1 million). Stock options qualify for an exemption under Section 162(m) since they are largely considered to be performance-based compensation. Therefore, Section 162(m), especially combined with the favorable accounting treatment for fixed-price stock options under current accounting principles, contributed to fixed-price stock options becoming the dominant form of executive compensation.

[3] S&P data show that 79 percent of the increase in median CEO compensation from 1992 to 2000 was due to growth in long-term incentives, primarily stock options. In 1992, options were 27 percent of median CEO compensation, whereas by 2000 options were 60 percent of median CEO compensation.

KEY RECOMMENDATIONS

1 **The Compensation Committee should exercise independent judgment in determining the proper levels and types of executive compensation to be paid unconstrained by industry median compensation statistics or by the company's own past compensation practices and levels.** The Committee should also be mindful of the differences in compensation levels throughout the corporation in setting senior executive compensation levels.

2 **The Compensation Committee should retain any outside consultants who advise it.** The outside consultants should report solely to the Committee.

3 **Performance-based compensation tied to specific goals can be a powerful and effective tool to advance the business interests of the corporation.** The use of performance-based compensation tools should be encouraged in a balanced and cost-effective manner.

4 **The Compensation Committee should establish, with the concurrence of the board, performance-based incentives that support and reinforce the corporation's long-term strategic goals set by the board** (examples of these goals include cost of capital, return on equity, economic value added, market share, quality goals, compliance goals, environment goals, revenue and profit growth, cost containment, cash management, etc.). The award of these incentives should be linked to achievement of specific strategic goals.

5 **The Compensation Committee should be responsible for all aspects of executive officers' compensation arrangements and perquisites, including approval of all employment, retention, and severance agreements.** The Compensation Committee should approve any compensation arrangement for a senior executive officer involving any subsidiary, special purpose entity or other affiliate, and such compensation arrangements should be disclosed in filings with the SEC.

6 **Compensation policies should encourage a meaningful financial stake in the corporation through long term "acquire and hold" practices by key executives and directors.** This practice provides an additional incentive to serve the long-term best interests of the corporation.

7 **Compensation decisions should be based on the effectiveness of various forms of compensation to achieve company goals and their respective relative costs, rather than simply on their accounting treatment.**[4] The costs associated with equity-based compensation should be reported on a uniform and consistent basis by all public companies in order to provide clear and understandable comparability.

[4] The Commission recognizes that accounting expertise and standards-setting authority resides with bodies such as the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) and urges these bodies to move expeditiously to determine appropriate accounting treatment for equity-based compensation consistent with the Commission's recommendations.

8 **Fixed-price stock options should be expensed on financial statements of public companies.**[5] The costs associated with equity-based compensation should be reported on a uniform and consistent basis by all public companies in order to provide clear and understandable comparability. In addition, the Compensation Committee must disclose in conspicuous ways the effective costs passed on to shareholders through dilution or share repurchases to limit dilution.

[5] Commissioners Volcker and Grove dissented (see pp. 13-14 of the Commission's full report).

9 **Shareholders should have control over potential equity dilution resulting from compensation practices.** Existing equity compensation arrangements should not be materially modified, including the re-pricing of options, without shareholder approval.

10 **Companies should make conspicuous disclosure of the size, costs, and effects of stock options on both earnings per share after dilution and the proportion of future shareholder value that such equity compensation plans would provide to executives and employees.** A corporation's public disclosures should include a conspicuous statement highlighting both earnings per share after dilution and the proportion of future shareholder value that equity-based compensation plans would provide to executives and employees. Such disclosure should be in plain English and in plain sight.

11 **Executive officers should be required to give advance public notice of their intention to dispose directly or indirectly (e.g., by hedging or other similar arrangement) of the corporation's equity securities.** In this connection, the Compensation Committee, with the assistance of experts as required, should develop and publish appropriate methods by which disclosure of such intentions must be made.

Corporate Governance

The Commission is profoundly troubled by the corporate scandals of the recent past. The primary concern in many of these situations is that strong CEOs appear to have exerted a dominant influence over their boards, often stifling the efforts of directors to play the central oversight role needed to ensure a healthy system of corporate governance.

Each board of directors should adopt a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors in which the ability of the independent directors to be informed, to discuss and debate issues they deem important, and to act objectively on an informed basis is not compromised. In creating such a structure, the Commission recognizes that: (1) the objective is to strengthen the independence and role of the board with appropriate checks and balances on the power, actions, and performance of the CEO; (2) board structures vary greatly among American corporations; and (3) no single board structure has yet been demonstrated to be superior in providing the oversight that leads to corporate success.

The relationship between the board and management need not be, and should not be, except in unusual circumstances, adversarial. Rather, the relationship should be open, honest, and constructive. The Commission also notes that having frequent, regular meetings of the non-management directors is a key component to effective board oversight.

In fulfilling its oversight function, boards must monitor management's operating performance as well as the company's ethical and legal compliance. In approving strategies, boards need to understand, among other things, the corporation's capital allocation, debt levels, risks and vulnerabilities, compensation strategy, and growth opportunities. Importantly, they must engage management on the central issues facing the company and have a firm grasp on the tradeoffs that lie at the heart of a corporate enterprise. Management should also look to the board for support and help as issues arise in particular circumstances.

Effective boards require the right structure, the right processes, and the right people to ensure independent and objective decision making. Boards must be composed of qualified individuals, a substantial majority[6] of whom are free from disqualifying conflicts of interest; who have and will devote the necessary time to fulfill their responsibilities; and who are able to understand the issues facing the company, challenge management with tough questions and goals, and take action when needed. Each director brings certain skills, backgrounds, and expertise to the board. In addition, boards have both a collective expertise as well as particular areas of knowledge of each of its members that can be used to solve problems and address issues on an as-needed basis.

To perform their functions effectively, directors must act diligently and independently of management. Each board committee must also be given the authority necessary to carry out its intended functions. Finally, the independent directors must have adequate information to make good decisions, the ability to put key questions on the agenda, and adequate time to deal with the central issues they are confronting. Companies will certainly have to develop ways to motivate and attract such independent directors in an era of rapidly increasing governance requirements.

A view toward the long term serves the best interests not only of the company and its shareowners, but also of the company's other constituencies, such as employees, customers, suppliers, and communities. Only a strong, diligent board, with a substantial majority of independent directors that both understands the key issues and asks management the tough questions, is capable of ensuring that the interests of shareowners and other constituencies are properly served.

6 The Commission goes beyond the recommendations of the New York Stock Exchange that companies, other than controlled companies, have a "majority" of independent directors to recommend that a "substantial majority" of directors be independent. A controlled company is one for which more than 50 percent of the voting power is held by an individual, a group, or another company. (See New York Stock Exchange, Sec. 1 of proposed amendments to Sec. 303A of Listing Standards.)

The Commission believes that the required strong focus on the corporation's long-term economic growth and viability involves not only the board's and management's long-term strategies and conduct of the business to create lasting value, but also the development of a base of shareowners whose investment is similarly for long-term growth and gain. Such a long-term ownership focus provides an impetus to avoid management focused exclusively on short-term gain.

The Commission believes that it is in the long term interests of the company to have a core investment base that is less volatile and more stable. Such a shareowner base should allow the company to focus on strategic business growth rather than meeting quarterly earnings targets to satisfy short-term traders. The short-term "trader" mentality, where stock is churned for short-term gain, does little good either for the corporation or for the company's many constituencies (although transaction costs shift a portion of the market returns from investors to financial intermediaries). Traders are apt to display little interest in governance.

KEY RECOMMENDATIONS

12 **The board should establish a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.** Three principal approaches are recommended including: separating the offices of Chairman and CEO; having a non-executive Chairman and a Lead Independent Director; or, if the Chairman and CEO are the same person, establishing a Presiding Director position for leadership of the independent directors. Where boards do not adopt any of these approaches, they should disclose how their board structure provides the appropriate balance.[7]

[7] Commission Biggs dissented (see page 35 of the Commission's full report).

13 **Each board of directors should adopt processes to ensure that the ability of the independent directors to be informed, to discuss and debate issues they deem important, and to act objectively on an informed basis is not compromised.** The roles of Chairman, Lead Independent Director, and Presiding Director should be clearly defined. Where companies have a non-independent Chairman, the Lead Independent Director or the Presiding Director should have ultimate approval over information flow to the board, meeting agendas, and meeting schedules to ensure that the independent directors have sufficient time for discussion of all agenda items.

14 **Directors should display the character, independence, integrity, and will to assert their points of view.** They must demonstrate loyalty exclusively to the corporation and its shareowners.

15 **Every board should be composed of a substantial majority of independent directors.** This goes beyond proposals by the New York Stock Exchange to have only a majority of independent directors.

16 **Every board should tailor the mix of directors' qualifications for its particular requirements.** Each board should collectively have knowledge and expertise in business, finance, accounting, marketing, public policy, manufacturing and operations, government, technology, and other areas that the board believes are desirable.

17 **Every board should establish a nominating/governance committee composed of independent directors.** This committee should monitor all governance matters for the board, as well as be responsible for nominating qualified candidates to stand for election.

18 **Each board should develop a three-tier director evaluation mechanism.** This should include evaluation of the performance of the board as a whole, the performance of each committee, and the performance of each individual director, as necessary. At a minimum, director evaluation should ensure that each director meets the board's qualifications for membership when the director is nominated or renominated to the board.

19 **Boards should be responsible for overseeing corporate ethics.** A major challenge to corporations and their leaders is to create a "tone at the top" and a corporate culture that promotes ethical conduct on the part of the organization and its employees. The single most important factor in creating such a culture is the quality of corporate leadership, especially the "tone at the top" set by boards, CEOs, and senior management. Leaders must also put in place appropriate management systems and processes to achieve and regularly monitor these results. Ethical conduct should be encouraged and reinforced by including it as an important and explicit part of each employee's annual review. Corporations should work to support responsible behavior and build environments in which employees are encouraged and feel safe to take the initiative to address misconduct rather than waiting until after the damage is done. Prevention is the best cure for malfeasance.

20 **If an independent investigation is reasonably likely to implicate company executives, the board and not management should retain special counsel for this investigation.** Investigative counsel should be chosen by, and report directly to, the board and should not be one of the corporation's regular outside counsel or a firm that receives a material amount of revenue from the company.

21 **Companies should formulate and communicate a strategy specifically designed to attract investors known to pursue long-term holding investment strategies.** In this way, the corporation may be able to reduce the volatility in trading of its shares and build a stronger shareowner base. Also, such a shareowner base would allow companies to focus on their strategic business rather than on meeting quarterly earnings targets to satisfy short-term traders who are apt to display little interest in governance. The Commission also believes that policy makers[8] should find ways to create incentives for investors to hold for the long term, perhaps such as increasing the differential tax rates for long-term and short-term holders.[9] The Commission believes, however, that any detailed consideration of tax policy is beyond the scope of its current work.

8 As a matter of policy, The Conference Board does not recommend specific legislative or regulatory actions.

9 Commissioner Snow recuses himself from discussion of tax policies.

22 **Shareowners, particularly long-term shareowners, should act more like owners of the corporation.** They should have the ability to exercise their right to participate more readily in the corporation's election process through involvement both in the nomination of directors and in proposals in the company's proxy statement about business issues and shareowner concerns regarding governance of the corporation.

23 **Boards of directors should develop procedures to receive and to consider shareowners' nominations for the board of directors as well as shareowner proposals related to serious business issues.** Boards of directors should give serious consideration to adopting advisory shareowner proposals that receive a significant number of the votes cast. In the event that the board chooses not to implement a proposal that receives a substantial percentage, even if less than a majority of the votes cast, it should publicly disclose its reasons for its actions.

Audit and Accounting

The audit process is integral to the confidence required for the financial markets to operate effectively. Every public company must be audited annually by a firm of independent accountants. In the last several years, crises involving companies such as Enron, WorldCom, Xerox, Cendant, Adelphia, and Tyco have focused attention on the integrity of the audit process and its oversight. The public's trust—including that of investors, insurers, and creditors—that audited financial statements provide an accurate picture of the company's finances is essential for the confidence that the capital markets require. The alleged auditing failures associated with the recent corporate scandals have been a major factor in the erosion of that trust.

The Sarbanes-Oxley Act ("the Act") of 2002, the proposed New York Stock Exchange listing standards, and the NASDAQ corporate governance proposals have each focused on a number of structural reforms to improve the independence of the outside auditors and to strengthen their oversight by the audit committees composed of financially literate independent directors, at least one of whom, under the New York Stock Exchange listing requirements, must have specific financial expertise. The Commission believes that the following recommendations, particularly with respect to larger public companies, will strengthen the reforms begun by the Act and the NYSE to bolster the public's confidence in audited financial statements.

KEY RECOMMENDATIONS

24 **Audit Committees should be vigorous in complying with the numerous new requirements imposed by the Sarbanes-Oxley Act and by the proposed listing standards of the New York Stock Exchange.** Boards should not underestimate these new requirements with respect to Audit Committees and should devote sufficient resources and time to implement its requirements. Members of the Audit Committee must be independent and have both knowledge and experience in auditing financial matters. Also, the board should understand the obligations under the Act that the company must disclose whether or not one or more members of the audit committee qualify as financial experts within the meaning of regulations promulgated pursuant to the Act and, if not, why not.

25 **There should be an orientation program for each member of the Audit Committee.** Members of the Audit Committee should participate regularly in continuing education programs. Compliance with the Sarbanes-Oxley Act will require scrutiny and evaluation by top management and the board of issues such as the company's control environment, business risks, information and communication systems, and monitoring processes.

26 **All companies should have an internal audit function.** This should be established regardless of whether it is an "in-house" function or one performed by an outside accounting firm that is not the firm that acts as the company's regular outside auditors. Public companies should revise their internal controls to reflect a broad risk-based approach and to support the certification process for both financial reports and internal controls. The internal auditor should have a direct line of communication and reporting responsibility to the audit committee.

27 **Audit Committees should consider rotating audit firms when there is a combination of circumstances that could call into question the audit firm's independence from management.** The existence of some or all of the following circumstances particularly merit consideration of rotation: (1) the audit firm has been employed by the company for a substantial period of time, e.g., over 10 years; (2) one or more former partners or managers of the audit firm are employed by the company; and (3) significant non-audit services are provided to the company– even if they have been approved by the audit committee.

28 **The Audit Committee should, if necessary, retain professional advisors to assist it in carrying out its functions.** These professional advisors should have no other ties to the company. Because of the scope and magnitude of their responsibilities, Audit Committee members may require additional expertise as well as additional staff assistance to fulfill their new responsibilities.

29 **Public accounting firms should limit their services to their clients to performing audits and to providing closely-related services that do not put the auditor in an advocacy position.** Such services might include developing novel and debatable tax strategies and products that involve income tax shelters and extensive offshore partnerships or affiliates.

30 **The leadership of the Big Four accounting firms should each examine their business model to ensure that the model is consistent with the idea that quality audits is their number one priority.** The Big Four firms must rethink all aspects of their business models and practices to ensure that providing quality audits is their number one goal and that they each represent a "gold standard" in auditing.

Accounting Principles

Report of the Subcommittee of the Commission

Commissioners Biggs, Bogle, Bowsher, Levitt, and Volcker formed a Subcommittee of the Commission to examine the process pursuant to which accounting principles are adopted, both in the United States and internationally. The other Commissioners did not believe that they had the technical expertise or requisite experience to comment on this topic.

Therefore, the following recommendations are those of the Subcommittee. They are made in an effort to improve the processes now in place for determining the accounting principles that businesses must use in reporting their performances to investors, both in the United States and internationally.

RECOMMENDATIONS

1. The balance in the process of adopting accounting principles between soliciting multiple opinions, on the one hand, and timeliness in response to issues, on the other hand, must shift toward timeliness of response.

2. The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should continue to consider a “principles”- rather than “rules”-based approach to audit opinions.

3. The emphasis on convergence between U.S. and global accounting standards and significant improvement in both bodies of standards should continue and be encouraged.

4. The SEC, the new Public Corporation Accounting Oversight Board, and the Financial Accounting Foundation (FAF) should find a way to finance the American share of the International Accounting Standards Board Foundation (IASBF) through the issuer assessments established under the Act.

5. The FAF should reconsider its composition, role, and function in the light of the new financing arrangement provided by the Act. We would recommend a smaller FAF board with no particular constituency requirement.

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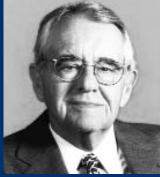

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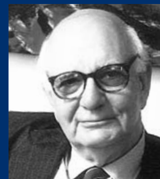

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