



The Conference Board

# Commission on Public Trust and Private Enterprise

Findings and Recommendations

Part 1 Executive Compensation

Part 2 Corporate Governance

Part 3 Audit and Accounting

## About The Conference Board Commission on Public Trust and Private Enterprise

The Conference Board convened the 12-member Commission in June 2002 to address the causes of declining public and investor trust in companies, their leaders and America's capital markets. The members include prominent leaders from business, finance, public service, and academia. Although sponsored and supported by The Conference Board, the Commission enjoys absolute independence and authority in its findings and recommendations, and is financially supported by The Pew Charitable Trusts. The Commission plans to address compensation, governance, and accounting issues and issue best practice guidelines. The Commission is 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.

## The Conference Board's Mission

The Conference Board creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. Working as a global independent membership organization in the public interest, The Conference Board conducts conferences, makes forecasts and assesses trends, publishes information and analysis, and brings executives together to learn from one another.

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## The Conference Board Commission on Public Trust and Private Enterprise

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The Conference Board

# Commission on Public Trust and Private Enterprise

Findings and Recommendations

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**The Conference Board Commission on Public Trust and Private Enterprise** was convened to address the circumstances which led to the recent corporate scandals and the subsequent decline of confidence in American capital markets. The Commission has suggested ways in which appropriate governance practices can work to rebuild confidence in the integrity, reliability, and transparency of these markets, by addressing three key, and much debated, areas—executive compensation, corporate governance, and audit and accounting issues—as they relate to publicly-held\* corporations.

The Commission issued its first set of findings and recommendations—Part 1: Executive Compensation—on September 17, 2002. Part 2: Corporate Governance and Part 3: Audit and Accounting were released on January 9, 2003.

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\* 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.

# A Rationale

### Recent Problems

The Commission shares the public's anger at the misconduct leading to the breakdown of public trust which grew out of the scandals at Enron, WorldCom and other companies. These egregious failures 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 policed. 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 judgement as they came to view management as the “client” instead of the corporation.

In addition, the Commission notes there is widespread perception of a lack of fairness since certain executives have garnered substantial compensation even as their companies and the retirement savings of their employees have collapsed.<sup>1</sup> 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.

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<sup>1</sup> An article in *Fortune* (“You Bought, They Sold,” *Fortune*, 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.

Other reports indicate that, at a time when certain CEOs presided over the demise of their companies, they also enjoyed egregious compensation excesses. Examples are: Enron's Chairman, Ken Lay, realizing gains on stock options of \$123.4 million exercised in 2000 and a loan of \$408.2 million to WorldCom's CEO, Bernard Ebbers.

### Recent Reforms— But Much More Needs to be Done

The Commission applauds the tough measures taken to date that are embodied in the Sarbanes-Oxley Act, stock exchange listing rule revisions, and Securities and Exchange Commission (SEC) orders and regulations. Together, these recent reforms constitute the most widespread new business regulations since the 1930s.

However, more needs to be done because:

- Some issues cannot be fully addressed by regulation and legislation;
- There is a need for procedures and practices within the companies themselves to change their governance policies; and
- Ultimately, the board of directors must step up to the problem and resolve the remaining issues in its company—including each director taking personal responsibility.

### Executive Compensation— The “Perfect Storm”

Federal Reserve Chairman Alan Greenspan described excessive executive compensation<sup>2</sup> of the last decade as “infectious greed.” Indeed, the Commission believes that there has been a “perfect storm”—a confluence of events

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<sup>2</sup> S&P data show that, in 1992, median CEO total compensation was \$1.8 million, however by 2000, it had reached \$6.1 million. A *Business Week* article (“How to Fix Corporate Governance,” *Business Week*, May 6, 2002, p. 69.) showed CEO compensation rose 340 percent versus a 36 percent rise in the compensation of “rank and file” employees over a 10-year period.

in the compensation area which created an environment ripe for abuse. Among them:

- Excessive use of stock options<sup>3</sup>—particularly fixed-price options—was encouraged by the fact that fixed-price options do not result in a charge to earnings,<sup>4</sup> while they provide the added benefit of substantial tax deductions.
- The speculative nature of stock options led, in some cases, to their being undervalued by executives to whom they were granted, which in turn necessitated higher levels of grants.
- Boards of directors became lax in performing their historical duty to monitor compensation.
- The balance in the relationship between the board, management and compensation consultants has, in too many cases, been skewed to produce an overly close relationship between consultants and management.
- The use of stock options and other equity-based incentives resulted in an enormous incentive to manage companies for short-term stock price gains.
- The unprecedented bull market led to massive, unanticipated gains from options unrelated to management's operating performance.

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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.

The overwhelming number of stock options granted have been fixed-price options which generally have an exercise price that is the same as the stock's fair market value on the date of grant and, therefore, result in no expense on the corporation's books. Other forms of equity compensation, such as restricted stock grants or performance stock options are required to be expensed.

4 Commissioner Grove dissents. His view is appended to these principles. He also notes that the impact of fixed-price stock options on dilution and earnings per share has been fully disclosed.

## Strengthening the Compensation Committee— The Starting Place

A diligent and independent Compensation Committee of the Board is critical to avoid abuses:

- Its role is to retain management in a reasonable and cost-effective manner, considering relevant factors such as motivating and retaining executives.
- The committee needs to act independently of management, hire its own consultants, and avoid benchmarking that keeps continually raising the compensation levels for executives (all company executives can not be in the top quartile of pay scales).
- Where recent compensation levels are excessive, compensation committees should not use these as a benchmark for setting future compensation levels.

## Performance-Based Compensation

The Commission strongly endorses the broader use of performance-based compensation:

- Performance-based compensation should correspond to the corporation's long term goals.
- Performance-based compensation will avoid windfalls due to stock market ups and downs which are not related to executives' contribution to corporate value.
- There should be a clear correlation between the costs of the increased compensation and the expected benefits to the corporation.

## Creating a Long-Term Focus

The Commission believes that compensation policies should have much more of a long-term focus:

- Key executives and directors should be encouraged to obtain and hold a significant amount of the corporation's stock, which should then provide an additional incentive to serve the long-term best interests of the corporation.
- Such a long-term focus may help prevent companies from artificially propping up stock prices over the short term to cash out options and making other potentially negative short-term decisions.

## Forms of Compensation—What Should Be Done About Stock Options?

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 stock options under current accounting principles, contributed to fixed-price stock options becoming the dominant form of executive compensation.

Nevertheless, the Commission recognizes that options can be an appropriate and important tool for companies, particularly start-up companies and companies where an important part of intellectual capital resides with employees, and that they have become a cultural way of life for high-tech companies.<sup>5</sup> Moreover, non-executive employees should

be appropriately compensated for their contributions and options may be a suitable method of doing so.

The Commission therefore endorses the following:

- As a “form” of compensation, compensation committees should look for tools to promote the long-term value of the enterprise, not make decisions based on accounting favorability or adopt plans that encourage short-term gains.
- Expensing fixed-price options will level the playing field.

The Commission acknowledges that such policies will probably result in fewer fixed-price options and higher cash payments as well as grants of actual stock and other forms of stock options more closely related to performance. The Commission also 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.

## Role of the Shareholder

The Commission believes that shareholders should have control over actions that could dilute<sup>6</sup> their investments, including the initiation or modification of equity based compensation plans and their terms, such as repricing of options.

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5 A Merrill Lynch study shows that expensing stock options would result in a decline of approximately 70 percent in earnings per share in the high-tech industry, compared with declines of 12 percent in the telecom industry, 9 percent in the consumer and materials industries, from 2-7 percent in other industries, and 10 percent in the overall S&P 500.

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6 Median dilution from equity compensation rose from 8.3 percent in 1990 to 16.3 percent in 2000. Companies often offset this dilution by using cash to buy back stock in the open market. The “costs” of these options is not widely understood by the public.

## Transparency and Disclosure

The Commission endorses the following relating to disclosure of executive compensation:

- Shareholders and markets need accurate and timely information to make informed decisions— this is, after all, the foundation of our capital markets.
- 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.

In sum, the Commission believes that this material information should not only be in plain English, but in plain sight as well.

Finally, the Commission believes that companies should require senior executives to provide advanced notice of their intention to sell stock—this will let the market help correct problems of unjust enrichment and also help address any public impression in the future that managements who cash in very large amounts of stock, particularly of failing companies or companies whose stock price falls substantially thereafter, may have known or suspected that the company’s results and stock price would be lower than was generally recognized.

# Principles, Recommendations, and Specific Best Practice Suggestions

## Preamble to Principles

The Commission shares the public’s anger over excessive executive compensation, especially to executives of failed or failing companies, and finds that compensation abuses have contributed to a dramatic loss of confidence in the governance of American publicly held corporations—with visible and damaging financial market effects.

While the previous section presents in greater detail the thinking of the Commission, the reasoning behind the formulation of these principles<sup>7</sup> on executive compensation is summarized as follows:

- Executive compensation has become too de-linked from the achievement of management’s long-term performance goals.
- There is an imbalance between unprecedented levels of executive compensation, with little apparent financial downside risk, and the relationship of this compensation to long-term company performance.
- Numerous factors have resulted in extraordinary executive compensation paid at certain corporations, primarily through fixed-price stock options. Their use has been bolstered by a number of factors, including differential accounting treatment among equity based types of compensation as well as a sustained “bull market.” These factors may have fostered what appears to be a vicious cycle of increasing short-term pressures to manipulate

earnings in order to bolster stock price in order to cash in on stock options.

- At all too many companies, the Compensation Committee of the Board has not played as central and vigorous a role as necessary to assure the public that executive compensation policy is determined independently from management or from compensation consultants hired by management.

The guiding concept underlying the compensation principles is to create an approach to compensation that provides the right incentives to management to maximize the long-term going concern value of the corporations they represent.

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<sup>7</sup> The Commission’s charter and expertise did not include tax policy issues relating to executive compensation. For example, such tax legislation in Section 162 (m) of the Internal Revenue Code that put limitations on the tax deductibility of tax compensation over \$1 million distorted executive compensation by encouraging the overuse of certain types of stock options. Examples like this also illustrate why this Commission’s charter does include encouraging the private sector—corporations and investors alike—to take a far more constructive leadership role in installing best practices than it has to date.

## Principles

**PRINCIPLE I: THE COMPENSATION COMMITTEE'S ROLE AND RESPONSIBILITIES** A strong, independent Compensation Committee should take primary responsibility for ensuring that the compensation programs and values transferred to management through cash pay, stock and stock-based awards, are fair and appropriate to attract, retain and motivate management, and are reasonable in view of company economics, and of the relevant practices of other, similar companies. The Committee should be held accountable for the decisions they make. The Compensation Committee should also recognize the potential conflict of interest in management's recommending its own compensation levels.

### Specific Best Practice Suggestions

1. The Compensation Committee should retain any outside consultants who advise it, and the outside consultants should report solely to the Committee.
2. The Compensation Committee should be comprised solely of directors who are free of any relationships with the company (except for compensation received in their role as directors) and its management and who can act independently of management in carrying out their responsibilities.
3. The Compensation Committee should vigorously exercise continuous oversight over all matters of executive compensation policy. In addition, the Chair of the Compensation Committee should "take ownership" of the Compensation Committee's activities and be available at shareholders' meetings to respond directly to questions about executive compensation.
4. No compensation arrangement should be permitted that creates an incentive for top executives to act contrary to the company's best interests or which could be interpreted as an attempt to circumvent either the requirements or the spirit of the law or accounting rules.
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.
6. The Compensation Committee should approve any compensation arrangement for a senior executive officer involving any subsidiary, special purpose entity (SPE) or other affiliate. Because of the significant potential for conflicts of interest, these compensation arrangements should be permitted only in very special circumstances and only when of benefit to investors. They should also be disclosed in filings with the SEC.
7. The Compensation Committee should exercise independent judgment in determining the proper levels and types of compensation to be paid unconstrained by industry median compensation statistics or by the company's own past compensation practices and levels, which, in certain companies, have been excessive. The Committee should also be mindful of the differences in compensation levels throughout the corporation in setting senior executive compensation levels.
8. The Compensation Committee should hold executive sessions as required (for example, to determine CEO pay and stock option grants) and the Committee should exercise its power to schedule meetings and set its own agenda.

**PRINCIPLE II: THE IMPORTANCE OF PERFORMANCE-BASED COMPENSATION** Performance-based compensation tied to specific goals can be a powerful and effective tool to advance the business interests of the corporation, and the use of performance-based compensation tools should be encouraged in a balanced and cost-effective manner.

### Specific Best Practice Suggestions

1. Compensation policies should meet the unique needs of each corporation in the market in which that corporation competes for executive talent.
2. 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 (for example, 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.) and whose award is linked to achievement of specific strategic goals.
3. The Compensation Committee should adopt specific policies and programs to recapture incentive compensation from executives in the event that malfeasance on the part of such executive or executives results in substantial financial harm to the corporation.

#### **PRINCIPLE III: THE ROLE OF EQUITY-BASED**

**INCENTIVES** The use of high levels of equity-based compensation, particularly in the form of fixed-price options, has been at the heart of much of the recent controversy over corporate compensation. The Compensation Committee should endeavor to use all equity-based compensation arrangements in a reasonable and cost-effective manner.

### Specific Best Practice Suggestions

1. Equity compensation, including stock options, can be an effective form of incentive compensation, particularly if it is designed to promote the type of performance goals being encouraged.
2. Consistent with its duty to preserve long-term value for the corporation, the Compensation Committee should establish compensation policy and arrangements that appropriately consider and balance the relationship between the perceived value of equity

compensation and the costs of that compensation to the corporation.

3. A broad distribution including non-executive employees of properly structured equity-based compensation may be desirable for various reasons, for example in start-up companies with limited cash, in industries in which equity-based compensation has become a part of accepted broad-based compensation packages or for companies where an important portion of intellectual capital resides with employees.
4. The Compensation Committee must disclose in conspicuous ways the effective costs passed on to shareholders through dilution or any direct costs associated with shares acquired in the open market to limit that dilution.

#### **PRINCIPLE IV: CREATING A LONG-TERM FOCUS**

Compensation policies should encourage a meaningful financial stake in the corporation through long-term "acquire and hold" practices by key executives and directors, while insuring that any contribution by the company to creating that stake is done in a reasonable and cost-effective manner.

### Specific Best Practice Suggestions

1. The Compensation Committee should: 1) require senior management to accumulate a meaningful amount of company stock on a long-term basis; and 2) specify substantial minimum holding periods for equity received as compensation, in each case in order to align the interests of management with those of the corporation. Holding periods for senior executives and directors should generally not be less than the holding periods for other employees under 401(k) or similar retirement plans.
2. While recognizing that director compensation involves policy issues different from those in management compensation, directors nonetheless should own and retain substantial amounts of

company stock they receive as compensation or otherwise acquire. Furthermore, at a minimum, required retention and holding levels by directors should also be established.

#### **PRINCIPLE V: ACCOUNTING NEUTRALITY**

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. 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.

##### [Specific Best Practice Suggestion](#)

1. To eliminate accounting bias in favor of one form of equity-based compensation, fixed-price stock options should be expensed on financial statements of public companies.<sup>8</sup> The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), as organizations with technical expertise in this area, should move expeditiously in order to determine appropriate accounting treatment for equity-based compensation including a uniform and broadly accepted method of valuing options.

**PRINCIPLE VI: SHAREHOLDER RIGHTS** Shareholders should have control over potential equity dilution resulting from compensation practices.

##### [Specific Best Practice Suggestions](#)

1. Equity-based compensation should be made through plans approved by shareholders.
2. Existing equity compensation arrangements should not be materially modified, including the re-pricing of options, without shareholder approval.

#### **PRINCIPLE VII: TRANSPARENCY AND DISCLOSURE**

Shareholder and market interests are best served through transparent and readily understandable disclosure of executive compensation and the economic impact of such compensation. Public trust would be enhanced if the Compensation Committee took specific steps and implemented policy to further reassure the public that senior management is not engaged in stock transactions involving the company in advance of material information being available to the public. These policies should be disclosed in filings with the SEC.

##### [Specific Best Practice Suggestions](#)

1. 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. This disclosure should illustrate in plain language the percentage of total equity (market overhang) represented by unexercised options.
2. 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.
3. Companies should be required to disclose publicly employment agreements entered into with executive officers promptly following their execution. A company's disclosure should include a summary in plain English of the significant terms of the agreement when the agreements are filed with regulatory authorities.

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<sup>8</sup> Please see Commissioner Grove's dissenting opinion.

# Dissenting Opinions

## Commissioner Volcker

Given both the very large capricious element inherent in the returns from fixed-price stock options and the distorted incentives for management, I believe the use of such options should be strongly discouraged for public companies. There are far better alternatives for seeking and achieving an appropriate alignment of shareholder and management interests.

## Commissioner Grove

I am writing to state my disagreement with the Commission's recommendation that accounting standards be changed to require that stock options be treated as an expense.

My own views on stock options are well known. Intel believes stock options create value for shareholders,<sup>9, 10</sup> and it issues them to virtually all of its employees. We have shared our views publicly, and we have deliberated them comprehensively and successfully with the FASB in the past. I am not writing to convince the commission to adopt the Intel way. This letter focuses on what I believe is most appropriate for the Commission.

## Let's focus on the economic and business issues and fix the abuse

The economic impact of a stock option is dilution.<sup>11</sup> Stock options do not alter the overall financial performance of a business but rather reduce each shareholder's portion of that business.<sup>12, 13</sup>

Shareholders should be able to easily find and understand information about the potential for dilution of their investments. The solution to this is more and better disclosure.

Shareholders should be able to act to prevent excessive dilution. The solution to this is strong corporate governance—-independent directors, a compensation committee with muscle and backbone, and provisions for shareholder approval.

Expensing options may or may not be good accounting, but as a practical matter it will not be an effective deterrent to abuse. It will create new and significant opportunities for managements to manipulate earnings. The expense is non-cash, and the valuation and timing of the grants are arbitrary. The result is less transparency, less consistency, and more susceptibility to abuse.

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9 "...incentives derived from employee stock option plans provide value-increasing benefits to the firm.", Lynn Rees and David M. Stott, "The Value-Relevance Of Stock-Based Employee Compensation Disclosures," *The Journal of Applied Business Research*, Volume 17, Number 2, 2001.

10 "A considerable body of literature has studied the data to measure whether the net effect of employee stock option grants on a company's stock price is positive or negative. The general finding is that stock prices preponderantly benefit from the issue of employee options." Burton G. Malkiel and William J. Baumol, "Stock Options Keep The Economy Afloat," *The Wall Street Journal*, April 4, 2002

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11 "Dilution arises when a shareholder owns a smaller proportion of the company than before. Economic dilution occurs only when the value of the share they own drops as a result of the issuance of new shares or options." William A. Sahlman, Dimitri V. D'Arbeloff—MBA Class of 1955 Professor of Business Administration, "Some Thoughts on Accounting for Stock Options," Harvard Business School, July 24, 2002.

12 "The value inherent in a stock option, when exercised, is value taken from other shareholders—without that value flowing through the company's books. In other words, their cost is entirely born by the company's shareholders. ... The effect of options is accurately reflected in the EPS number—where it belongs." Harvey Golub, "The Real Value of Options," *The Wall Street Journal*, August 8, 2002.

13 "This is not to deny that stock options represent a cost. It's just that the cost is borne not by the company but by the existing stockholders in their personal holdings, through dilution. This cost is fully reflected under current accounting standards in the diluted earnings per share figure. Placing an options expense in the numerator of the EPS figure while leaving its effect in the denominator would be a clear case of double-counting..." Fred Sellers, Ph.D., CPA, Associate Professor of Accounting and Chair, Department of Economics and Business, Southwestern University, *The Wall Street Journal*, September 9, 2002.

The broader issues the Commission should be addressing are inequitable distribution of wealth and financial risk, excessive compensation, and misalignment of management and stockholders' interests.<sup>14</sup> Most of our recommendations place great confidence in the power of full disclosure and strong corporate governance; I believe we should direct this power at the abusive use of stock options as well.

### Let the accountants make accounting decisions

The issue of the accounting treatment of stock options has become an economic Rorschach test onto which people project their basic beliefs about American enterprise, their notions of how companies should be run, how management compensation should be controlled, and their preferences for investments. Unfortunately, this does not encourage a rational discussion of accounting issues.

This Commission is not an accounting body. If I read our bios correctly, only one of us is an accountant. As a group, we lack the expertise for such a difficult issue.

This is a subject on which reasonable accountants differ.<sup>15</sup> There is a reasonable alternative view that deserves to be heard, and it was not considered by this Commission. In contrast, when the Financial Accounting Standards Board ruled on this issue, it first held extensive hearings and deliberations with a range of experts.

The Conference Board seems to have formed an a priori opinion. The materials prepared for this Commission focused on various financial models that could be used to implement a foregone conclusion of expensing. There was no review of the underlying accounting issues regarding the proper treatment—no discussion for example of dilution, of accounting theory for expenses, or of alternative methods of control such as comprehensive disclosure.

Under no circumstances should we compromise the integrity of accounting decisions.<sup>16</sup> If we as a group of business people decide we can mandate what the accounting should be without exploring the accounting issues, then our assumption and our message to the public is that accounting can be whatever a few elite people want it to be.<sup>17</sup> How does that restore public confidence?

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14 "The dramatic rise in CEO compensation has been driven to a large extent by increases in annual stock option grants, which have produced a large buildup in total CEO holdings of stock options." Brian J. Hall and Jeffrey B. Liebman, "Are CEO's Really Paid Like Bureaucrats?" *The Quarterly Journal of Economics*, Vol. CXIII, Issue 3, August 1998.

15 "Accounting for stock-based compensation is a complex and controversial issue. AcSEC [American Institute of CPAs Accounting Standards Executive Committee] commends the board [Financial Accounting Standards Board] for its thorough and thoughtful study of this issue...opinions may differ on the best answer to the stock-based compensation question." Comment letter to the Financial Accounting Standards Board (FASB) from the American Institute of CPAs Accounting Standards Executive Committee, News Report, *Journal of Accountancy*, (March): 9, 1994.

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16 "The only thing that I would guide against is the notion of doing what is in essence really the more popular thing and the simpler thing to do, which is 'let's just have an expense', because in fact I think you obscure not elucidate these issues. ...The most important issue is 'what is the right accounting?' ...Accounting does matter. It will have impact." Steven MH Wallman, Former Commissioner of the Securities Exchange Commission, presentation to CalPERS (California Public Retirement Employees System), June 17, 2002.

17 "It's apparent that pressure to change accounting for stock options is motivated by political rather than accounting concerns. Those exerting it are well aware that the proposed changes would discourage the use of broad grants of stock options, and this is the result they wish to achieve. These proposals would meddle destructively in a complex financial and entrepreneurial ecosystem." James V. DeLong, "Competitive Enterprise Institute Study: Leave Stock Options Alone," *Accounting Today*, v16 i13 p16(1), July 22, 2002.

# A Rationale

### The Role of the Corporation

The modern corporation has played a central role in many of the remarkable social, industrial and scientific achievements of our times. From U.S. public companies' origins in developing canals and railroads to breakthroughs in curing illnesses, creating technological innovations, and achieving the enormous improvement in standards of living, corporations have been at the center of our lives. The corporate form has proven to be a superior means for attracting capital, organizing labor, stimulating ideas, and providing efficient systems of production and distribution. Therefore, sustaining confidence and trust in the performance of that corporate system is a matter of enormous public concern. Indeed, Federal Reserve Board Chairman Alan Greenspan has testified that diminished confidence in corporate earnings reports has been linked to depressed valuations of equity securities, higher debt costs, and slowing of new capital investment as companies place greater emphasis on cash generation and accumulation.<sup>18</sup> The continued success and optimal functioning of our economic system requires the confidence and trust of investors, employees, consumers, and the public at large.

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<sup>18</sup> Federal Reserve Board Chairman Alan Greenspan testified: "the difficulties of judging earnings trends have been intensified by revelations of misleading accounting practices at some prominent businesses." He also noted that the resulting investor skepticism about earnings reports has depressed the valuation of equity securities. For some companies it also has been reportedly a factor in the rising risk spreads on corporate debt issued by the lower rung of investment-grade and below-investment grade firms, further elevating the cost of capital for these borrowers. He noted: "Businesses concerned about the impact of possible adverse publicity regarding their accounting practices on their access to finance could revert to a much heavier emphasis on cash generation and accumulation. Such an emphasis could slow new capital investment initiatives." See Alan Greenspan, Federal Reserve Board's Semiannual Monetary Policy Report to the Congress, Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 16, 2002.

### The Compact as Foundation for the Corporation

Investor trust in our corporate system is premised on a series of relationships among shareowners,<sup>19</sup> boards of directors and management. Shareowners invest their assets in corporations managed by professionals. This separation of owners from managers is an important feature of the modern public corporation. A key role of the board of directors is to provide oversight to ensure that management acts in the best long-term interests of the corporation and thus in the best long-term interests of its shareowners.

A view toward the long term serves the best interests not only of the company's shareowners, but also of the company's other constituencies, such as employees, customers, suppliers and communities. We recognize the challenge executives face in meeting short-term goals for some constituencies while at the same time achieving the company's long-term goals. However, we firmly believe that managing the corporation for continued long-term viability as a productive organization on behalf of its shareowners can be generally beneficial for other stakeholders (see Other Constituencies discussion on page 17).

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<sup>19</sup> The Commission recognizes the importance of holders of a company's stock developing a perspective for long-term growth and retaining their stock to realize these objectives; accordingly, this report uses the term "shareowner" for such holders.

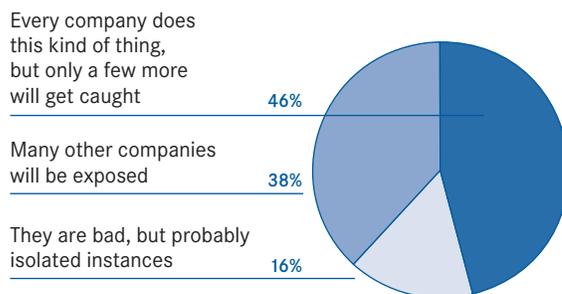
The Commission also notes that the corporation’s interests, as well as those of its other stakeholder constituencies, are best served with a shareowner base that holds its investment for the long term. Shareowners who keep their investment over an extended period of time strengthen the corporate compact and provide management with incentives to manage the corporation in ways that benefit the interests of both shareowners and other constituencies. Retaining a long-term shareowner base and strengthening the compact works effectively only when shareowners have a high level of trust that the business is being managed honestly and in their best long-term interests.

In order to provide the oversight and guidance required of them, directors must have a firm grasp of the central business issues that drive the success of the company. They must understand how capital is spent and why, as well as other key strategic issues such as debt and other balance sheet structures, the deployment of resources, the company’s focus, and the definition and assessment of the company’s business risks, to name just a few. In addition, they must always remember that, just as managers work on behalf of the corporation and its shareowners, the board’s efforts must be thus directed as well. Only a strong, diligent board, with a substantial majority<sup>20</sup> of independent directors that both understands the key issues and asks management the tough questions, is capable of ensuring that shareowner interests are properly served.

The events of the last year 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 data suggest that large

20 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. New York Stock Exchange, Sec. 1 of proposed amendments to Sec. 303A of Listing Standards.

Chart 1  
**Public thoughts on the prevalence of incidents of corporate wrongdoing**



Source: The American Survey, July 2002

numbers of people believe executives are willing to take improper actions to enrich themselves at the expense of the corporation. 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 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).

Table 1  
**People Who Can Be Trusted**

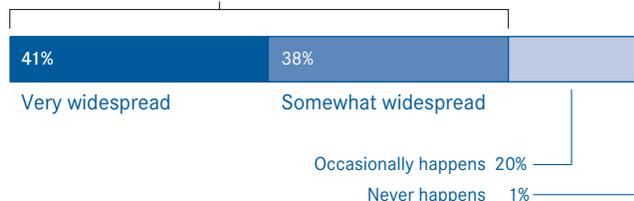
	Most can be trusted	Can't be too careful with them
People who run small businesses	75%	22%
Military officers	73	24
CEOs of large corporations	23	73
Car dealers	15	81

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

Chart 2

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

79 percent responded that improper actions are “very” or “somewhat” widespread



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

To address some of these issues, Congress enacted the Sarbanes-Oxley Act (the “Act”) of 2002, and the stock exchanges and the Securities Exchange Commission (SEC) continue to propose the most far-reaching regulatory changes to the law affecting public companies since the 1930s. We endorse the basic thrust of these reforms, but we must reserve our final opinion pending promulgation of the final regulations implementing Congress’s directives. At the heart of many of these regulatory changes—both enacted and proposed—is the proposition that boards must be strong and must assume a more active posture, consulting their own advisors when they feel it appropriate in order to successfully play their role in the governance of the corporation.

### The Importance of Other Constituencies

Although most state corporation laws establish that corporations should be run to enhance that corporation’s economic interests, and therefore the interests of its shareholders, corporations are also expected to fulfill their legal and ethical obligations to other constituencies.<sup>21</sup> As noted previously, respect and concern for a range of corporate constituencies, including employees, customers, communi-

ties and suppliers, contributes to a positive climate for optimal corporate behavior. In such a climate, the corporation can then continue to provide the jobs which sustain employees and, by extension, the communities in which they live. It can provide communities not only with an employer for its residents, but also with a more solid tax base and with an organization that can contribute money, talent, and vitality to civic life. It can also continue to serve the customer and supplier constituencies that depend on the products it makes or services it provides.

Furthermore, public opinion widely endorses the view that companies should not neglect the expectations of these constituencies. In a *Business Week* survey, 95 percent of respondents felt that U.S. corporations have responsibilities to constituencies such as employees and communities in which they operate, even at the sacrifice of some profit.<sup>22</sup> In the final analysis, the free enterprise system exists at the pleasure of society, and the trust and confidence of these other constituencies is crucial to its productive functioning.

### A Long-Term Ownership Focus

The Commission believes that a strong focus on the corporation’s long-term economic growth and viability is essential to the restoration of trust in public corporations. This focus 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 (see discussion on shareowner obligations). Such a long-term ownership focus provides an impetus to avoid management focused exclusively on short-term gain. 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.<sup>23</sup>

21 For a list of states which by statute permit or require boards to consider interests of other constituencies in reaching their decisions, see Guhan Subramanian, “The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the ‘Race Debate’ and Antitakeover Overreaching,” 150 U.Pa.L.Rev.1795 (June 2002), at p.1828.

22 A. Bernstein, “Too Much Corporate Power?” *Business Week*, September 11, 2000; [www.businessweek.com/2000/00\\_37/b3698004.htm](http://www.businessweek.com/2000/00_37/b3698004.htm).

23 In its report on executive compensation (see note 1, supra), the Commission explained the relationship between managing for short-term stock price results and abuses in executive compensation.

## The Roles of the CEO and Chairman

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. In such circumstances, boards have often either lacked the structure and information to perform their roles properly, or they have simply abdicated their responsibilities to provide the oversight required of them. In such circumstances, the board cannot properly oversee the CEO's performance.

The ultimate responsibility for good corporate governance rests with the board of directors. Only a strong, diligent and independent board of directors that understands the key issues, provides wise counsel and asks management the tough questions is capable of ensuring that the interests of shareowners as well as other constituencies are being properly served.

If boards are to be accountable for good corporate governance, they must have the information and flexibility to work with senior management in choosing how best to achieve good governance within the framework of the unique personal chemistry in the company, as well as its distinctive history and culture. Moreover, 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 structural component for oversight of the CEO function.<sup>24</sup>

The responsibilities of leading the board and of managing the company are distinct. The CEO is the highest-ranking member of the management team. As such,

he or she is accountable for the corporation's management and performance. As noted above, the board is charged with ensuring that management is carrying out its responsibilities in the company's and the shareowners' best long-term interests. Typically, the CEO is a member of the board, but he or she is also part of the management team that the board oversees. This dual role can provide a potential for conflict, particularly in those cases in which the CEO attempts to dominate both the management of the company and the exercise of the responsibilities of the board.

The Commission believes that a crucial governance challenge facing American corporations involves establishing an appropriate balance between managing the corporation and providing the independent directors with the powers and resources they need to perform their role. The Act and the proposed amendments to the New York Stock Exchange (NYSE) listing standards<sup>25</sup> recognize this conundrum, and they endeavor to resolve it by requiring a relationship between the CEO and the independent directors in which the independent directors can—and must—exercise certain responsibilities without management interference. These initiatives have attempted to create a better balance in the relationship between senior management, including the CEO, and the independent directors, facilitating the exercise of the roles and powers of each.<sup>26</sup>

Therefore, each board of directors should adopt a structure that provides an appropriate balance between the

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<sup>24</sup> Section 3 of the NYSE's proposed amendments to its listing standards would make "regularly scheduled executive sessions" of the non-management directors a requirement.

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<sup>25</sup> New York Stock Exchange, Proposed Amendments to Listing Standards Manual, [www.real.com/ads/html/gator\\_770x300\\_us2.html](http://www.real.com/ads/html/gator_770x300_us2.html).

<sup>26</sup> For example, the New York Stock Exchange proposes to require that the independent directors compose a majority of the board and that they meet regularly in executive session. New York Stock Exchange, Proposed Amendments to Listing Standards Manual, [www.real.com/ads/html/gator\\_770x300\\_us2.html](http://www.real.com/ads/html/gator_770x300_us2.html). (For clarification, and as noted above, The Commission recommends that a "substantial majority" of directors be independent.) As another example, the Act requires audit committees, composed solely of independent directors, to take a more active role in ensuring the accuracy and integrity of the corporation's financial statements. See, for example, Section 301 of the Act.

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.

In order to achieve the objectives of board independence, each board must be sensitive to any relationships between the CEO and the leaders of the non-management directors that could impair the appropriate balance between the Board's and CEO's roles. Each board should be particularly sensitive to the possibility of such relationships and should tailor its inquiries about these relationships to its company's particular circumstances.

The Commission notes three principal approaches that could be taken to provide the appropriate balance between board and CEO functions:

1. The roles of Chairman and CEO would be performed by two separate individuals, and the Chairman would be one of the independent directors. The Commission recommends that each corporation give careful consideration, based on its particular circumstances, to separating the offices of the Chairman and Chief Executive Officer. The Commission believes that separating the positions of Chairman and CEO is fully consistent with the objectives of the Act, the proposed New York Stock Exchange listing requirements, and the proposed NASDAQ requirements,<sup>27</sup> and that separating the roles of Chairman and CEO enhances implementation of the Act and stock exchange reforms.

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<sup>27</sup> For summary see NASDAQ Web site: [www.nasdaq.com](http://www.nasdaq.com) - Inside NASDAQ, Legal and Compliance, Proposed Rule Changes.

2. The roles of Chairman and CEO would be performed by two separate individuals. However, if the Chairman is not an independent director under stock exchange standards, (a situation which often occurs when the founder or a major stockholder is Chairman), he or she should not be a member of the management team and should not report to the CEO. In this case, a Lead Independent Director (LID) position (or other equivalent designation) should also be established.

Under this approach, it is essential that the Chairman, while perhaps not meeting the technical requirements of independence under stock exchange standards, does not, in fact, have any relationships with the CEO or other members of management that compromises his or her ability to act free from the control of the CEO and management. In this situation, the board must be particularly diligent in making that determination. The Commission believes that this separateness in status and reporting relationships, coupled with the creation of the LID or equivalent position, can provide an appropriate balance between the leadership of the board and the management of the company.

3. Where a board does not choose to separate the Chairman and CEO position, or when such boards are in transition to a structure where the positions will be separated, a Presiding Director position should be established.<sup>28</sup>

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<sup>28</sup> The concept of a "lead" or "senior" director who chairs meetings of the non-management directors and who serves as the liaison between the CEO and the independent directors has been discussed for many years and has been adopted by some, albeit a limited number of, companies. The number of companies ranges from 2.4 percent to 6 percent to 13 percent, depending on the variety and number of companies surveyed (data from Investor Responsibility Research Center *Board Practices/Board Pay 2001* survey, The Conference Board's *Directors' Compensation and Board Practices 2002* survey, and the American Society of Corporate Secretaries *Current Board Practices 2002* survey, respectively). Here, the Commission takes this lead director concept further and recommends that the Presiding Director, who effectively functions as the "lead" or "senior" director, also take on certain functions previously reserved to the Chairman.

Boards that choose not to take any of these approaches should explain their reasons for doing so, as well as the board structure which they employ to achieve the objectives of strong, independent board leadership.

In each of the three situations described above, the roles of Chairman, Lead Independent Director, and Presiding Director should be clearly defined. In the first case, at a minimum, the Chairman should preside at board meetings, 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.

In the second case, where the Chairman is not one of the independent directors, the Lead Independent Director should work closely with the Chairman to finalize information flow, meeting agendas, and meeting schedules. The Lead Independent Director should also chair meetings of the non-management directors and serve as the principal liaison between the independent directors and the Chairman. The non-CEO Chairman and Lead Independent Director (or other equivalent designation) could also take a lead role, in conjunction with the Chairman, in the board evaluation process.

In the third case, the responsibilities of the Presiding Director should, at a minimum, include presiding at board meetings when the Chairman/CEO is not present, presiding at meetings of the independent directors, and having ultimate approval over information flow to the board, meeting agendas, and meeting schedules. It may also be desirable for the Presiding Director to take a lead role, in conjunction with the Chairman, in the board evaluation process (see Board Evaluation discussion on facing page).

## The Role of the Board of Directors

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<sup>29</sup> 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. 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, as noted earlier, 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.

In fulfilling its oversight function, boards must monitor management's operating performance as well as 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.

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.

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<sup>29</sup> This requirement would not necessarily apply to controlled companies. See footnote 20, *supra*.

To discharge their responsibilities most effectively, directors should:

1. Exercise objectivity and autonomy to make independent, informed decisions;
2. Develop the knowledge and expertise to provide effective board oversight;
3. Display the character, integrity, and will to assert their points of view, and demonstrate loyalty exclusively to the corporation and its shareowners;
4. Devote the time necessary to fulfill the legal, regulatory and stock exchange requirements imposed upon them; and
5. Have the ability to retain, to the extent they deem necessary, advisors and independent staff support.

### The Nominating/Governance Committee

The Commission believes that it is important that each corporation establish a committee of independent directors to oversee corporate governance issues, including the statement of corporate governance principles and the performance evaluations of the board, its committees, and each director, as necessary. The Commission therefore endorses the New York Stock Exchange's proposal that each listed company, other than controlled companies,<sup>30</sup> have a nominating/corporate governance committee composed entirely of independent directors (or functional equivalent consisting solely of independent directors).<sup>31</sup> As the NYSE notes in the commentary to this proposal, "[a] nominating/corporate governance committee is central to the effective functioning of the board."<sup>32</sup>

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<sup>30</sup> See footnote 20, *supra*.

<sup>31</sup> New York Stock Exchange, Section 4 of the proposed amendments to Rule 303A.

<sup>32</sup> *Id.*

### Board Evaluation

The Commission believes that each board should develop a three-tier director evaluation mechanism which includes evaluation of the performance of the board as a whole, the performance of each committee and the performance of each individual director, as necessary. The Commission does not believe there is any one approach to evaluation that is appropriate for all corporations. At a minimum, evaluation of directors should ensure that each director meets the board's qualifications for membership when the director is nominated or renominated to the board. Evaluation of the board and its committees should also determine whether each has fulfilled its basic, required functions.

Beyond meeting baseline standards, evaluation can be a powerful tool for directors to improve their performance by understanding areas which require further development or training. Evaluations should provide feedback to develop more effective director, committee, and board functions. Each board should establish evaluation processes and criteria that best reflect the board's own requirements.

Responsibility for development of evaluation methods and criteria should reside with the nominating/governance committee or equivalent committee of independent directors or their designee, depending on the governance model adopted by the board.<sup>33</sup> It may be desirable for the independent Chairman, the Lead Independent Director, or the Presiding Director, depending on the company's board structure, to take a lead role, in conjunction with the Chairman, in the board evaluation process.

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<sup>33</sup> The Commission recognizes that it is the responsibility of the full board to evaluate the CEO.

## Ethics Oversight

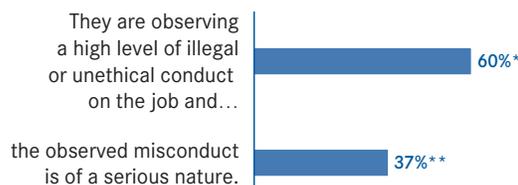
A major challenge to corporations and their leaders is to create a “tone at the top” and a corporate culture that promotes ethical conduct on the part of the organization and its employees. Improvements in systems of corporate governance alone will not restore the public’s trust. Corporations should work to support responsible behavior and build environments in which employees take the initiative to address misconduct rather than waiting until after the damage is done.

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 this result. Poorly designed compensation systems, for example, can provide strong incentives for misbehavior that undercut even explicit statements on ethics.

Empirical studies suggest a large percentage of employees are aware of inappropriate conduct in their companies.<sup>34</sup> 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

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.

a significant loss of public trust if it were to become known (Chart 3).<sup>35</sup> Only 45 percent of employees at these companies believe that members of senior management are approachable if an employee needs to deliver bad news, and only 62 percent of this same group is confident that senior management would not authorize illegal or unethical conduct if necessary to meet business goals.<sup>35</sup>

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).

The same survey found that only 64 percent of employees believe their CEOs and other senior management would respond appropriately if they were to become aware of misconduct (Chart 6).

Moreover, whistle-blowers often suffer retaliation for reporting their concerns about potential wrongdoing (Chart 7).

34 The findings vary considerably. At the high end is a survey of selected U.S. industries published in 2000 by KPMG LLP which found that 60 percent of employees had observed violations of law or company standards at least ‘sometimes’ during the previous twelve months. The figure rises to 76 percent when those who observed violations only ‘rarely’ within the previous twelve months is included. See KPMG LLP, Integrity Management Services, “2000 Organizational Integrity Survey: A Summary,” KPMG US Web page, [www.us.kpmg.com/services/content.asp?1lid+10&12id=30&cid=718](http://www.us.kpmg.com/services/content.asp?1lid+10&12id=30&cid=718) (November 18, 2002). (The 60 percent figure is based on customized analysis performed for the Commission.) A national employee survey conducted between December, 1999 and February, 2000, by the Washington, D.C.-based Ethics Resource Center found that 37 percent of those working in organizations with more than 500 employees had observed violations of law or their company’s ethical standards within the previous year; and 56 percent said they had observed at least one of eleven specific types of misconduct in their company (no time period was specified.) See Joshua Joseph, *2000 National Business Ethics Survey Volume I* (Washington, D.C.: Ethics Resource Center), pp. 13-14. See also Joyce Rothschild and Terance D. Miethe, “Whistle-Blower Disclosures and Management Retaliation,” *Work and Occupations*, Vol. 26, No.1 (February 1999), pp. 107-128 at p. 112 (37 percent of employed adults had observed misconduct at work).

35 KPMG, Integrity Management Services, “2000 Organizational Integrity Survey: A Summary,” KPMG US Web page (2000), [www.us.kpmg.com/services/content.asp?1lid=10&12id=30&cid=718](http://www.us.kpmg.com/services/content.asp?1lid=10&12id=30&cid=718) (November 18, 2002).

36 *Id.*

Chart 4

### What kinds of misconduct do employees observe?

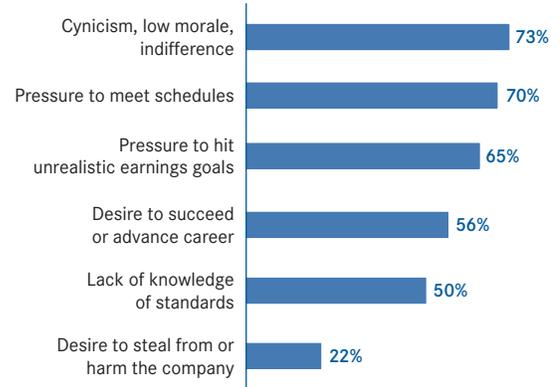


Source: KPMG LLP, 2000 Organizational Integrity Survey.

Chart 5

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

#### Employees believe misconduct is caused by...

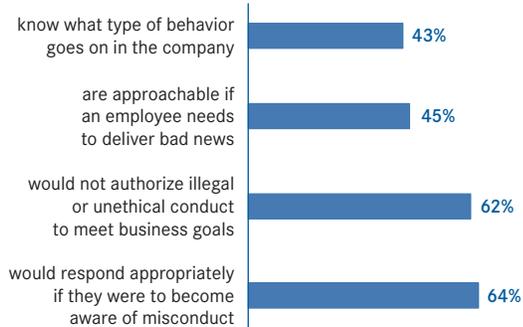


Source: KPMG LLP, 2000 Organizational Integrity Survey.

Chart 6

### Management is perceived as unable or unwilling to deal with unethical conduct

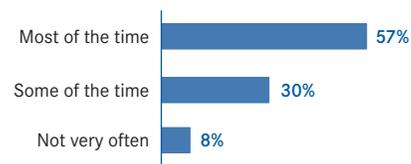
#### Employees believe their CEOs and other senior management...



Source: KPMG LLP, 2000 Organizational Integrity Survey.

Chart 7

### How often does the public think whistle-blowers face negative consequences at work, such as being fired or treated poorly?



Source: Time/CNN Survey/Harris Interactive, December 2002.

### Exposure of Whistle-Blowers

Of 300 whistle-blowers interviewed, 69% said they had lost their jobs or were forced to retire as a result.

Source: Joyce Rothschild and Terence D. Miethe, "Whistle-Blower Disclosures and Management Retaliation," *Work and Occupations*, vol. 26, no. 1 (February 1999), p. 120.

A strengthened stance on ethics 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. Prevention is the best cure for malfeasance.

Each corporation should adopt its own policies and practices for promoting ethical behavior and should develop practices for determining that appropriate behavior is understood and followed. Too often, boards find out about malfeasance only in extraordinary circumstances, for example, after a criminal or other investigation has begun. Only then, do other employees admit they were aware of the inappropriate behavior. At that point, the damage may have been done, and the costs to the company and its reputation may be irreversible. Preventing these circumstances raises the challenge to develop a culture that encourages responsible behavior and does not inhibit employees from coming forward with concerns about misconduct.

The Commission believes that encouraging appropriate behaviors and preventing misbehavior are major factors in rebuilding the public's trust in corporations. This task is an on-going one to ensure that later lapses in appropriate conduct do not rekindle the cycle of mistrust and further undermine investor confidence.

### Hiring Special Investigative Counsel

In the event an independent investigation is reasonably likely to implicate company executives, the board—not management—should retain special counsel for this investigation.

Special investigations of company activities that may implicate the conduct of company executives require independence from management. Typically, lawyers

and law firms are in the best position to conduct investigations, and care must be taken that these investigations are conducted thoroughly, vigorously, and objectively. It is important, therefore, that investigative counsel be chosen by, and report directly to, the board. To ensure that special counsel's interests are not aligned with, or influenced by, management, the Commission believes that special counsel should not be one of the corporation's regular outside counsel or a firm that receives a material amount of revenue from the company.

### The Roles and Responsibilities of Shareowners

Shareowners, particularly long-term shareowners, should act more like responsible owners of the corporation. They should have not only the motivation, but also the ability to participate 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.

State laws pursuant to which corporations are organized place management of the corporation under the direction of the board of directors. Shareowner involvement in the corporation's governance is primarily through the corporate electoral process where shareowners are given the statutory right to vote on only a limited number of matters of significance to the corporation, including, for example, election of directors, mergers, and amendments to charter documents.

The most significant matter on which shareowners regularly vote is the election of directors. Under current SEC rules, management is not required to include a shareowner's nomination for a board position in the company's proxy materials. If the company refuses voluntarily to include a shareowner's nominee, the shareowner's only alternative process for putting a nominee before the shareowners is to print, mail, and pay for his or her own proxy material. This process is usually prohibitively expensive. As a result, unless the incumbent board of directors voluntarily includes their nominees in the company's slate of nominees, shareowners have no

meaningful way to nominate or to elect candidates short of waging a costly proxy contest.

A second way that shareowners have participated in the electoral process is by submitting proposals to be included in the company's proxy statement. Typically, these proposals are advisory only, intended to provide management with the proponent shareowner's views on these issues. Under current SEC rules, however, management can omit a shareowner proposal if, among other reasons, it relates to the ordinary business operations of the company. This "ordinary business" exclusion has often operated to omit proposals that were of considerable importance to shareowners, and the SEC is considering relaxing the standard.<sup>37, 38</sup>

The Commission believes that corporations have an obligation to recognize the legitimate interests of shareowners in the nominees presented for election as directors and in other issues that properly come before a meeting of shareowners. Such increased shareowner involvement should begin through communication with the nominating committee of the corporation or its committee's representatives and with company management on proxy proposal topics. The Commission believes that the nominating committee and management, as the case may be, should actively encourage constructive shareowner input, including, where appropriate, direct discussions between shareowners and the members of the committee, their representatives, or management. It is only after this avenue has been exhausted that the shareowner should go directly to the corporation's owners through the proxy process to nominate directors or submit business proposals.

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<sup>37</sup> Remarks before the Council of Institutional Investors' Fall Conference by Chairman Harvey L. Pitt, New York, NY, Sept. 23, 2002.

<sup>38</sup> Commissioners Levitt, Bogle, Bowsher, Gilbert and Paine believe that the SEC should reconsider and reevaluate whether the ordinary business exclusion should be eliminated or modified in order to allow shareholders greater participation in the electoral process. They believe that such a reevaluation is consistent with the current reexamination of corporate governance practices.

The Commission's recommendations for increased shareowner involvement are premised on the views that: a) substantial long-term shareowners must have a means to assure that the corporation is being directed and managed in their behalf; and b) the views of substantial, long-term shareowners on corporate policy can be of significant benefit to the corporation. Shareowners who have the motivation to participate more actively in the shareowner election process must also have the ability to do so.

Long-term holders of substantial amounts of shares, in particular, may have greater knowledge of and familiarity with the corporation because of the extent and duration of their ownership positions. In contrast, short-term stock traders are unlikely to reflect an on-going interest in the corporation's long-term welfare. The Commission recommends, therefore, that a corporation consider factors such as length of time of ownership in assessing the gravity of recommendations for including shareowner nominees or proposals in proxy material.

## Institutional Ownership

Institutional owners have large holdings, and they also have the resources that can be brought to bear on good corporate governance. The following data show that not only the ownership of the largest 1,000 U.S. corporations, but of the total equity market, has come increasingly into the hands of institutions.

Table 2  
**Institutional Ownership Trends**

Institutional ownership in the top 1,000 U.S. corporations

1987	1995	2000
46.6%	57.2%	61.4%

Percentage of equities held by institutions in overall equity market

1970	1980	1990	2001
19.4%	33.9%	46.9%	55.8%

Source: The Conference Board's Global Corporate Governance Research Center—Institutional Investment Report, V4N2&3 and V5N1 (prelim).

This increase in institutional ownership has been accompanied by increased competition among managers of mutual funds and pension funds to attract assets under management. Partly as a result, there has been a substantial shortening of investment performance measurement periods for managers of both pension plan assets and mutual funds, as these investors have increasingly focused on the short-term price of a stock rather than the long-term value of the corporation. At the same time, stock trading facilities have improved, making the prompt movement of large blocks of stocks more efficient. These two fundamental changes have exacerbated a short-term focus on the part of the large institutional shareowners, leading to a reduced concern about long-term considerations such as governance. In addition, in some situations, institutions have been reluctant to critique management or governance of a company whose pension assets they manage. These institutions should reconsider whether these practices are in the best interests of the investors whose money they manage.

### Portfolio Turnover

While trading shares provides needed liquidity in the marketplace, there are substantial benefits to corporations when they have long-term shareowners who can provide the corporation with “patient capital” and the ability to make long-term plans without fear that short-term earnings reports will trigger a sell-off in the company’s stock.

Average turnover and trading has increased markedly over the years. For example, average turnover on the New York Stock Exchange was only 19 percent in 1970, but increased to 36 percent in 1980, then to 46 percent in 1990. During the 1990’s, trading continued to escalate, so that, by 2001, average turnover on the New York Stock Exchange was more than 100 percent.<sup>39</sup> This means that, on average, every share of stock changed hands at least once a year. Trading on the NASDAQ

was even higher, averaging 288 percent in 2001.<sup>40</sup> Because the average turnover rate is reduced by the sizeable institutional investments in indexed funds (known for their long-term holdings), as well as other shareowners who hold for long periods, it is clear that turnover rates are even higher for investors who churn their portfolios on a regular basis.

Turnover has increased for many reasons, including:

1. Sharply lower stock exchange commission rates and highly economical electronic trading networks have drastically reduced unit transaction costs, meaning that many more shares can be traded for the same aggregate dollar cost. It is likely that the aggregate costs of portfolio turnover of 100 percent today are no higher than for a 30 percent turnover three decades ago.
2. Institutional investor assets have not only been increasing, but moving from corporate and public pension funds into the hands of mutual funds that tend, on average, to have higher turnover (see item number 3, below). Table 3 shows that private trustee pension funds held equities which amounted to 17.2 percent of U.S. outstanding equities in 1990, whereas by 2001, they held equities amounting to only 12.5 percent of U.S. equity. Also, state and local pension funds saw their equity share reduced slightly from 8.1 percent of the total equity market in 1990 to only 8.0 percent by 2001. At the same time, mutual funds significantly gained in their share of the equity market, from 6.6 percent in 1990 to 18.7 percent in 2001.
3. Differences in portfolio turnover for investors such as public and corporate pension funds and mutual fund managers appear to be attributable primarily to how much indexation each type of investor uses. (Index strategies, by their design, involve long-term holdings.) Public pension funds are the largest users of index and index-like strategies, corporate pension

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39 New York Stock Exchange Web site; Market Data - Statistics Archive.

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40 Calculated by Bogle Financial Markets Research Center, based on data provided by NASDAQ.

Table 3

**U.S. Institutional Investor Equity Ownership**

	1990 (\$Trillions)	Percent of total U.S. equity	2001 (\$Trillions)	Percent of total U.S. equity
Pension Funds	\$1.0	27.8%	\$4.0	26.3%
Private Trusteed	0.6	17.2	1.9	12.5
Private Insured	0.09	2.5	0.9	5.8
State and Local	0.3	8.1	1.2	8.0
Investment Companies	0.3	7.1	2.9	18.8
Open-End Mutual Funds	0.2	6.6	2.8	18.7
Closed-End	0.02	0.5	0.03	0.2
Insurance Companies	0.2	4.6	1.1	7.1
Life Insurance	0.08	2.3	0.9	6.0
Property & Casualty	0.08	2.3	0.2	1.1
Bank & Trust Companies	0.2	5.6	0.3	1.7
Foundations	0.07	1.9	0.3	1.9
TOTAL (All Institutions)	\$1.7	46.9%	\$8.5	55.8%

Source: The Conference Board's Global Corporate Governance Research Center—Institutional Investment Report, V5N1 (prelim).

funds next, and mutual funds lowest. About 12 percent of mutual fund equity assets are in index funds.<sup>41</sup> Mutual fund turnover was 15–20 percent during the 1950s and early 1960s, but has averaged 80 percent during most of the 1990s and has been above 100 percent for the past three years.<sup>42</sup> (One hundred percent turnover suggests that a portfolio stock is held for just one year.)

4. Individual investors have also been estimated to have much shorter holding periods.<sup>43</sup> The New York Stock Exchange calculates a shortening of the average holding period for corporate stocks held by individual investors from 5.6 years in 1985, to 2.9 years in 1993.<sup>44</sup> Other data show that the

propensity of individuals to trade stock they own directly has increased remarkably, from 32 percent in 1995, to 47 percent in 1998. According to a recent Bain & Company analysis, individuals held stock for an average of only 11 months in 2001, compared with eight years in 1960.<sup>45</sup>

In the long-term, the price of a stock will theoretically match the intrinsic value of the company.<sup>46</sup> As we witnessed most recently during the stock market boom and bust, however, substantial short-term volatility can exist in the relationship between price and value.

41 Bogle Financial Markets Research Center.

42 *Id.*

43 Factors such as decreasing in costs of trading shares, on-line brokerage accounts, and on-line trading have all facilitated easier turnover of shares for individuals.

44 New York Stock Exchange Shareownership 2000, p.55.

45 Market Perspectives, *New York Times*, Sunday, February 17, 2002, p.8.

46 Warren Buffett, 1996 Owner's Manual states: "Intrinsic value is the discounted value of the cash that can be taken out of a business during its remaining life...Over time the aggregate gains made by *shareholders* must of necessity match the *business* gains of the company." (Italics supplied). Peter Bernstein, *Economics and Portfolio Strategy*, 1984. "The purpose of the stock market is to enable investors to realize the present value of future streams of income...i.e., to give investors the opportunity to compress time." Benjamin Graham, *Security Analysis*, 1934, "In the short run the market is a voting machine, but in the long run it is a weighing machine...Over time, stock (prices) tend to move towards the true or intrinsic value of the business."

Given low transaction costs and focus on short-term performance, the customary practice of the day is for many institutional investors simply to “vote with their feet” and sell stock when they perceive a company’s prospects to become dim. The result is that the benefits of ownership go to some short-term shareowners at the expense of others. Only to the extent that investors have long-term horizons will the investment experience of its owners parallel the business results of the corporation.

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. The best mechanism for corporate governance is the active involvement of the company’s shareowners. Thus, to the extent institutional investors—holding more than half of all equity securities of U.S. companies—are traders rather than owners, they do not exercise their responsibilities of corporate ownership and they squander their potential influence on corporate management and policy.

The Commission believes it is in the long term interests of the company to have a core investment base which 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. As traders become owners, these investors may see benefit as the company takes actions to fulfill its longer term strategies. Thus, a longer term investment horizon can benefit both companies and investors alike, and, accordingly, large institutional investors should take a more active role in becoming shareowners. This recommendation includes establishing compensation arrangements for portfolio managers that encourage a long-term rather than short-term focus.

Finally, the Commission believes that policy makers<sup>47</sup> 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.<sup>48</sup> The Commission believes, however, that any detailed consideration of tax policy is beyond the scope of its current work.

The Commission believes that the implementation of the following recommendations will be a major factor in building corporations that are strong and productive. Adoption of these recommendations will help to restore the public’s trust in our corporate governance system and to complement the substantial regulations that have already been implemented.

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

48 Commissioner Snow recuses himself from discussion of tax policies.

# Principles, Recommendations, and Specific Best Practice Suggestions

## Principles

### **PRINCIPLE I: RELATIONSHIP OF THE BOARD**

**AND MANAGEMENT** Each board of directors should establish a structure, based on its particular circumstances, that provides an appropriate balance between the powers of the CEO and those of the independent directors, enables it to carry out its oversight function, and gives the independent directors, in particular, the powers they require to perform their oversight roles.

## Specific Best Practice Suggestions

1. The Commission notes three principal approaches to provide the appropriate balance between board and CEO functions:
  - a. Each corporation should give careful consideration to separating the offices of Chairman of the Board and CEO, with those two roles being performed by separate individuals. The Chairman would be one of the independent directors.
  - b. The roles of chairman and CEO would be performed by two separate individuals; however, the Chairman could be a non-independent director within the meaning of stock exchange standards, but would not be a member of management and would not report to the CEO. Where the Chairman is not one of the independent directors, a Lead Independent Director position, or other equivalent designation, should be established. Under this approach, it is essential that the Chairman not have any relationships with the CEO or management that compromises his or her ability to act independently.
  - c. Where boards do not choose to separate the Chairman and CEO position, or when they are in transition to a structure where the positions will be separated, a Presiding Director position should be established.
2. The duties of the non-CEO Chairman, whether he or she is one of the independent directors or not, the Lead Independent Director (or other equivalent designation), and the Presiding Director should be carefully articulated.
  - a. The independent non-CEO Chairman's duties should, at a minimum, include: presiding at board meetings and at meetings of the non-management directors; having ultimate approval over information sent to the board; having ultimate approval over the board meeting agenda; serving as the principal liaison to the independent directors; and setting meeting schedules to ensure that the independent directors have time for discussion of all agenda items. It is contemplated that the non-CEO Chairman will devote considerable time to company affairs.
  - b. The duties of the Lead Independent Director (or equivalent designee) should, at a minimum, include: chairing meetings of the non-management directors; serving as the principal liaison to the independent directors; and working with the non-CEO Chairman to finalize information flow to the board, meeting agendas, and meeting schedules.
  - c. The duties of the Presiding Director should be clearly articulated and should, at a minimum, include: presiding at board meetings in the absence of the Chairman; presiding at executive sessions of the non-management directors; serving as the principal liaison to the independent directors; having ultimate approval over information sent to the board; having ultimate approval over the board meeting agenda; and setting meeting schedules to assure that the directors have sufficient time for discussion of all agenda items.

3. Boards that choose not to take any of these approaches should explain their reasons for doing so, as well as the board structure which they employ to achieve the objectives of strong, independent board leadership.
4. A non-CEO Chairman who is not an independent director within the meaning of stock exchange requirements should not be a member of the management team and should not report to the CEO.
5. As part of their duties, and depending on their corporate governance model, boards should consider having the independent Chairman, Lead Independent Director (or equivalent designee), or Presiding Director take a lead role, in conjunction with the Chairman, in the director evaluation process.
6. As a matter of right, exercised reasonably, all directors should have the ability to place items on the board agenda, be assured that adequate time is allotted for discussion of those items, and request such information as they believe necessary to make sound, informed business decisions on a timely basis.
7. The non-management directors should have regular, frequent meetings without the CEO or other directors who are members of management present.
8. Directors undertaking the roles of separate Chairman, Lead Independent Director (or equivalent designee), or Presiding Director should be prepared to devote a greater amount of time to board service than other directors. Their roles, however, should not involve management of the company or any of its businesses.

**PRINCIPLE II: FULFILLING THE BOARD’S**

**RESPONSIBILITIES** Among the core responsibilities of the board are: understanding and approving the corporation’s long-term, central strategies; understanding the issues, forces, and risks that define and drive the company’s business; and overseeing the performance of management.

A vigorous and diligent board of directors, a substantial majority of whom are independent, with an appropriate committee structure, is the key to fulfilling the board’s responsibilities and to a corporation’s effective governance.

**Specific Best Practice Suggestions**

1. A substantial majority of the board should be composed of independent directors.<sup>49</sup>
2. Independent directors should not only be independent in accordance with legislative and stock exchange listing requirements, but should also act independently of management.
3. Boards should develop norms that favor open discussion, and encourage the presentation of different views.
4. Each director should disclose to the board or to a designated committee all relationships between and among that director, the company, and senior management of the company, including any potential conflict of interest, whether or not required for public disclosure, in order to allow for a comprehensive determination of a director’s independence.
5. Boards should develop an appropriate committee structure, retaining outside advisors and staff as appropriate, to fulfill their responsibilities.

**PRINCIPLE III: DIRECTOR QUALIFICATIONS**

Basic qualifications for membership on the board should be articulated. The mix of director backgrounds and qualifications should depend, among other things, on the nature of the company, its stage of development, its future strategic vision, and its current business needs.

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<sup>49</sup> The Commission goes beyond the recommendations of the New York Stock Exchange that companies have a “majority” of independent directors to recommend that a “substantial majority” of directors be independent.

Corporations' businesses vary greatly, and each board should ensure that the mix of its directors' qualifications is tailored to its specific needs. Collectively, the board should have knowledge and expertise in areas such as business, finance, accounting, marketing, public policy, manufacturing and operations, government, technology, and other areas that the board has decided are desirable and helpful to fulfilling its role. Diversity in gender, race, and background of directors, consistent with the board's requirements for knowledge, standards, and experience, are desirable in the mix of the board.

### Specific Best Practice Suggestions

1. Each board should determine the mix of backgrounds and expertise most advantageous for it and should attempt to ensure that those characteristics are present among the collective group of directors.
2. The Board should articulate in writing the basic qualifications of all directors for membership on the board.

**PRINCIPLE IV: ROLE OF THE NOMINATING/ GOVERNANCE COMMITTEE** The nominating/ governance committee should be responsible for nominating qualified candidates to stand for election to the board, monitoring all matters involving corporate governance and making recommendations to the full board for action in governance matters. The nominating/ governance committee should be composed entirely of independent directors.

### Specific Best Practice Suggestion

1. At a minimum, the nominating/governance committee should recommend to the full board of directors:
  - a. an appropriate board organization, including committee assignments;
  - b. qualifications for board membership;

- c. an appropriate slate of qualified nominees for election to the board that they have identified and evaluated;
- d. requirements for, and means of, director orientation and training;
- e. corporate governance principles for adoption by the full board; and
- f. candidates for CEO succession.

**PRINCIPLE V: BOARD EVALUATION** Each board should develop a three-tier director evaluation process which includes evaluation of the performance of the board as a whole, the performance of each committee and the performance of each individual director, as necessary. The board should also adopt a process for review and evaluation of the Chief Executive Officer.

### Specific Best Practice Suggestions

1. Boards should develop processes to evaluate, at least annually, the performance of the board as a whole, the performance of each board committee and the performance of each individual director, as necessary.
2. Boards should develop processes to evaluate the performance of the CEO on at least an annual basis.
3. Depending on the corporate governance model adopted, boards should consider having the non-CEO Chairman, the Lead Independent Director (or equivalent designation) or the Presiding Director take a lead role, in conjunction with the Chairman, in the board evaluation process.<sup>50</sup>

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<sup>50</sup> The Commission recognizes that it is the responsibility of the full board to evaluate the CEO.

**PRINCIPLE VI: ETHICS OVERSIGHT** Boards should be responsible for overseeing corporate ethics. The Commission believes that ethical conduct, including adherence to the law’s requirements, is vital to a corporation’s sustainability and long-term success. Therefore, oversight of ethical and appropriate behavior in and by the corporation is a responsibility of the board.

A crucial factor in establishing ethical corporate practice is the active leadership by senior management. “Tone at the top” is critical to responsible behavior throughout the corporation, as are appropriate management processes and “follow through” on violations of a company’s code of conduct. Therefore, ethical standards and the skills required to foster ethical practice throughout the organization should be among the core qualifications for the CEO and other senior management positions.

#### Specific Best Practice Suggestions

Among the practices which boards should consider for establishing an ethical corporate culture are:

1. Tone at the top
  - a. Continued and repeated emphasis, and commensurate behavior, by the board and CEO, on the importance of ethical conduct to the corporation and its business; and
  - b. Using, as criteria for selection of the CEO and senior management, a candidate’s ability to and prior history of fostering ethical practices, including the candidate’s demonstrated business values and response to any misconduct in prior organizations in which the candidate was employed.
2. Tools and processes
  - a. Programs to ensure that employees understand, apply, and adhere to the company’s code of ethics;
  - b. Processes that encourage and make it safe for employees to raise ethical issues and report possible ethical violations;

- c. Processes for prompt investigation of complaints and prompt disposition, including discipline and corrective action, if necessary; and
- d. Processes to measure and track employees’ adherence to the company’s ethical requirements and to assess the ethical performance of the company as a whole.

#### 3. Oversight

- a. Designation of a board committee to oversee ethics issues;
- b. Designation of an officer to oversee ethics and compliance with the code of conduct;
- c. Inclusion of ethics-related criteria in employees’ annual performance reviews and in the evaluation and compensation of management;
- d. Representation by senior management that all known ethics breaches have been reported, investigated, and resolved; and
- e. Disclosure of practices and processes the company has adopted to promote ethical behavior.

**PRINCIPLE VII: HIRING SPECIAL INVESTIGATIVE COUNSEL** In the event an independent investigation is reasonably likely to implicate company executives, the board and not management should retain special counsel for this investigation.

Special investigations of company activities that may implicate the conduct of company executives require independence from management. Typically, lawyers and law firms are in the best position to conduct investigations, and care must be taken that these investigations are conducted thoroughly, vigorously, and objectively. It is important, therefore, that investigative counsel be chosen by, and report directly to, the board. To ensure that special counsel’s interests are not aligned with, or influenced by, management, the Commission believes that special counsel should

not be one of the corporation's regular outside counsel or a firm that receives a material amount of revenue from the company.

#### Specific Best Practice Suggestion

1. Special counsel retained to conduct independent investigations with likelihood to implicate company executives should report directly to the board or an appropriate committee of the board and should not be an individual or a firm that the company regularly uses as outside counsel or that derives a material amount of revenues from the company.

#### **PRINCIPLE VIII: SHAREOWNER INVOLVEMENT**

Shareowners, particularly long-term shareowners, should act more like owners of the corporation. As shareowners, they should have the ability 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.

#### Specific Best Practice Suggestions

1. 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. In evaluating shareowner nominees and proposals, whether made individually or collectively, boards should take into account the extent of the share holdings involved and the length of time those shares have been held.
2. In evaluating shareowner nominees and proposals, boards should not preclude proposals made by smaller, individual shareowners.
3. The procedures for receiving shareowner nominations and proposals should include, where appropriate, meetings of shareowners with the nominating/ governance committee or its representatives.

4. Boards of directors should give serious consideration to adopting advisory shareowner proposals that receive a substantial percentage, even if less than a majority, 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.

#### **PRINCIPLE IX: LONG-TERM SHARE OWNERSHIP**

Long-term share ownership best encourages companies to maximize long-term value.

The Commission recognizes that liquidity in the marketplace is essential to an efficient stock market. However, it also recognizes that the stock market can have a high degree of volatility which may not necessarily be related to the underlying fundamental long-term value of the corporation. This volatility is not necessarily supportive of a corporation's ability to plan and execute a long term strategy for the benefit of the company's long-term shareowners.

#### Specific Best Practice Suggestions

1. Company executives charged with communicating with shareowners, such as the Corporate Governance Officer, Corporate Secretary and Investor Relations Executives, should formulate and communicate to investors a strategy specifically designed to attract investors known to pursue long-term holding investment strategies (e.g. public and private pension funds and mutual funds that emphasize index strategies, money managers with stated long-term investment horizons, etc.). In this way, the corporation may be able to reduce the volatility in trading of its shares and build a stronger shareowner base.
2. Corporations should encourage short-term "traders" to become long-term "owners," pointing out the benefits both to the company and to long-term shareowners in making its investment decisions in order to fulfill longer term strategies. While investors can and should pursue strategies intended to maximize

their rates of return on investment, they should view high volatility trading as a risk factor in making their investment decisions.

3. Policy makers should formulate differential tax strategies,<sup>51</sup> such as, for example, significantly increasing the tax differential between long-term and short-term holding periods,<sup>52</sup> and other policies to encourage investors to trade with a long-term investment horizon.
4. While corporations cannot dictate how investors make their decisions, they can provide them with information that is focused more on long-term

strategies, financial goals, and intrinsic values, and less on transitory short-term factors. Corporations should reevaluate the implications of providing short-term “earnings guidance,” as well as the advisability of meeting financial targets through aggressive accounting techniques.

5. Institutional investors should establish compensation arrangements for portfolio managers that reward a long-term rather than short-term focus.

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

52 Commissioner Snow recuses himself from discussion of tax policies.

# Dissenting Opinion

## Commissioner Biggs

I dissent from the principle and best practice suggestions in Principle I, that would create a separation of the job of Chairman and CEO or add a “Presiding Director,” who would take over some or most of the duties of the Chairman but not those of the CEO.

Since the corporate governance scandals of the last year, a number of regulations, laws, and recommendations have been created to weaken the authority of the typical American corporate Chairman-CEO. These actions range from desirable strengthening of audit and compensation committees’ authority, to the unwise recommendations in Principle I. It is ironic that Enron, WorldCom, and Global Crossing did separate the roles of the Chairman and the CEO, although they were not independent.

It seems clearly desirable for independent directors to meet privately without the CEO in regularly scheduled sessions. Someone should preside over such meetings and be the conduit for information to the CEO. Many well-governed American boards follow this practice and ask the independent board member who chairs the governance or nominating committee to add this function to their duties. It is not an onerous addition. It takes considerably less time than the additions legislated or recommended for the chair of the audit or compensation committee. I believe this is a desirable “best practice,” which does not include any responsibility for the agendas or information flow or other functions of a Chairman of the Board.

The Commission explicitly rejected the above simple solution as inadequate. The majority of the Commission insists that some director be given, in addition to presiding over the private sessions, the more powerful role of the independent chairman, “Lead Independent Director” or “Presiding Director.” The “Presiding Director,” as defined by Principle I, is expected to have “ultimate approval over the information flow to the board, the ultimate board meeting agenda, and meeting schedules.”

If this is done in a perfunctory way, say the day before the meeting, it is probably irrelevant. However, to do this competently, he or she would have to devote substantial extra time to understanding the company’s operations, discussing with the CEO and others in senior management the issues currently confronting the company, and probably “rehearsing” the meeting to be sure those issues can be discussed adequately.

We have supported better corporate governance over many years at TIAA-CREF. Yet we have often observed that good corporate governance has never created a great company—great leaders, great CEOs have done so. Are we wise to create checks on this leadership role by adding to the much needed oversight of: (1) a more energized board; (2) a challenging audit committee; and (3) an independent compensation committee, with a further much more substantive limitation—a separate chair or “Presiding Director” who “would have ultimate approval of the board meeting agenda,” “has ultimate approval over information sent to the board,” and such other functions as might be imagined?

I dissent since I think the Principle I governance “best practices” imposes far more costs than benefits on American business and are simply not warranted when a simpler “best practice” exists which is an effective and appropriate check on the Chairman-CEO: an independent director, as chair of the governance or nominating committee, who presides over regularly scheduled private meetings of directors and who serves as the information conduit to the CEO.

# Principles, Recommendations, and Specific Best Practice Suggestions

## Introduction

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 Conference Board Commission on Public Trust and Private Enterprise believes that the following seven principles, 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.

## Principles

**PRINCIPLE I: THE ENHANCED ROLE OF THE AUDIT COMMITTEE** Audit committees should be vigorous in complying with the numerous new requirements imposed by the Act and by the proposed listing standards of the New York Stock Exchange.

Members of the audit committee must be independent and have both knowledge and experience in auditing financial matters. The Act also requires that the company disclose whether or not the audit committee has a member who is a "financial expert" who: (1) understands financial statements and GAAP accounting; (2) has experience with (a) application of GAAP in connection with the accounting for estimates, accruals, and reserves, and (b) preparing or auditing financial statements; (3) has experience with internal accounting controls; and (4) understands audit committee functions.<sup>53</sup>

Among the many new duties and responsibilities that the Act imposes are the requirements that the audit committee be responsible for the appointment, compensation and oversight of the work of auditors, and that the outside auditors report directly to the audit committee. In addition, the audit committee of a public company must pre-approve all the services, whether audit or non-audit, that are provided to a public company by a registered accounting firm.

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<sup>53</sup> Section 407 of the Sarbanes-Oxley Act of 2002, the text of which is contained in the Appendix to these Principles.

### Specific Best Practice Suggestions

1. Boards should not underestimate the requirements of the Act and of the proposed New York Stock Exchange listing requirements with respect to audit committees and should devote sufficient resources and time to implement their requirements.
2. In keeping with the requirements of the Act, the board of directors should assess the independence and qualifications of the members of the audit committee, using outside counsel or consultants if desirable, to ensure that each qualifies for membership on the committee.
3. 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.
4. Audit committees should conduct an annual assessment of the performance of the committee and its members, including in such review a comparison of the committee and its members to legal and stock exchange requirements and to prevailing best practices for audit committees.

#### **PRINCIPLE II: AUDIT COMMITTEE EDUCATION**

There should be an orientation program for each member of the audit committee, and members of the audit committee should participate regularly in continuing education programs.

The Act and the proposed NYSE listing standards impose numerous requirements on audit committees. For example, the Act contains provisions as to hiring and oversight of outside auditors, establishment of an employee complaint system for accounting and audit matters, and engagement of outside counsel and advisors when they deem it advisable. The Act and NYSE listing standards enumerate a variety of areas for which audit committees are responsible, including examination of financial statements, assessments of company risks and vulnerabilities, and oversight of external and internal auditors.

To fulfill their duties, audit committee members must understand their responsibilities and the substantive basis for their actions. Therefore, the Commission believes that audit committee members should participate in a thorough audit committee orientation program and in continuing education programs.

### Specific Best Practice Suggestion

1. Members of the audit committee should participate in an initial orientation program upon appointment to the committee, as well as educational programs thereafter. They should exercise their right to retain outside advisors or educational consultants as they deem appropriate.

#### **PRINCIPLE III: IMPROVING INTERNAL CONTROLS**

**AND INTERNAL AUDITING** 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 Act imposes two sets of requirements designed to force public companies to strengthen their internal control systems. Many of the Act's requirements deal specifically with financial reporting. Effective internal control systems should be designed to encompass all major areas of risk and vulnerability in a company's operation, including corporate governance issues. These areas of risk and vulnerability can have significant impacts on the company's financial results and financial statements. The company's outside auditors should include these areas of risk and vulnerability in assessing the effect of these risks on the company's financial statements and internal controls.

As part of the requirements of Section 302<sup>54</sup> of the Act, the principal executive officer and principal financial officer must certify that they have designed disclosure

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<sup>54</sup> The text of Section 302 of the Sarbanes-Oxley Act of 2002 is contained in the Appendix to these Principles.

controls and procedures. In implementing Section 404 of the Act, the SEC has proposed rules that would require a similar certification with respect to internal controls.<sup>55</sup> Section 404<sup>56</sup> of the Act requires the SEC to promulgate rules requiring each issuer to include in its annual report a report on internal controls for financial reporting and an assessment of those controls. In addition, the company's outside auditor must "...attest to, and report on the assessment made by the management of the issuer"<sup>57</sup> on its internal controls.

Compliance with these provisions of the Act will require scrutiny and evaluation both by top management and by the board of issues such as the company's control environment, business risks, information and communication systems and monitoring processes. The Act speaks in terms of internal controls for financial reporting issues. However, any substantive improvement in oversight of internal controls must begin with the recognition that internal controls are not limited to financial matters. The Committee of Sponsoring Organizations of the Treadway Commission (COSO)<sup>58</sup> defined internal controls to include the reliability of financial and operating data but also includes controls that promote operating effectiveness and efficiency, the safeguarding of assets, and compliance with law, regulation and contractual requirements.

While the Act does not provide issuers with guidance as to how to comply with its requirements, there is useful precedent to which management and boards may look in formulating their approach to compliance. That precedent is found in the Federal Deposit Insurance Corporation Improvement Act of 1991. This legislation has promoted

the successful transformation of the internal control environment in the banking industry and related reforms, despite some initial resistance to its requirements.

A recent study of corporate directors conducted jointly by the Institute of Internal Auditors and the National Association of Corporate Directors<sup>59</sup> found that over 50 percent of directors surveyed indicated that their companies did not have in place effective risk management systems. With the passage of the Act, these companies will have to undertake corrective action that will require close cooperation between management, boards of directors and internal and external auditors.

The Commission believes that the evaluation of the company's control environment should include an analysis of the company's overall risk environment and the controls and information systems that address these risks.

### Specific Best Practice Suggestions

1. All companies should have an internal audit function, 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.<sup>60</sup>
2. The internal auditors should prepare for review and approval by the audit committee a multi-year audit plan of not less than three years, centered on the corporation's risks and vulnerabilities. The audit committee and any other committee of the board dealing with risk management should review and update this risk-based plan on an annual basis.

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55 Securities Exchange Commission Release 33-8138, 34-46701, IC-25775 (October 18, 2002).

56 The text of Section 404 of the Sarbanes-Oxley Act of 2002 is contained in the Appendix to these Principles.

57 Section 404 of the Sarbanes-Oxley Act of 2002.

58 Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control—Integrated Framework*, 1992.

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59 The Institute of Internal Auditors and The National Association of Corporate Directors, *After Enron: A Survey for Corporate Directors, 2002*, cited in The Institute of Internal Auditors, "Recommendations for Improving Corporate Governance," (April 8, 2002).

60 The proposed amendments to the New York Stock Exchange listing standards would require that all NYSE-listed companies have an internal audit function.

3. The internal auditor should have a direct line of communication and reporting responsibility to the audit committee, and he or she should attend all regularly scheduled audit committee meetings, report on the status of audits conducted by the internal audit group, report to the committee on other matters that the internal auditor, in his or her judgment, believes should be brought to the audit committee's attention, and meet with the audit committee in executive session.
4. The Commission believes that every public company board, and especially the audit committee, should make enterprise risk assessment and internal controls high priorities in order to facilitate the certification and reporting processes required by Sections 302 and 404 of the Act.

**PRINCIPLE IV: AUDITOR ROTATION** 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.

Recent and repeated revelations of audit failures (Enron, WorldCom, Sunbeam, Waste Management and others) have focused attention on whether auditors are sufficiently independent of management and whether investors perceive that auditors' opinions are based on impartial review and application of accounting requirements. The Act has taken important steps to ensure auditor independence by restricting the extent of non-audit services provided by the auditor, limiting the employment by a company of audit firm personnel, and requiring five-year rotation of certain of the firm's partners who have participated in the audit. The Act has not, however, addressed rotation of the firm itself as some recommended. Rather, the Act has directed the General Accounting Office to study this issue.

When there is a confluence of circumstances that could put into question the audit firm's independence, the Commission believes that audit committees

should carefully consider rotation of audit firms. The Commission believes that 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.

The presence of some or all of these three factors would represent a situation where the independence of the auditor could be called into question. When these extensive relationships exist, especially over a long period, auditor rotation would provide a useful tool in building shareholder confidence in the integrity of the audit and of the company's financial statements.

Auditor rotation has other significant advantages to the integrity of the audit process. The incoming audit firm would have the benefit of a fresh look at the firm's finances, accounting practices and the former firm's audit. Rotation of auditors would also reduce any financial incentives for external auditors to compromise their judgment on borderline accounting issues. In disagreeing with management, auditors would no longer be risking a stream of revenues that they believed would continue in "perpetuity," since the audit engagement would no longer be perceived as permanent. Further, knowing their work will be reviewed by another firm at the end of the rotation period would also deter "questionable" judgments and decision-making on the part of the auditor.

The Commission recognizes that there could be some incremental costs to public companies in changing auditors on a periodic basis because the new audit firm would have to learn about the company's finances and operations. However, this transition could be facilitated by requesting, or requiring by contract, the outgoing audit firm to retain and transfer all its working papers to the incoming audit firm. The Commission believes the cost of implementing

this best practice may be significantly less than costs endured by investors in capital markets resulting from the loss of investor confidence in response to inaccurate financial statements.

Alternatively, the Commission suggests that the audit committees of public companies allow the current auditor as well as other qualified firms to submit proposals in the review process for an audit engagement. A review process should focus on the quality of the auditors and audit, rather than on savings on audit fees. Even if the company's previous auditor is selected, the bidding process would emphasize the point to external auditors that they report to the audit committee, rather than management.

### Specific Best Practice Suggestions

1. In order to ensure the independence of any audit, the audit committee should seriously consider rotating outside audit firms when some or all of the following circumstances exist: (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 approved by the audit committee.
2. Although audit committees should evaluate their current public accounting firm at least annually, the audit committee should, in addition, perform a more thorough evaluation and review at least every five to seven years. The audit committee should consider other public accounting firms as part of this evaluation and review.
3. The primary emphasis in choosing an audit firm should be the demonstrated experience, quality and depth of knowledge of all audit personnel to be assigned to the audit, specific industry expertise, the scope of work to be performed, and any inspection reports available about the audit firm. The committee should ensure that the audit fees do not negatively impact the scope of work necessary for the auditors to perform a quality audit.

**PRINCIPLE V: PROFESSIONAL ADVISORS FOR THE AUDIT COMMITTEE** The audit committee should, if necessary, retain professional advisors with no other ties to the company to assist it in carrying out its functions.

The Act and the proposed NYSE listing standards recognize that audit committees may require additional resources to carry out their responsibilities. 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. These experts, however, should not substitute for the audit committee fulfilling its duties.

The Commission recognizes that, to operate independently of management, audit committees should not rely exclusively on company employees for additional assistance. Instead, the Commission believes that they should explore retention of “professional audit advisors” if they feel there is the need for additional assistance in order to increase their effectiveness. For instance, these advisors would: (1) have the temperament and experience “to take both a knowledgeable and skeptical approach toward the complexities of financial reporting;” (2) have the time and knowledge “to probe closely into the financial management and financial controls of the company and to evaluate and oversee the outside auditor;” and (3) not be bound by the “collegial” nature of boards of directors and would be free to ask the tough questions.<sup>61</sup>

These professional audit advisors could:

1. Serve as a resource to evaluate and to report back to the audit committee regarding the numerous tasks that are being demanded of the audit committee, including, but not limited to:
  - a. the hiring and firing of the independent auditors;
  - b. approving any significant non-audit work by the independent auditors;

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<sup>61</sup> Paul Volcker, draft of Op-Ed article (not published), August 8, 2002.

- c. discussing the annual and quarterly financial statements, including the notes thereto, and Management’s Discussion and Analysis (MD&A) disclosure with management and the independent auditor;
  - d. discussing earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;
  - e. understanding the primary risks facing the company; and
  - f. meeting separately, periodically, with management, the internal auditors and with the independent auditors.
2. Provide specialized expertise to the audit committee concerning the increasingly complex financial issues that it must evaluate.

At the audit committee’s request, these professional audit advisors could also be required to report to the committee on complicated financial reporting matters. Examples of such matters include critical accounting policies adopted by the company, issues for which the committee must make judgment decisions, off-balance sheet financing, related party transactions, derivatives, contingent liabilities, and the readability of the company’s financial statements. The professional audit advisors should report solely to the audit committee and should have access to: (1) all levels of management; (2) the internal audit staff; (3) the independent auditors; and (4) all documents and records, including audit work papers, that they deem relevant to carrying out their work.

#### Specific Best Practice Suggestion

- 1. In order to obtain the expertise, analysis of issues, and staff assistance that they deem necessary or appropriate, audit committees should consider retaining professional outside advisors that have no relation to management, outside auditors, or internal auditors.

#### **PRINCIPLE VI: SERVICES PERFORMED BY ACCOUNTING FIRMS**

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 as novel and debatable tax strategies and products that involve income tax shelters and extensive off-shore partnerships or affiliates.

Until recently, large public accounting firms performed audit and substantial advisory work for their clients. A significant amount of advisory work for clients has been prohibited by recent changes in the law, responding to the failures of certain audits in situations in which the accounting firm also provided extensive advisory services.

Public accounting firms are permitted to perform certain tax services for their clients. The Commission believes that any work performed by the company’s outside auditors be closely related to the audit. Auditors’ development and recommendations of new tax strategies for their clients is not closely related to the audit and, in our opinion, removes focus from their audit work and poses a potential conflict of interest. Furthermore, the development and recommendations of these tax strategies have often been accompanied by “success fees.” In turn, these strategies, if implemented, were often then subject to an audit by the firm. This practice, in our opinion, is highly undesirable. The firms’ need for impartiality in conduct of the audit is in direct conflict with the financial incentives to provide tax strategies and products which themselves must be audited.

The Commission does not believe that there is a conflict of interest in a public accounting firm providing certain income tax and other services, such as preparing tax returns for corporations, provided that these services do not place the auditor in the role of acting as advocate for the company.

### Specific Best Practice Suggestion

1. Public accounting firms should limit their services to performing audits for clients and closely related services that do not put the auditor in an advocacy position, such as novel and debatable tax strategies and products that involve income tax shelters and extensive off-shore partnerships or affiliates.

**PRINCIPLE VII: THE BUSINESS MODEL OF ACCOUNTING FIRMS** 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.

American business and the capital markets depend importantly on the credibility of what are now only the “Big Four” accounting firms. The financial statements for over 80 percent of the public companies in the United States are audited by these four firms, and, accordingly, our focus is on these firms.

The high-profile auditing failures over the last few years have caused the public to question whether or not the Big Four are producing quality audits. We believe that to restore the public’s trust, the four firms must rethink all aspects of their business models and practices to ensure that providing quality audits is their number one goal. The Big Four must be sure they each represent a “gold standard” in auditing. The Sarbanes-Oxley Act is an important and necessary step to mandate appropriate oversight on the public company audits of the firms, but other serious questions remain about the business models of the firms.

During the last decade, there was a rapid consolidation of the eight major auditing firms into the four conglomerates that currently dominate auditing for public companies in the United States and internationally.<sup>62</sup>

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62 The Act requires that the Government Accounting Office conduct a study by August, 2003, which will include, among other matters, identification of factors that have led to the consolidation of public accounting firms since 1989, the impact of such consolidation, and solutions to any problems caused by such consolidation.

This dramatic consolidation resulted in huge firms with, in some cases, over 100,000 employees.

Since this consolidation, we have witnessed some of the most extraordinary collapses and accounting restatements in corporate history. For example, WorldCom filed for bankruptcy following the discovery of billions of dollars of transactions that were improperly recorded and went undetected by its auditors; Adelphia filed for bankruptcy following the discovery of improperly disclosed loans; Enron filed for bankruptcy, in part, because it improperly accounted for unconsolidated special purpose entities. In a number of the other recent high-profile examples of corporate failures and scandals, the effectiveness of the outside auditors has also been called into serious question.

Separate from the question of whether providing consulting services to an audit client compromises the auditor’s independence, we believe that the recent events demand answers to the following questions:

1. Is the huge financial conglomerate the right business model for firms providing professional audit work? Can huge auditing firms be managed in a way to ensure quality audits?
2. Can a culture of professional values be maintained in organizations that, in some cases, have over 100,000 employees?
3. Should the Big Four firms be engaged in various businesses other than auditing?
4. Should the Big Four strengthen their national control mechanisms to help ensure quality audits?

### Specific Best Practice Suggestion

1. The business model, strategies and focus of the Big Four should ensure that quality audits are their number one priority. The Big Four must be sure that they each represent a “gold standard” in auditing.

# Report of the Subcommittee of the Commission

Commissioners Biggs, Bogle, Bowsher, Levitt and Volcker (referred to below as “the Subcommittee”) believe that the recent high-profile auditing failures require us to also 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 views expressed below are those of the Subcommittee.

The adoption of accounting principles always requires that a balance be achieved between soliciting other opinions, on the one hand, and timeliness in responding to important issues, on the other hand. Although exposure drafts, public hearings, and comments by various constituencies (e.g., preparers, auditors and users) are all important, the rapid emergence of financial instruments and accounting practices in the U.S. require timely responses from those who set accounting standards. For example, efficient capital markets cannot tolerate a four-year delay for the publication of an over 600-page statement on derivatives or a 20-year delay for the publication of a standard relating to off-balance sheet, special purpose entities. Even a full year to respond to stock option accounting is too long given the significant work and research that has been done in this field over the last decade. We acknowledge the role played by market participants in the opposition to these projects and that this opposition delayed a timely completion of the accounting standards. However, we believe that the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) must give greater recognition to the need for timely responses to important accounting issues.

We also believe that some of the recent failures in accounting were the result of a narrow technical compliance with specific rules rather than reasonable judgment made by audit and accounting professionals within a context of significant and more simply stated principles. Therefore, we urge the FASB and the IASB to continue to consider moving toward a “principles” rather than “rules” based approach to audit opinions. In considering a “principles-based” approach, the overall objective of accounting standards should be to reflect the actual underlying economics of the business transactions in the financial statements. Principles-based standards should, if adopted, require that there be some level of implementation guidance necessary to ensure comparable reporting by companies for similar transactions, a hallmark of the American capital markets. The use of principles-based accounting standards should, if adopted, also require that accounting standard setters eliminate alternative accounting treatments that are inconsistent with the fundamental principles—a system which in the past has resulted in a greater need for detailed rules for many permitted exceptions.<sup>63</sup>

Global capital markets could be made more efficient if accounting standards were harmonized on a world-wide basis. We strongly support both the emphasis on convergence between U.S. and the global standards and significant improvement in both bodies of standards. We applaud the efforts of the leadership of FASB and the IASB toward finding common ground on higher quality standards so that the infrastructure of our global economy can advance towards an integrated international capital market.

In this regard, we further recommend that the SEC, the new Public Corporation Accounting Oversight Board (PCAOB), and the Financial Accounting Foundation<sup>64</sup>

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63 Commissioners Volcker, as Chairman of the Trustees of the International Accounting Committee Foundation (IACF), and Biggs, as Trustee of the IACF, did not participate in discussions regarding an appropriate approach to accounting standards, which will be determined by the Independent Accounting Standards Board appointed by the Trustees.

64 The Financial Accounting Foundation is the organization that appoints members of FASB and oversees its operations and funding.

(FAF) find a way to finance the American share of the International Accounting Standards Board Foundation (IASBF) through the issuer assessments established under the Act. The international financial community is encouraged also to adopt such a funding mechanism. The heavy reliance on funds contributed by the accounting firms and by corporations may create eventually the same “constituency” mentality for the IASBF that we have now taken steps to eliminate in the FAF. The need for a sound international process for global standards is as important to American companies as a sound process for U.S. standard setting.

Finally, we believe that the FAF should reconsider its composition, role, and function in the light of the new financing arrangement provided by the Act, which requires that public companies pay accounting support fees to support the annual budgets of the PCAOB and the FASB.<sup>65</sup> Much of the need in the original function of the FAF as a constituency board organization arose from the requirement to raise funds from accounting firms (auditors) and the corporate community (preparers). The dangers of a “constituency” based board can be illustrated by a recent vote by the Emerging Issues Task Force that was reportedly decided by the vote of a task-force member who was an employee of one of the major banks that had a constituent interest in one of the issues.<sup>66</sup> “Constituency” based boards tend to reflect the interests of the constituents involved. Although constituencies may bring legitimate points of view to the process, when constituencies attempt to influence the process through political pressure, the process is unable to work effectively. We have seen clear examples where political pressures have unduly influenced professional

judgment. In light of the Act, which provides adequate support through issuer fees for the FAF’s funding, we believe that a smaller FAF board with no particular constituency requirement is now possible.

### Recommendations Relating to the Adoption of Accounting Principles

We believe that the following recommendations would 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:

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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<sup>65</sup> The FAF has 16 trustees, 11 of whom are nominated by constituent organizations and five of whom are elected “at large” by the FAF’s trustees. Financial Accounting Foundation, press release dated July 25, 2002.

<sup>66</sup> According to the *Wall Street Journal*, at a June 2002 meeting of the Emerging Issues Task Force, a task force member voted on an issue that may have posed a conflict of interest. The article noted that critics of the process of adopting accounting principles argue that “it’s a process rife with conflicts of interest, at the expense of investor protection.” Jonathan Weil, “Heard on the Street,” *The Wall Street Journal*, October 8, 2002.

Appendix:  
**Excerpts from the Sarbanes–Oxley Act**

**Section 302—CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTS**

(a) REGULATIONS REQUIRED—The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—

- (1) the signing officer has reviewed the report;
- (2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- (3) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
- (4) the signing officers—
  - (A) are responsible for establishing and maintaining internal controls;
  - (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
  - (C) have evaluated the effectiveness of the issuer’s internal controls as of a date within 90 days prior to the report; and

(D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;

(5) the signing officers have disclosed to the issuer’s auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—

(A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer’s ability to record, process, summarize, and report financial data and have identified for the issuer’s auditors any material weaknesses in internal controls; and

(B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer’s internal controls; and

(6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

(b) FOREIGN REINCORPORATIONS HAVE NO EFFECT—Nothing in this section 302 shall be interpreted or applied in any way to allow any issuer to lessen the legal force of the statement required under this section 302, by an issuer having reincorporated or having engaged in any other transaction that resulted in the transfer of the corporate domicile or offices of the issuer from inside the United States to outside of the United States.

(c) DEADLINE—The rules required by subsection (a) shall be effective not later than 30 days after the date of enactment of this Act.

#### **Section 404—MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS**

(a) **RULES REQUIRED**—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) **INTERNAL CONTROL EVALUATION AND REPORTING**—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

#### **Section 407—DISCLOSURE OF AUDIT COMMITTEE FINANCIAL EXPERT**

(a) **RULES DEFINING ‘FINANCIAL EXPERT’**—The Commission shall issue rules, as necessary or appropriate in the public interest and consistent with the protection of investors, to require each issuer, together with periodic reports required pursuant to sections 13(a) and 15(d) of the Securities Exchange Act of 1934, to disclose whether or not, and if not, the reasons therefore, the audit committee of that issuer is composed of at least one member who is a financial expert, as such term is defined by the Commission.

(b) **CONSIDERATIONS**—In defining the term ‘financial expert’ for purposes of subsection (a), the Commission shall consider whether a person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions—

(1) an understanding of generally accepted accounting principles and financial statements;

(2) experience in—

(A) the preparation or auditing of financial statements of generally comparable issuers; and

(B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;

(3) experience with internal accounting controls; and

(4) an understanding of audit committee functions.

(c) **DEADLINE FOR RULEMAKING**—The Commission shall—

(1) propose rules to implement this section, not later than 90 days after the date of enactment of this Act; and

(2) issue final rules to implement this section, not later than 180 days after that date of enactment.

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