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## DANGEROUS THOUGHTS ON CORPORATE GOVERNANCE

*Corporate* governance lends itself to conventional wisdom -- beliefs and measures that rapidly fossilize into certainties. But freethinking, unconventional wisdom offers lessons as well. Consider the following outrageous ideas:

-- *We should be concerned if there is too little corporate crime.* Visionary, outside-the-box business ideas are tricky, dangerous things. They create whole new industries and business models… as well as brilliantly innovative ways for executives to cheat shareholders. We forget that, before Enron destroyed billions in shareholder value, it leaders used the same guile and creativity to build those billions. I don't know if Ken Lay or Bernie Ebbers will ever be rehabilitated as business school models. Still, we should ask if grand, breathtaking business scams are merely the dark side of an oversized business innovation wave – and the lack of such scams a hint that innovation is in retreat.

-- *Principles-based vs. rules-based accounting.* The former, common in most developed economies (Great Britain, for example), is an accounting and audit culture that judges positions on whether they fairly reflect company results. Rules-based accounting, the US system, lays out an ever-growing body of specific laws (which then invites people to cook up new work arounds). The US system comes in for much abuse, but if we recast "principles vs. rules" as "subjective vs. objective" we can see why it remains popular here. Americans love government based on "laws, not men," without subjective judgment calls, and this applies to their accounting. Being able to say "if there's no rule against it, why not?" no doubt leads to some mischief -- but also to much innovation

– ***RDW***

## 4 TIPS FOR USING THE SOX 404 DELAY

In September the US Securities and Exchange Commission voted to delay Sarbanes-Oxley Section 404 compliance for smaller companies for one more year, until fiscal years starting on or after July 15, 2007. How can your company (and your audit committee) best use this extra year?

- Ask management for a long-term compliance plan that makes use of the extra time. Mike Rhodes, director of corporate governance at Citrin Cooperman, says that "whenever deadlines are extended, things tend to fall by the wayside, and no one looks at the program until the new deadline hits." Ask management for their timeline that prioritizes risks and evaluates the resources needed. "The audit committee needs to say let's see your new plan, and then monitor it."
- Ask tough, specific questions of management. What are the most complex accounting issues that need to be addressed? Where is the most manual bookkeeping going on (a key issue with some smaller companies)? What legacy systems are in place that will need to be upgraded?
- Here's a little-noted bonus smaller corps can gain from the extra year. Accelerated filers, the big guys, are already wrestling with 404 issues, and now your compliance people have extra time to see what their biggest mistakes (and smartest solutions) are. Benchmarking on the early filers can save you much time, effort and trouble.
- Keep your pending 404 certification needs in line with other new disclosure requirements. Mike Rhodes points out that your company already needs to file certifications under Section 302, so you may have some of the 404 groundwork in place and not be using it to full advantage.

## THE SEPARATE CHAIR VS. THE CEO/CHAIR

The past few years have seen a revolution in board leadership, and, as with most revolutions, those at the vanguard are forced to make up many of the rules as they go along. The role of a separate chair or lead

director has quickly become the norm, but how are their roles jobs different from those of a traditional CEO/chair?

- The board gains a distinct spokesman. The reality of a CEO/chair is that this person will always be a management-side person dealing with the board as a part-time distraction. The separate chair gives the board its own voice, with legal strength that's hard to ignore.
- Within the board meeting itself, a division between the CEO and chair roles brings out the different elements that go into chairing a board. Management reports and explanations tended to meld seamlessly into parliamentary business and votes with a CEO chair. But a separate chair tends to break the board housekeeping away from the discussion elements. This can be a positive by divorcing the person who pitches an idea from the one who leads debate on it. However, if the separate chair is too deferential, speeding straight from the CEO's discussion into a vote, much of the value of a separate chair is lost. "An independent chair can still be allied with the CEO, who is pushing an agenda" says Madeline Condit, a senior client partner with KornFerry.
- Condit sees little functional difference in how separate chairs operate, although there may be "more attention to board structure" with an independent board leader. This makes good sense. A CEO, even a progressive one, tends to view the board as an (often expensive) necessity for public company status. A separate chair, while perhaps not "empire building," will tend to organize a board and committee structure that serves primarily as an effective governance tool.
- Related to the above, a separate chair has more motivation to make full use of each member of the board, prompting them to be active in discussion. A separate chair works to "ensure that directors express their views, and that the board gets the most out of them" observes Shelia Penrose, board chair at Jones Lang LaSalle and a member of 2 other boards. The outside directors are the separate chair's backup in the boardroom, and it's in his or her interest that they not be wallflowers.
- Penrose also notes that a separate chair takes the "power of the agenda" out of executive hands, letting the board itself decide how much time to allot to an issue, what goes first, and who from management presents to the board. For this power to be workable, though, the chair needs close, regular contact with managers below the CEO level – and with the CEO himself. "The CEO and separate chair must work well together, and that requires lots of trust and mutual respect."

## AUDITOR CONFLICT? QUESTIONS YOUR COMMITTEE MUST ASK

In recent comments, the SEC's deputy chief accountant Andrew Bailey noted that the commission will be taking a closer look at more subtle independence conflicts outside auditors may have with a company -- and that they consider the board's audit committee a key gatekeeper on this issue. So what are some of these "hidden auditor conflicts your board should be asking about?

- Third-party conflicts. Perhaps your audit firm is doing nothing more than your basic audit services, or any non-audit work is certified and minor. But what if your company gets tax-planning advice from another firm that's affiliated with the auditor? How about if your company and the audit firm both sell services to the same third party? Ask the auditor to look into any such "degree of separation" conflicts.
- "Boilerplate" versus "bespoke" services. Kim Stephen, a partner with the firm of Graham, Dunn, notes that audit committees may OK some tax work with a client if the work uses pre-packaged software of service plans the auditor offers to anyone. But watch out for attempts to "customize" the software to your company's specific needs. If that happens, "the auditor is essentially providing you with tax services," she warns -- and potential conflict looms.
- This preapproval of non-audit services by the committee can lead to further landmines, notes Stephen. "The committee may think it can give a blanket OK for non-audit services at the beginning of the year and everything will be covered." Not so fast -- "in fact, the committee needs to address each specific issue."
- Potential conflicts extend to personnel, and the audit committee must be watchful on this. Particularly in smaller markets, companies tend to hire new finance personnel, such as controllers, from the audit firm they've worked with because they know the company. Your committee needs to quiz both inside counsel and the audit firm on exactly how long this staffer needs to be off your account (and how far off) to avoid any conflict.

## ANNUAL MEETINGS -WHO DOES WHAT

Spring may seem a long time away, but now is the time for the board to look at management's annual meeting plans. The Society of Corporate Secretaries and Governance Professionals is always a great resource for info on the nuts-and-bolts of good governance, and their recently released survey of annual meeting practices is no exception. Among the findings:

- 47 percent of companies have a policy that requires directors to attend the annual meeting.
- 81 percent of companies disclose how many directors attend the annual meeting.
- New York continues to be the most popular city to hold annual meetings, with 14 companies holding their annual meeting there in 2005, followed closely by Houston (13) and Chicago (8).
- The most popular month to hold annual meetings is May, with 100 meetings scheduled to take place, followed by April, with 83 meetings scheduled.
- The most favored location for holding annual meetings is at corporate headquarters (36%) followed by a hotel (32%).
- Most annual meetings are held in the morning (76%). 10:00 a.m. is the preferred start time, (33%), followed by 9:00 a.m. (13%), 9:30 a.m. and 11:00 a.m. (both 8%).
- 75 percent of companies submit the selection of auditors on a routine basis at the annual meeting, with 116 submissions calling for ratification of the auditors, 16 for appointment and 4 for election.
- Seventy-two companies are making their annual meetings available on the internet. Thirty-six of those companies are planning a "live" broadcast, twenty are permitting viewing senior management's presentation and six are including annual meeting highlights.
- 23 percent of respondents plan to streamline their annual meeting by one or more of the following: eliminate video presentation, not serve lunch or refreshments, shorten the script, not use motions or seconders, no chairman's speech, short welcome by the chairman, and shorten discussion of financial results.

## Q&A: What Makes the Board Meeting Different?

**Q**: *"I've had a good year -- some months back I was named CFO of our firm, and now I've been asked to join the board of a major regional financial services firm. But, while I think I've proven I'm well qualified for the former, I have some nagging doubts about the latter Though I've had more experience in corporate meetings than I care to remember, I've had almost zero involvement with boards before taking my current position. This may sound basic, but… how is boardroom dialogue different from that in other corporate meetings?"*

**A**: Your question is a good one, because the board of directors truly is a different world. "The scope of understanding is different," says George Torok, a speech coach for executives based in Ontario. Although it seems obvious to say that the board works at a higher, strategic level than of a more tactical management meeting, outside board members can actually find this liberating. "When board members are talking to board members, it's different from when managers meet. Managers have to defend their turf, but the board can be beyond that." Most top-level management meetings involve battles over resources, seeking credit for successes (or avoiding blame for failures) and general politicking. As a director, you're not (or shouldn't be) feeling personal turf at risk in the meeting.

Still, directors today face more personal risk than they had a few years ago, says Dr. Kerry Sulkowicz, founder of the Boswell Group corporate psychology firm in New York, and this prompts more probing questions than would have been seemly pre-Enron. "Directors have skin in the game, but it's different skin than that of managers." Sulkowicz also points to the most distinctive way a board meeting looks and sounds different from a management meeting – the level of formality. "These are people who only get together a few times a year, and the meetings tend to be tightly scripted."

## UPCOMING IN *BOARDROOM INSIDER*…..

- *WHO MAKES THE BEST SEPARATE CHAIRMAN?*
- *DEFINING A BOARD "VACANCY"*
- *DO YOU KNOW WHERE YOUR GOVERNANCE RECORDS ARE?*

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**RALPH WARD'S BOARDROOM INSIDER** is published monthly for directors, CEOs, those who work with corporate and nonprofit boards (corporate secretaries, corporate counsel, support staff, and consultants), and those who are board prospects. Ralph D. Ward is author of the books *SAVING THE CORPORATE BOARD* (John Wiley & Sons, 2003), *IMPROVING THE CORPORATE BOARD* (2000) and *21st CENTURY CORPORATE BOARD* (1997), and a speaker on corporate board issues.

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