

# FT Mastering Corporate governance

**PART TWO**  
of a four-part weekly series

Friday May 27 2005

In association with **ERNST & YOUNG**  
Quality In Everything We Do



## A blueprint for good governance

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JAY LORSCH

# Building better boards by design

Important board decisions are often hampered by constraints of time, knowledge and group process. To address these difficulties, directors need to pay careful attention to performance, leadership and structural issues

**F**or 20 years, I have been observing and working in boardrooms, as a director in the US and Europe, as a consultant to boards in those continents and Latin America, and as a researcher and author. I have also been leading education programmes for corporate board members at Harvard Business School for the past decade.

My perspective on the current state of boards is that there has been a significant improvement in their functioning in the past two decades. New laws, regulations, guidelines and rising investor and public expectations have had a positive impact. The great majority of boards are less under the thumb of their CEOs than they once were, and are seriously trying to govern their companies. A set of best practices has emerged that are documented in country corporate governance codes, stock exchange listing requirements and company annual reports.

For sure, boards are being asked to do more because of these new expectations. It is also true that too many of these demands focus on matters that are visible from public documents but are not central to what actually takes place in boardrooms. Nevertheless, I find individual directors are willing to accept these additional duties and spend more time on them. Further, I see no evidence that there is a shortage of suitable new candidates for board seats.

This is all good news. However, because so many directors are trying to do more and do it better, they are also frustrated by difficulties that they encounter. The most common concern I hear is: "We don't spend enough time considering and dealing

with company strategy." Obviously, this is related to a second worry: "We are spending too much time focused on issues related to complying with new laws and rules." This is a particular concern in the US because of the Sarbanes-Oxley Act. Directors are also often troubled that they are so regularly criticised about their CEO's compensation. Finally, they often admit that the trend to bring in more new CEOs from outside is the result of their failure to do an adequate job in ensuring sound management development and succession planning. All these concerns are important because they are about matters that directors consider their core responsibilities.

## ◆ Limits on board effectiveness

Boards are experiencing these difficulties for several reasons. The first is the increasing emphasis on independent directors. While the precise definition of independence varies from country to country, as does the desired proportion of such directors on each board, the basic idea is the same. Most directors should not have any other connection with the company, past or present.

The goal, which certainly is a worthy one, is to ensure that boards are objective and have no conflicts of interest. However, the problem is that, with this emphasis on independence, boards are usually made up of directors with little current or past knowledge about their company's industry or businesses. Further, independent directors are truly part-timers. They have other day jobs that limit the time they can realistically devote to each board. Consequently, well-intentioned directors find that they have insufficient time and

knowledge to perform their jobs well.

A director's lack of knowledge is complicated by another problem – the quality of information they receive from management. Oddly, it is not that they receive too little, but that they receive too much, which is often poorly organised and does not illuminate the most significant issues.

Another problem is that boards are often unclear about what role they should be undertaking and, in most countries, their legal duties and responsibilities are broad and vague. The one exception is Germany, where laws are quite specific, but boards there have other difficulties because of their size and the emphasis on co-determination.

Rather than considering carefully what their focuses should be, too many boards simply do what they have always been doing, and respond reflexively to new requirements, such as the Sarbanes-Oxley Act, without explicit attention to how to deal with the additional duties. As a result, directors lack clarity of purpose.

As the old saying goes: "If you don't know where you are going, any road will get you there." This is the problem too many boards have. They have no clear criteria to use in determining how to allocate their precious time together. Rather, they focus on whatever issues management feels are most pressing and on what they have traditionally done.

A third problem stems from the basic fact that boards are groups of individuals who must work cooperatively to get things done. The advantage of having many individuals on a board is that there should be diverse perspectives, healthy debate and sound decisions. The difficulty, as anyone who has worked in a group setting or studied social psychology will immediately recognise, is that effective group decision-making takes time and requires skilful leadership.

Achieving effective leadership is a complicated and related matter. First, there is the question of whether the board chair and the CEO should be two individuals (as they are in most European, Australian and Canadian companies) or whether the functions should be performed by the same individual (as is common in the US). My own view is that either structure is workable, but

the roles and responsibilities must be clearly defined and agreed.

Regardless of the structure, the person who is in the chair often has difficulty creating agendas and leading discussions to reach consensus in the time available. To some extent, this may be due to a lack of leadership skill on the part of chairs, but I think the more important reason is that all board members legally are equal and they expect to be treated that way by each other. This makes it hard for a chair to control the meetings effectively and requires self-discipline on the part of all the members.

## ◆ Board concerns and their causes

These impediments to board effectiveness underlie the concerns that so many directors express. For example, complaints that too much time is being spent on compliance and not enough on matters of strategy usually arise because the board has not paid explicit attention to its role. As boards are asked to do more, they simply try to cram more into the same size container, and this does not work.

Additionally, because boards are unclear about their role, directors' complaints about lack of strategic involvement, while heartfelt, are unclear and vague. How do they want to be involved in strategy? What contribution to strategic decisions do they have the knowledge to make? Where should the line be drawn between the board and management on strategic matters? How can the board provide effective oversight of the company's strategic direction and progress within the limits of time and knowledge? All are important questions that are too rarely addressed.

I recently encountered an example of this with the board of a financial services company that operates in several distinct businesses. Because almost all the directors were independent, they were unfamiliar with the complexities of these financial service businesses and their underlying economics. Further, the information that management was providing, while well intentioned, was complex and not well organised. On top of all



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this, the board was intent on complying with the requirements of the Sarbanes-Oxley Act. The directors were frustrated and anxious to get more involved in strategy, but unclear how to do so in the time available and with their limited understanding of the company's businesses.

### ◆ Succession planning

While there are a few examples of companies (and boards) that handle management succession well, such as General Electric and Unilever, these are certainly the exceptions. In my experience, when directors complain that they do not effectively monitor management development and succession, the problem is not that they are unclear about the role they should play. Rather, the difficulty is that the topic is not properly addressed due to the constraints of time. It is a longer-term issue and its consideration can always be postponed because of more urgent matters.

For example, on one board with which I am familiar, the question of how to ensure a smooth transition between the current CEO and the next initially came up at meetings five years before the incumbent's retirement. The topic was put on the agenda of meeting after meeting, but it always was squeezed out by a new acquisition opportunity, or a crisis in a particular business. Suddenly, or so it seemed to the board, the old CEO was going to retire in 18 months, and there was only one internal candidate that he believed could replace him. The other directors did not consider his candidate satisfactory, but they had done nothing in the previous years to address the issue. Not surprisingly, the situation evolved into a bitter dispute between the CEO and the rest of the board.

The root cause of the problem was simply that the topic, which all recognised was the board's responsibility, was never given priority. It is also true that the lack of time to address this issue (as so often happens) was the result of allowing other discussions to wander about with little or no attempt by the chairman to keep them on track and the inability of other directors to help manage the boardroom dialogue.

### ◆ Executive compensation

The issue of executive compensation can also be a problem for boards. Many reasons have been put forward to explain why boards end up rewarding their CEOs so richly. Some even suggest that directors, who are themselves CEOs, conspire to make sure that the CEO in question is highly compensated, so that the general level of pay for corporate leaders keeps rising. Perhaps such things go on in some compensation committees and boardrooms, but I have not seen them.

In my experience, the causes are more subtle. The directors involved in compensation decisions, even if technically independent, often find their independence is hard to sustain psychologically. They know their CEO

and other top managers from working with them over years of board service. They appreciate the efforts they have put in and the results they have achieved and they want to reward them for their efforts as well as their results. In deciding what is the "right" amount, they usually have only one source of information – the "market surveys" provided by compensation consultants, which are usually flawed because they do not recognise company performance. Further, since the survey information is always organised by quartile, it is difficult for any director to recommend that his CEO should fall below the mean of other CEOs. So we end up with almost all CEOs being in the top half, and more than 25 per cent being in the top quar-

worse unless we can find a way to get directors to step back and reflect together on how they can be more effective and efficient. Fortunately, there is good news on this front. Some new regulations, such as the NYSE and Nasdaq listing requirements in the US and the Combined Code in the UK, are requiring boards to undertake a self-evaluation of their performance on an annual basis. Elsewhere, many boards are doing this on their own initiative. These assessments are like an annual physical exam. The purpose is to identify problems and what should be done about them. They also enable directors to identify opportunities to work together more effectively. I have been involved in many such assess-



tile. As a result, CEO and executive pay in general keeps rising.

A further problem arises because directors, despite having this connection with management, are too often not aware of the desire of shareholders. In essence, there is an information asymmetry. Directors understand and empathise with what top executives expect but are less aware of shareholder concerns. In the UK, where shareholders are now given an advisory vote on the past year's director compensation, this has changed, as directors at GlaxoSmithKline, WPP and some other UK companies will doubtless confirm.

### ◆ Board design

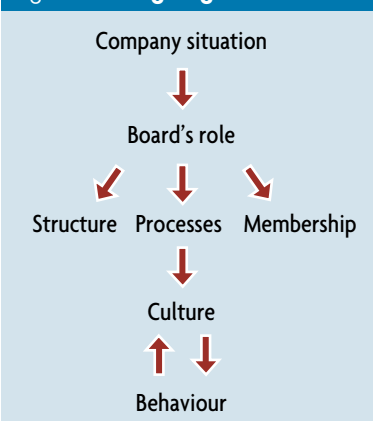
It seems clear that the constraints of time, knowledge and group process make it difficult for many boards to accomplish what the public and shareholders expect of them, and what they, themselves, are trying to do. In my judgment, all the new rules and guidelines in the world will not solve such problems. Rather, the key to improving the board's capacity to deal with such problems rests in the hands of each board.

These difficulties are likely to get

ments and I am confident that they can be powerful catalysts for board improvement.

In the case of boards, what is needed is attention to the way the board has been designed and how that design can be improved (see figure 1). The first consideration, as I have already emphasised, must be what role the board wants to play in major issues, such as ensuring compliance to laws, principles and regulations, involvement in strategic questions, and in ensuring healthy management development and succession.

Figure 1 Designing the board



Consideration of the board's role involves being explicit about which decisions the board should take and which should be the purview of management. It also involves understanding which aspects of company and management performance the board intends to monitor. These are matters that should be considered periodically – perhaps every few years – as company and management circumstances change. Once the board has a clearer understanding of what it wants to accomplish, it then becomes possible to clarify other aspects of its design.

Design choices begin with the size of the board, the proportion of management and independent directors, and the mix of talent and experience the board needs. Explicit attention must be paid to the question of what directors need to know for a board to be effective.

Boards also need to consider their leadership structure – for example, whether they have one person as CEO and chair or two, whether there is a lead director and what the role of com-

**“Boards are often unclear about what role they should be undertaking and, in most countries, their duties are broad and vague”**

mittee chairs should be. Of course, this also includes the matter of which committees the board needs – just those required, or others additionally.

Decisions also need to be made about the length and number of meetings, including those of independent directors in the absence of executives. This, of course, depends on the role the board wants to play and the fullness of meeting agendas. A process must be defined for how the annual cycle of the board's business is to be defined and by whom, and also who will determine the agenda for each meeting.

Design should also include explicit and thoughtful attention to what information the directors need in order to play their role, and when it will be transmitted. Attention must also be given to how to organise the information, so that busy directors can comprehend what is happening within the limits of the available time.

Finally, when I speak about design, this includes explicit consideration of the best procedures for the board to use in handling its major tasks – approving and assessing strategies, evaluation of the CEO and ensuring compliance with laws and regulations.

Making all these choices may seem like a large effort for a group of people who already feel overtaxed. However, in my experience, it is always a pleasant surprise how quickly directors can agree on these matters. And in any case, the improved results always seem to be worth the effort.

RUTH AGUILERA &amp; GEORGE YIP

# Global strategy faces local constraints

Variations in national corporate governance systems and the degree to which groups of stakeholders influence strategy decisions can have a substantial impact on a company's efforts to look beyond its borders

**C**orporate governance systems vary across countries, and these differences directly affect both the process for developing global strategies and the kinds of strategies that can be adopted. In this article, we examine how different corporate governance systems might influence decisions about company globalisation and, in particular, decisions to take operations abroad.

Global strategy decisions pose a very tough test for the effectiveness of corporate governance systems in that they seek to maximise profits and global competitiveness, often at the expense, at least in the short term, of some corporate governance players. By definition, a global strategy means taking a global, rather than a single-country, view of strategy, and this can be hard for those players with strong ties to the company's home country. Moreover, some aspects of global strategy, particularly the overseas relocation of jobs, mean real sacrifices for some, especially employees.

## ◆ Players in corporate governance

We identify five critical stakeholder players that most affect the company's decisions about global strategy:

**Employees** and their collective organisations, such as unions and work councils, have various legislated, statutory, contractual or negotiated rights, such as employment conditions, that must be considered.

The **board of directors** is the ultimate governing body of an organisation and, as such, it must approve all company strategies, including global ones.

The **top management team** is charged with day-to-day responsibility for strategy and operations.

**Shareholders** exercise their voice through their shareholder rights, such as cumulative voting or proxy voting, but they can also exit the company by selling their shares if they do not agree with globalisation strategies or other decisions.

Finally, **governments** set and enforce the overall rules of national corporate governance; they design specific norms about international business, such as trade policies; and they can selectively intervene in individual globalisation decisions, such as moving operations abroad, or subsidising a given company because of its national strategic relevance. Supranational governments, such as the European Union, also play a role in regulating corporate governance, the consultation rights of workers, bankruptcy procedures and the like. We exclude other stakeholders, such as customers, suppliers and competitors, because they tend to be less involved with corporate governance.

## ◆ Cross-national differences

Corporate governance systems vary by country, as do the roles and power of the five corporate governance players. Figure 1 summarises these differences for some major countries and types of corporate governance systems: the "Anglo-American" systems of the US and UK; the "Continental" systems of Germany, France and Italy; and the "Extended" system of Japan.

In the rest of this article, we briefly describe the main characteristics of these corporate players across countries and their potential influence on global decision-making.

## ◆ Employees

Two main variables differentiate employees, as a collective group, across countries. First, the country's labour market will influence the flexibility and mobility of employees. Countries such as the US that have employment at will, whereby a contract can be terminated at any time, are likely to have flexible labour markets and short-term labour commitment. Generally, the consequence is that labour training is done outside the company and employees have general and portable skills.

In more rigid labour markets, such as Germany and Japan, companies invest a great deal in bespoke, in-house training, which tends to result



in more highly skilled labour forces and company-specific skills. These, in turn, are less transferable from one company to another.

Second, the strength of labour unions and unionisation rates varies from one country to another. For instance in France, where union rights are extended to all employees regardless of union affiliation, unionisation will have a much greater influence on corporate decision-making than in the US or UK, where only union members benefit from collective bargaining agreements. Japanese companies tend to have enterprise unionism, which leads to collective bargaining at the company level and grants a strong voice to employees.

We consider that employees who are less mobile and who have a

stronger voice within the company will get more involved in global strategy decisions. Generally speaking, these employees will seek to keep their jobs domestically as opposed to moving them around the globe.

In 2004 for example, employee opposition to job losses prevented the restructuring, via a merger with a foreign partner, of France's financially troubled Alstom, a major producer of ships and trains. In the same year Volkswagen, despite suffering from very high labour costs, had to promise its western German employees job security until 2011 in exchange for a wage freeze until 2007 and more flexible working hours. The company's workers wield considerable power, partly through co-determination rights, which require employees to be consulted on corporate decisions.

## ◆ Top management teams

Cross-national variation in top management teams is mostly reflected in their functional background and their international experience, as well as the patterns of managerial career mobility. Managers in the US and UK tend to have professional backgrounds (often with formal business school education) and strong functional backgrounds in finance or marketing. This is not the case in Germany, where managers are more technically oriented. In France, managers often share a common *grandes écoles* background and ideology, frequently linking them back to government positions that they have previously held.

There is also variation in the international experience and background of managers, with US managers having the most foreign-born individuals in their management teams and France, Italy and Japan the least. Managerial career mobility tends to be very fluid in the US and UK due to open labour markets whereas, in Japan and France, managers tend to remain with a company for a long period of time.

The presence of foreign nationals and managers with prior international experience, combined with open labour markets, means that teams will be more likely to push global



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strategies. In the US, more and more companies have or had foreign-born CEOs, including Charles Bell of McDonald's, who is Australian, E. Neville Isdell of Coca-Cola, who is Irish, and Carlos Gutierrez of Kellogg's, who was born in Cuba. There is also wide acceptance of leaders from across borders in the UK – consider Americans Marjorie Scardino at Pearson and Rose Marie Bravo at Burberry, Indian-born Arun Sarin at Vodafone, and French-born Jean-Pierre Garnier at GlaxoSmithKline.

Conversely, management teams dominated by closed labour markets and ties to government, or founding or controlling family, will be more reluctant to engage in global strategies, mostly due to their preference for keeping control domestically. For example, Germany's Bertelsmann, one of the world's largest media companies, is controlled by the Mohn family. In 2002, the company fired its chief executive, Thomas Middelhoff, for pursuing global expansion strategies too vigorously and for what was perceived as an abrasive US-style approach to management. Middelhoff was replaced by Gunter Thielen, who had long-term ties to the Mohn family.

◆ Shareholders

Countries vary in their mix of types of shareholders. At one extreme, the US and UK have mostly arms-length, neutral shareholders, who are focused on shareholder value maximisation. Although many UK shareholders are large institutions, such as pension funds, these generally play passive roles, compared with the shareholder activism that arose in the US among institutional investors such as Calpers. Japan has plenty of institutional shareholders, but these tend not to be neutral and often act as part of a network, or *keiretsu*, that supports the role of the company and, hence, incumbent management. Germany's main trait is that banks play a leading role in influencing corporate policy at many companies, both as lenders and shareholders.

Employee shareholders typically use their ownership to block the global relocation of jobs. This applies even in the US where United Airlines provides a rare example of a large public company with majority ownership by its employees (55 per cent owned by an employee stock ownership plan). This employee stake and, hence, control have greatly constrained the ability of the airline to relocate jobs overseas. For example, United's flight attendants' union has been able to block plans to staff more flights from its lower-cost Taiwan base.

◆ Boards of directors

The composition of boards of directors also shows strong contrasts across countries. For instance, Japanese companies are renowned for having very large and inefficient boards, sometimes with more than 50 members. Japanese boards also have very few outsiders to monitor managers and the strategic direction of the company.

Italian and French boards are considered medium-sized, although still quite inefficient due to the lack of outsiders. Germany is unusual because it tends to have a wide variety of

Figure 1 Main characteristics of corporate governance players in six countries

	United States	United Kingdom	Germany	France	Italy	Japan
EMPLOYEES	<ul style="list-style-type: none"> <li>• Flexible labour</li> <li>• Low unionisation</li> <li>• Employment at will</li> </ul>	<ul style="list-style-type: none"> <li>• Flexible labour market</li> </ul>	<ul style="list-style-type: none"> <li>• Work councils</li> <li>• Co-determination</li> <li>• High skills</li> <li>• Non-flexible labour market</li> </ul>	<ul style="list-style-type: none"> <li>• Work councils</li> <li>• Low unionisation</li> <li>• Short-term contracts</li> </ul>	<ul style="list-style-type: none"> <li>• Long-term contracts</li> <li>• Rigid labour market</li> <li>• Medium skills</li> </ul>	<ul style="list-style-type: none"> <li>• Enterprise union</li> <li>• Life-time employment</li> <li>• Medium skills</li> </ul>
SHAREHOLDERS	<ul style="list-style-type: none"> <li>• Institutional investors and individuals</li> <li>• Dispersed</li> </ul>	<ul style="list-style-type: none"> <li>• Institutional investors</li> <li>• Dispersed</li> </ul>	<ul style="list-style-type: none"> <li>• Other non-financial companies</li> <li>• Banks</li> </ul>	<ul style="list-style-type: none"> <li>• Foreign investors</li> <li>• State</li> </ul>	<ul style="list-style-type: none"> <li>• State</li> <li>• Families</li> </ul>	<ul style="list-style-type: none"> <li>• Other non-financial firms</li> <li>• Banks</li> </ul>
GOVERNMENT	<ul style="list-style-type: none"> <li>• Liberal policies</li> <li>• Arms-length</li> <li>• Weak takeover barriers</li> </ul>	<ul style="list-style-type: none"> <li>• Liberal policies</li> <li>• Arms-length</li> <li>• Weak takeover</li> </ul>	<ul style="list-style-type: none"> <li>• Protectionist policies</li> <li>• Medium takeover barriers</li> </ul>	<ul style="list-style-type: none"> <li>• Protectionist policies</li> <li>• Interventionist</li> <li>• Medium takeover barriers</li> </ul>	<ul style="list-style-type: none"> <li>• Protectionist policies</li> <li>• Interventionist</li> <li>• Strong takeover barriers</li> </ul>	<ul style="list-style-type: none"> <li>• Protectionist policies</li> <li>• Strong takeover barriers</li> </ul>
BOARDS OF DIRECTORS	<ul style="list-style-type: none"> <li>• High activism</li> <li>• High % of outsiders due to investor pressure</li> </ul>	<ul style="list-style-type: none"> <li>• High activism</li> <li>• High % of outsiders determined by law</li> </ul>	<ul style="list-style-type: none"> <li>• Moderate activism</li> <li>• Stakeholders as a significant minority</li> <li>• Medium size</li> </ul>	<ul style="list-style-type: none"> <li>• Moderate activism</li> <li>• Minority outsiders</li> <li>• Medium size</li> </ul>	<ul style="list-style-type: none"> <li>• Low activism</li> <li>• Large % of insiders</li> <li>• Medium size</li> </ul>	<ul style="list-style-type: none"> <li>• Low activism</li> <li>• Large % of insiders</li> <li>• Large size</li> </ul>
TOP MANAGEMENT TEAM	<ul style="list-style-type: none"> <li>• Professional (Finance/MBA) background</li> <li>• Some foreign-born management</li> <li>• Open labour markets</li> </ul>	<ul style="list-style-type: none"> <li>• Semi-professional background</li> <li>• Some foreign-born management</li> <li>• Open labour markets</li> </ul>	<ul style="list-style-type: none"> <li>• Technical background</li> <li>• Few foreign-born managers</li> <li>• Closed labour markets (long term)</li> </ul>	<ul style="list-style-type: none"> <li>• Common educational backgrounds</li> <li>• State links</li> <li>• Few foreign-born managers</li> <li>• Closed labour markets (long term)</li> </ul>	<ul style="list-style-type: none"> <li>• Non-professional</li> <li>• No foreign-born management</li> <li>• Closed labour markets (long term)</li> </ul>	<ul style="list-style-type: none"> <li>• Common educational backgrounds</li> <li>• No foreign-born management</li> <li>• Closed labour markets (long-term)</li> </ul>

stakeholders represented in the upper (supervisory) board, such as employees, industrial banks and suppliers. In November 2004, a commission convened by BDA, the German employers association and BDI, the industry federation, concluded that the German co-determination system had become a hindrance to German companies operating internationally and a barrier to inward investment. It recommended changes to the laws, which were last revised in 1976. Under this proposal, individual companies would be free to choose a system of employee representation, taken from three options, ranging from retention of the current system to a looser consultation system separate from the supervisory board.

France Telecom provides an example of how board representation can be distorted by national interests. Although privatised in 1997, France Telecom still has significant intervention by the French government. Out of 15 members of the board of directors, only seven are elected by the shareholders meeting, while three represent employees and five members represent the French government.

The most active boards are in the UK and US, in part due to the enforcement of corporate law. In the UK, the Cadbury Report and subsequent codes of good governance have had a great deal of influence in designing efficient boards. In the US, the Sarbanes-Oxley Act of 2002 has also introduced pressure for a higher percentage of outsiders on boards.

◆ Government

Finally, countries also differ in terms of the degree of government intervention in their economies and protectionism of their markets. Government intervention is usually in the form of market regulation. A representative measure for government intervention in the economy is regulation around takeovers. The US and, to a lesser degree, the UK have weak takeover barriers and it is mostly up to individual companies to design anti-takeover measures. Conversely, in countries such as France, Germany, Italy and Japan, government intervention often provides strong takeover barriers, such as golden shares, which bestow on the holder veto power over changes to the company's charter.

The various hindrances to hostile

takeovers in many continental European countries continue to make it difficult for foreign companies to make acquisitions across borders in Europe. In 2001, plans for a European takeover code, which would guarantee the right of shareholders to be consulted during bids, were shelved following objections from the German government. The previous year Vodafone, the UK telecoms company, made a successful hostile bid for Mannesmann, a German telecoms company, and the German government was worried that other local companies might fall into foreign hands. For example, Volkswagen is protected from takeover by special law and the European code threatened to undermine this protection. Nevertheless, individual countries, including Germany, are now making gradual changes to make takeovers easier.

Sweden, which falls in the Continental governance model, is one of several countries that use multiple voting rights to help prevent its companies from becoming vulnerable to takeover. The Wallenberg family, for instance, owns only 7 per cent of Ericsson, the telecoms company, yet controls the company by owning a class of shares that carries 1,000 times the rights of ordinary shares.

France is also particularly active in preserving national ownership of major companies. In 2004, the French government brokered the takeover of Aventis, a French-German pharmaceutical company, by France's Sanofi-Synthelabo, while blocking a bid from Switzerland's Novartis. Similarly, France blocked Germany's Siemens from bidding for Alstom's railway operations, which manufacture the high-speed TGV trains.

◆ How managers can use their corporate governance systems

Top managers need to recognise that they are not in sole charge. Global (and other) strategy is an equilibrium game among corporate governance players. Managers need to work on building coalitions and aligning interests behind a common approach.

Assuming that you want to improve your use of global strategy, then how can you do this from the various countries? If you are a manager in an Anglo-American system, then you are generally in luck. Your country's corporate governance

system is a source of competitive advantage. A manager in a Continental system faces many constraints, especially from the legal involvement of employees. But, committed employees can also be a major source of global competitive advantage.

In the Continental system, managers have to align, trade off and meet other stakeholders' interests halfway. They have to craft their language and rhetoric to meet the other players' expectations. The watchwords here are consensus and social cohesion.

In the Extended (Japanese) system, companies have generally capitalised on their export-oriented model and high innovation driven by employee loyalty. But because of the rigidity of their corporate governance system, they have not exploited as much as

“Managers need to build coalitions and align interests behind a common approach”

they could the different dimensions of global strategy. We would recommend that the system becomes more open in terms of the diversity of the top management team and more flexible in their governance by introducing leaner boards as well as allowing greater levels of shareholder activism.

In sum, if governments care to sustain national competitiveness and to help their companies to globalise, then they should assess the degree to which the players in their corporate governance system are aligned with each other and with their intended global strategies. For example, France might need to upgrade its compensation policies to recruit and retain world-class talent in the top management teams of its global companies.

Government policies should also become less inimical to foreign owners and use such capital to provide the much-needed global knowledge. This can only be accomplished if the right mechanisms are in place to give a voice to these foreign owners. We think that governments have the responsibility as well as the policy tools to gear the country's corporate governance system so that it enhances national competitiveness.



DAVID LARCKER, SCOTT RICHARDSON AND İREM TUNA

# Ratings add fire to the governance debate

There is a widespread belief that good governance ratings generally lead to improved stock market performance. But is there any evidence to back up this assertion?

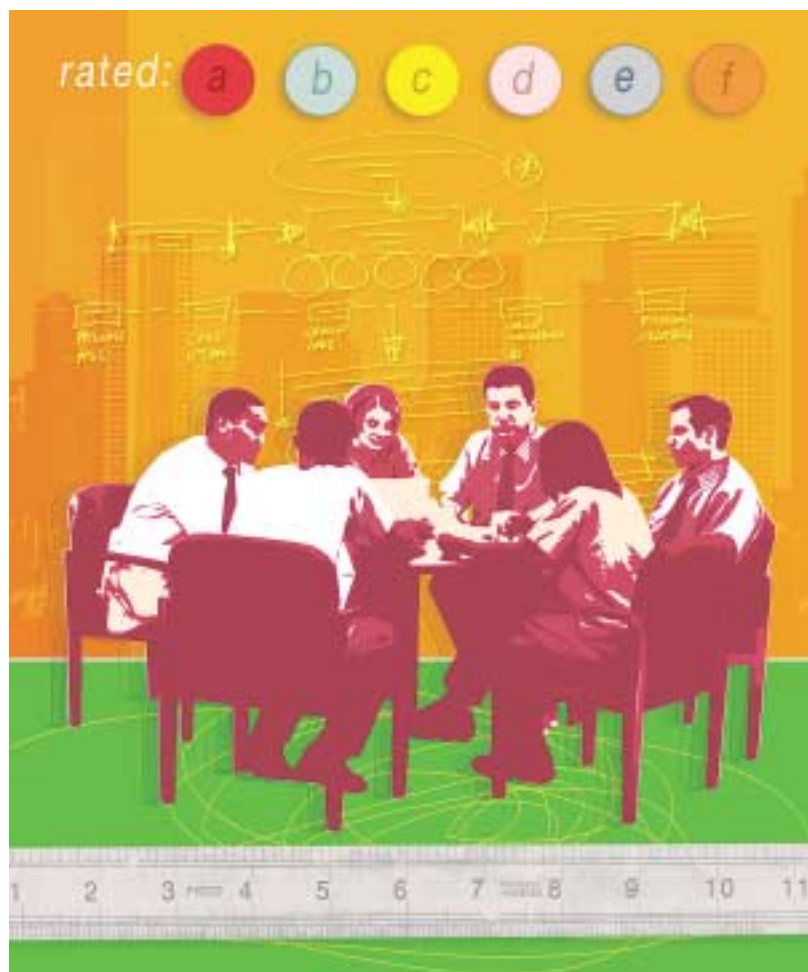
**W**hat is this thing called “corporate governance” that is occupying more and more time in the boardroom?

Does having more of it create value for stakeholders in the company? Are institutional activists, politicians, regulators and media pundits justified in their efforts to reform it? And are the costly changes they are proposing likely to be socially desirable?

Corporate governance clearly matters to shareholders, customers, employees and parties that interact with the company. Moreover, there is little doubt that governance mechanisms are a necessary and vital part of economic growth and the functioning of a liquid capital market.

The separation of ownership and control that characterises the structure of the corporation means that managers can potentially make self-serving decisions at the expense of stakeholders. It is therefore important to put in place a set of mechanisms to constrain such managerial decisions in a way that maximises the net benefits to stakeholders. As well as giving general protection to stakeholders, an appropriate governance structure should lead to better performance.

In order to understand whether there are indeed net benefits from corporate governance, it is necessary to take an agnostic and scientific look at the data and assess the merits of the claims made by the business press, ratings agencies and many others. For example, are companies with more



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independent directors on the board or a separate CEO and chair priced at a premium in the market? And do managers of these companies make higher-quality reporting, investing and financing decisions?

There is substantial variation in governance structures across different countries and even across companies within a country. One interpretation of this observation is that each company faces a unique set of problems and costs to institute various mechanisms, and thus a different governance structure is optimal. In other words, governance should not be considered a “one size fits all” proposition.

By contrast, there is a widely held belief among consultants, politicians and ratings agencies that there is a single, optimal governance structure, and that any company that deviates from this has a governance problem. This type of “boiler-plate” governance

benchmark is obviously simple to apply. At face value, recommendations such as the appointment of a majority of independent directors to the board and the separation of the roles of CEO and chair seem reasonable. However, adopting these “boiler-plate” recommendations is a costly process and it is far from clear whether these changes will produce better-managed companies as well as satisfy stakeholder objectives.

## ◆ Measuring corporate governance

Before attempting to assess the impact of governance or managerial decisions on company performance, it is necessary to come to grips with how to measure corporate governance. Can a complex structure of governance be reduced to a summary statistic? How does one go about identifying which of

the myriad governance mechanisms should be included?

As might be expected, researchers and ratings services use a multitude of measures. For example, the Institutional Shareholder Services Corporate Governance Quotient is based on 61 variables and the Governance Metrics International Corporate Governance Score is based on 450 data points. Regardless of the precise computation, most of the ratings examine factors related to board and committee structure, executive pay, anti-takeover provisions, concentration of equity ownership and other measures.

Any external assessment of the quality of corporate governance is limited to what can be observed. This means that the majority of measures captured by the various ratings agencies and academic research is based on characteristics, such as board structure and processes, disclosed executive compensation, distribution of ownership, various anti-takeover provisions and so on.

However, these simple measures do not include insights into the inner workings of the corporate board. There are no detailed interviews with management and board members to assess whether their objectives are consistent with stakeholder goals, and no assessment of whether various constituencies are directing the right questions to top management. As a result, ratings based on observable governance characteristics do not answer questions such as: “Are the number of board meetings, the composition of the board and sub-committees, the age of the directors and other structural measures sufficient to capture the complex nature of how an effective board should work?” Yet, these are the types of measures that are the focus of the business press, customers, employees, investors and regulators.

## ◆ Analysis of governance measures

We obtained data from four major intermediaries that specialise in rating corporate governance practices of companies: Governance Metrics International (GMI), Investor Responsibility Research Center (IRRC), Institutional Shareholder Services



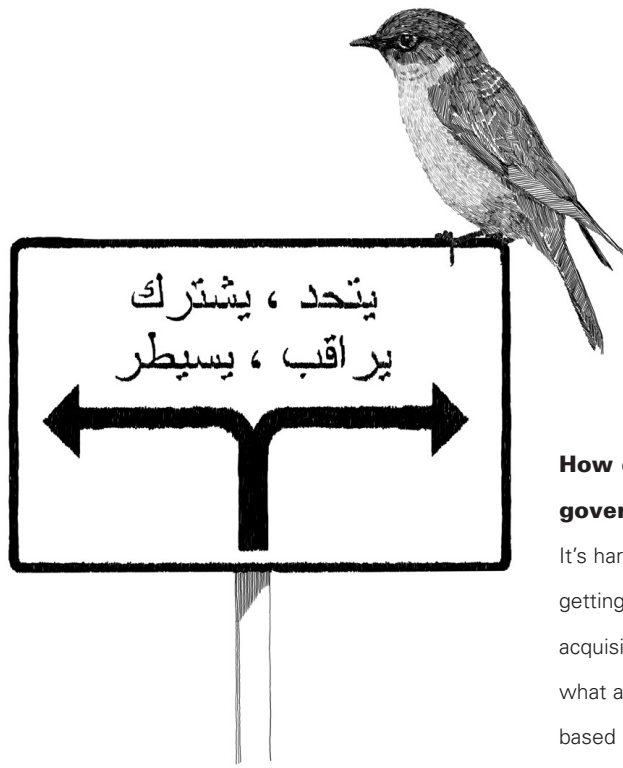
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### How do you say corporate governance in Djibouti?

It's hard enough to know what you're getting into with mergers and acquisitions in your own country. But what about when your new affiliate is based in Tadjoura? Or Turkmenistan? Or the Côte d'Ivoire? Just how much do you know about their corporate governance regulations?

Today, it's as important to know business regulations abroad as it is at home. Can your business deliver good governance across 42 different offices in 29 different countries? Ignorance simply isn't an excuse. The penalties for an innocent mistake can be severe.

As the world continues opening up to more and more opportunities, at Ernst & Young we think it's critical that people start talking about conformance and the impact the many other aspects of corporate governance are having on the way they do business. Whether governance regulations are central or marginal to your investment decisions, we believe it is an essential debate to have.

Effective corporate governance can lead to better controls, better market understanding, and ultimately, better performance. At Ernst & Young we believe a proper dialogue with all stakeholders is the key ingredient to delivering that value. And we think that's a conversation worth having.

But if that's something you're not interested in, just remember "غير مذنب". That's "not guilty" in Arabic. Just in case.

To carry on the conversation, visit us at [www.ey.com/conformance](http://www.ey.com/conformance)

(ISS) and The Corporate Library (TCL). For each of the agencies, we analysed the association between their ratings, and subsequent company operating performance and stock returns. A potential benefit of these measures is that they presumably reflect not only formal structural measures of governance but also the expertise of the analysts working for the ratings agencies.

Overall, the results of our analyses were similar regardless of the source of the ratings. We found no evidence that the summary ratings were associated with stock returns. Alternatively stated, an investment strategy based on the governance ratings was not a profitable one. We did, however, find some evidence that governance ratings are associated with the level of future operating performance. The

stock performance from July 1 in the year that the rating is disseminated through to June 30 the following year. TCL's analysts conduct their analysis in conjunction with other sources during the proxy season period (up to the middle of 2003 for the 2002 fiscal year). Therefore, examining stock returns for the period of July 1 2003 through to June 30 2004 will capture the 12-month period following the issuance of the TCL rating. We repeated this process for the three years for which we have data and rebalanced the portfolios every year on July 1.

In Figure 1, we illustrate the average returns that would have been earned for \$1 invested in companies with "good" ratings for board effectiveness and those with "bad" ratings. As is evident from our analysis, there is very little difference in the returns to an equity investor based on the TCL board effectiveness rating. Indeed, statistical tests revealed no difference between the two portfolios. We found a similar lack of stock return predictability for the composite ratings from GMI and ISS, as well as the shareholder rights provisions collected by IRRC.

A potential explanation for the stock return results is that the market correctly anticipates the future performance of "good" and "bad" governance companies, and thus there should be no differential stock price returns for these two groups. However, if governance is important to performance, we should be able to detect performance differences using measures of operating performance. Thus, a more direct way to assess performance is to see whether "good" governance companies have higher return on assets (that is, the ratio of operating income to total assets).

In our research, we examined the ability of the TCL board effectiveness ratings to predict both the change in and the level of one year-ahead return on assets. Consistent with our stock return results, we found no evidence that the TCL board effectiveness rating is associated with *change* in operating performance. We did, however, find some evidence that companies with "good" TCL ratings have a higher *level* of operating performance in the year following the release of the rating relative to those with "bad" ratings. Companies receiving a "good" TCL rating experienced higher return on assets in the order of 1.5 per cent in the year following the release of the board effectiveness rating.

Collectively, the evidence suggests that there may be a modest association between governance scores and future operating performance, but this association does not translate into future company value (as measured by changes in stock price).

While not necessarily damning of measures of governance, the lack of a robust pattern between popular governance ratings and future performance should raise questions about the assertion that governance changes will improve shareholder returns. Of course, the time period we examined for these ratings is quite limited (July 2002 through to December 2004), and it may take a longer period for the valuation effects of governance to materialise. Nevertheless, our empirical analysis is based on the most current data and collectively it

suggests that there is not much evidence supporting recent claims that governance is associated with performance.

A limitation of our analysis is that we have only used overall scores. Furthermore, these governance ratings are somewhat unsophisticated aggregates of multiple measures of governance structures. To address this limitation, we conducted our own study on the relation (or lack thereof) between corporate governance and company value. This involved a detailed statistical analysis of 2,106 US companies with fiscal years ending between June 2002 and May 2003. Our sample spans many sectors of the economy and represents over 70 per cent of the market capitalisation of the Russell 3000 as of the end of 2003.

In order to be included in our sample, we required companies to have available data (much of which was provided by TrueCourse Inc. and Equilar Inc.) on the characteristics of the board of directors, stock ownership by executives and board members, stock ownership by institutions, stock ownership by activist holders, debt and preferred stock holdings, compensation mix variables and anti-takeover provisions. In all, we used 39 different structural measures of corporate governance. There is substantial overlap between the measures that we use and those used by the ratings agencies.

Using a variety of statistical techniques, we assessed whether these 39 measures actually explain differences in managerial behaviour and organisational performance. We found that companies with a lead director experienced higher stock returns. Similar to the analysis with the governance ratings, we did not find any association between our governance measures and changes in operating performance. We did, however, find evidence that companies with activist shareholders, more accounting-based incentive compensation and without poison pills and staggered boards experienced a higher level of operating performance in fiscal 2003.

What is most interesting about our analysis is that, of the 39 governance measures examined, only a small fraction was connected with the level of operating performance and, often, the direction of the associations was unexpected. For example, companies with larger boards and more control by insiders via dual class stock and fewer outsiders on the board exhibit a higher level of operating performance.

Overall, our results imply either that corporate governance is of modest importance (which is difficult to believe) or that the available structural indicators and ratings are not especially useful for measuring it.

#### ◆ Discussions with asset managers

We also interviewed several leading portfolio managers representing large actively managed US and international equity portfolios about their evaluation of governance ratings. We received consistent reports that measures of governance are not effective in generating excess returns (or alpha) for equity portfolios. These responses are likely to reflect several issues. First, as we discussed above, governance is a multi-dimensional construct that is difficult to measure and reduce to a summary

statistic. The failure to find an association with stock returns may simply reflect measurement error. Second, there is only a limited period for which governance ratings are available and this makes it impossible to do the type of back-testing that quantitative equity managers typically undertake. Third, the signals that these portfolio managers are already using in their asset allocation decisions may be subsuming any ability of the governance measures to predict future returns. Finally, for measures of governance to be associated with future stock returns, it must be the case that these measures provide predictive information that is not priced by the market in a timely and efficient fashion.

Although governance ratings have been given a very lukewarm reception by some leading actively managed equity funds, there is still a strong interest from equity investors in governance risk of their portfolios. Portfolio managers at some of the larger US pension plans, such as TIAA-CREF and Calpers, have been strong advocates of governance reform. Indeed, their proxy voting has been significantly influenced by perceived governance crises. The ratings agencies themselves are selling ratings and governance advice to a broad base of clients including institutional investors. The fact that there are buyers for these ratings must mean that there is some value to having access to this information. However, the value of these ratings is not related to their ability to predict future company performance.

#### ◆ Conclusions

The relation between corporate governance and organisational performance is of fundamental importance. As might be expected, many conjectures about the features of superior corporate governance have been advanced. In addition, various governance-rating schemes have been proposed as the basis for the design of governance structures. While these ideas make for interesting discussion, there are few compelling results that clearly demonstrate how corporate governance produces the outcomes desired by stockholders or, more broadly, stakeholders. Thus, there is little evidence that the costly governance changes that are currently being imposed on companies will produce expected net benefits in terms of improved performance.

We certainly believe that appropriate governance mechanisms are a necessary and vital part of a capitalistic economy. However, we have considerable concern about whether any of the existing structural measures of governance or governance ratings provide a useful basis for identifying good governance. Before imposing some governance structure on a company, it seems necessary to verify scientifically that the changes are likely to produce the expected outcome. This statement, of course, assumes that we are interested in learning about the value that can be produced from making costly changes to governance mechanisms. If instead, the debate continues to rage based on rhetoric, we should be aware that costly policy decisions are being made without a careful and rigorous analysis of the data.

## “There is still a strong interest from equity investors in the governance risk of their portfolios”

results for operating performance were strongest with data from TCL, so we explain the analysis of these specific ratings in more detail below.

The analysis for the TCL data was drawn from 2,012 companies for the period 2002-2004. The overall TCL "board effectiveness" rating is based on the following components: board composition, CEO compensation, shareholder responsiveness, accounting quality, strategic decision-making, litigation problems and takeover defences. Thus, the TCL rating appears to be a relatively comprehensive and broad-based measure of corporate governance.

Each of the components is given a rating between A and F, and the combination of the categories also yields an A-F overall score for board effectiveness. Companies receiving an A, B

or C grade are considered to be have "good" governance and those with a D or F rating to have "bad" governance.

We utilised the discrete (good versus bad) distinction in the TCL ratings and examined stock price performance after issuance of their reports. The analyst reports are compiled after the end of each proxy season. To ensure that the information in the reports is available to investors, we tracked the

Figure 1 Return to \$1 invested in companies with "good" and "bad" governance







### **Avoiding the issue?**

Corporate governance isn't a simple subject. And as we all know, when faced with a difficult matter, the tendency is to not talk about it. The problem is, when it comes to corporate governance, communication is essential – both internally and externally.

According to a recent study, there is a clear connection between the quality of a company's earnings and financial transparency and its corporate governance practices. Meanwhile, the Financial Standard Authority say that as many as 50% of UK FTSE companies have not communicated the full impact of reporting under International Financial Reporting Standards to their shareholders. How can you make sure every single stakeholder is aware of exactly what is at stake? Are you telling your shareholders what they need to know?

We think it's time people started asking questions about their communication strategy, and talking about the impact of the many other aspects of corporate governance on the way they do business. Effective corporate governance can lead to better controls, better market understanding, and ultimately, better performance. At Ernst & Young we believe a proper dialogue with all stakeholders is the key ingredient to delivering that value. And we think that's a conversation worth having.

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NEIL WEBB

# When earnings management becomes cooking the books

The line between legitimate and inappropriate accounting techniques can be a blurry one, but the audit committee must endeavour to make a clear distinction

**T**he polestar of the audit committee is shifting – rather than focus exclusively on mechanics, structures and controls (which are necessary but not sufficient), it is turning towards the overriding policy issue, namely whether or not financial disclosure presents a “true and fair” view of the company’s state of affairs. Faced with intense pressure to meet earnings estimates from analysts and investors, executives at many companies use a variety of “earnings management” techniques to help them “make the numbers”. These techniques will frequently exploit loopholes in generally accepted accounting principles (GAAP) to manipulate deliberately the company’s revenues.

“Earnings management” includes both legitimate and less than legitimate efforts to smooth earnings over accounting periods or to achieve a forecasted result. It is the responsibility of the audit committee members to identify, by appropriate questioning and their good faith judgment, whether particular earnings management techniques, accounting estimates and other discretionary judgments are legitimate or operate to obscure the true financial position of the company.

Examples of legitimate earnings management efforts include postponing an acquisition or a disposal of assets or other transaction until a later period, or otherwise accelerating expenses when earnings are high and postponing expenses when earnings are low (for example, by accelerating or deferring advertising expenditures

in a quarter). Others might include not replenishing inventories, or for financial organisations, selling securities for a gain or loss during a period of high or low earnings. As you get closer to the line between legitimate and less legitimate, some companies opt for disclosure.

The line between appropriate earnings management techniques and “cooking the books” can be a blurry one, notwithstanding the plethora of detailed rules that are currently in place to deter malfeasance. If audit committees fail to make this distinction, further intrusive regulation could follow.

There will always be a temptation to manage earnings inappropriately because meeting projections and “guidance” suits everyone, from executives whose compensation may be based on earnings-driven performance

measures, to holders of options and Wall Street analysts. Earnings management efforts require co-operation along reporting lines, and will often involve boards and senior management at some level. Testifying in the recent trial against Bernie Ebbers, former chief executive of WorldCom, Scott D Sullivan, the company’s former chief financial officer, admitted that he “falsified the financial statements to meet analysts’ expectations”. And as a lower-level former WorldCom employee, who was jailed for fraud, observed: “When boards open the door a crack to unethical behaviour . . . then it leaves a lot of interpretation for everyone down the line.” In this respect, it would seem that the title of Bob Garratt’s 2003 book, *The Fish Rots from the Head*, may be an accurate metaphor.

Regulators began paying serious attention to the use of earnings management techniques in the 1990s, when the market’s short-term focus and the importance to management of increasing the value of stock options and share prices swayed companies to use them more widely. In 1998, at an address at New York University, the then-chairman of the Securities and Exchange Commission, Arthur Levitt, spoke of the emergence of a “grey area where the accounting is being perverted; where managers are cutting corners; and where earnings reports reflect the desires of management rather than the underlying financial performance of the company.” He referred to the following techniques, which were being used by some companies inappropriately to manage earnings in response to analyst and market pressure:

- Deliberately overstating one-time “big bath” restructuring charges to provide a cushion to satisfy future Wall Street earnings estimates;
- Misusing acquisition accounting, particularly improper write-offs of acquired in-process research and development, to overstate future earnings inappropriately;
- Over-accruing charges for items such as sales returns, loan losses or warranty costs when the company is profitable and using those reserves to smooth future earnings when the company is not so profitable – known as “cookie jar reserves”;
- Prematurely recognising revenue – for instance, before a sale is complete, before a product is delivered to a customer or at a time when it is possible that the customer may still terminate, void or delay the sale;
- Improperly deferring expenses to improve reported results;
- And misusing the materiality concept to mask inappropriate accounting treatment.

Mr Levitt asked the New York Stock Exchange and the National Association of Securities Dealers to create a committee to study intensively audit committee effectiveness in discharging their oversight responsibilities and then make recommendations aimed at improving US practices. I co-chaired the committee, along with John C Whitehead, former Deputy Secretary of State and retired co-chairman and senior partner of Goldman Sachs. We drew on previous studies and gathered input from regulators and members of the business, accounting, legal and academic

communities to produce our February 1999 report entitled "Improving the Effectiveness of Corporate Audit Committees".

The report focused on the reforms that were needed to ensure "disclosure, transparency and accountability". We recommended that generally accepted auditing standards require the outside auditor to discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.

The report also emphasised that the discretionary nature of much financial accounting work means that there cannot be a "one size fits all" solution to preventing accounting irregularities. It encouraged each audit committee to think deeply about its role and to develop its own guidelines to assist with supporting and monitoring both responsible financial disclosure and active oversight. The NYSE and the NASD embraced many of the suggestions set out in the report, by mandating that they be included in audit committee charters. However, those rules do not require audit committees specifically to think about earnings management and the resultant ability to move financial disclosure away from a true and fair representation of the state of the company.

Many of our recommendations were beginning to be put in place before the Sarbanes-Oxley Act was enacted, but private sector reform did not happen fast enough. Companies such as Enron and WorldCom continued to engage in improper earnings management techniques such as those outlined above, and worse. The private sector's failure to adopt reforms voluntarily led to the bulk of our recommendations eventually being enshrined in regulations, rules and practices by the SEC, the NYSE, the NASD and prosecutors.

Broadly, NYSE and NASD listing rules now require audit committees to adopt a formal written charter and be comprised solely of "independent" and "financially literate" directors, including at least one member with special expertise. In addition, SEC regulations require the outside auditor to report to the audit committee all critical accounting policies and practices that are to be used and details of the alternative treatments of financial information within GAAP that have been discussed with management.

SEC regulations also require the audit committee to prepare a report for inclusion in the company's annual proxy statement, outlining whether it has reviewed and discussed the audited financial statements with management, discussed audit difficulties and accounting adjustments with the outside auditors, and recommended to the board that the audited financials be included in the annual report. Moreover, professional standards set by the Public Company Accounting Oversight Board require the outside auditor to discuss with the audit committee certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting policies.

The enactment of the Sarbanes-Oxley Act, and section 404 in particular, has increased attention on process and mechanics, such as internal

controls and compliance with accounting rules. However, this approach deals inadequately with the fact that questionable earnings management can still occur within a sound network of internal controls and within the boundaries of GAAP. Recent restatements by companies such as Krispy Kreme, Nortel, Fannie Mae and SunTrust Bank, combined with the increasing number of fraud-related enforcement actions, indicate that accounting irregularities are still relatively commonplace. Pressure to "make the numbers" is still being felt – for instance, the stock prices of Amazon and eBay dropped 16 per cent and 19 per cent respectively in recent months after the performance of those companies failed to match forecasts.

Rather than focus exclusively on process and mechanics, it is important to bring attention back to the substance of financial reporting or risk even more regulation. The audit committee has a key role to play in this process by focusing committee members on looking beyond GAAP when evaluating discretionary judgments.

Guidance as to how to achieve this may be gleaned from the approach taken in the UK. The United Kingdom's Companies Act of 1985 requires directors to prepare accounts for each financial year that give a "true and fair view of the state of affairs of the company" (sections 226 and 227). Directors of listed companies must also comply with the Combined Code requirement to "present a balanced and understandable assessment of the company's position and prospects" (Code provision D.1), or explain why compliance has not been achieved.

The annual report of a company listed in the UK will include a statement signed by the board. This outlines the responsibility of the directors to prepare accounts that give a true and fair view of the state of the company, confirms that suitable accounting policies have been used, and states that reasonable judgments and estimates were made. The advantage of the UK model is that it squarely focuses board attention on the integrity of financial reports, compared with the more limited role of the management certification approach recently adopted in the US under section 302 of the Sarbanes-Oxley Act.

Although useful, the UK approach is not suitable for wholesale adoption in the US due to the differently constituted nature of UK boards, which usually include many company managers who are knowledgeable about the details. Moreover, as noted above, directors in the UK are responsible for preparing the accounts, in contrast to the US, where management prepares the accounts under the direction of the board.

However, a US audit committee could achieve a similar result by requesting assurance from the outside auditor that the report gives a true and fair view of the state of affairs of the company, and that reasonable and prudent judgments and estimates have been made, especially regarding revenue recognition, expenses and other items that may involve earnings management. This will bring the focus back to quality and fairness in substance, and beyond mechanics and structure. Audit committee members

can, in good faith, question the outside auditor about discretionary judgments resolved in management's favour to effect a better earnings picture both currently and looking forward, notwithstanding compliance with GAAP.

The audit committee should encourage the outside auditor to be candid and prepared to risk management displeasure. Anecdotal evidence suggests that outside auditors, now directly employed by the audit committee, are increasingly comfortable with challenging management. For example in January, outside auditors at Eastman Kodak issued an "adverse opinion" citing "material weaknesses" in the company's internal financial controls for 2004.

This increased dialogue between audit committees and outside auditors in the quest for quality financial reporting should be the next major step in the long road of audit committee improvement. Audit committees have been evolving in the US since the late 1930s and early 1940s, but did not emerge as a major feature of large corporations until the 1970s, after financial manipulation led to the collapse of Penn Central – then the largest railroad company and sixth-largest industrial corporation in the US. An SEC investigation that followed the collapse specifically criticised the outside directors' passivity and lack of financial acumen, as well as the dearth of opportunities for outside directors to engage in discussions among themselves. The investigation also revealed widespread inappropriate financial reporting practices.

These shortcomings ushered in the audit committee as a corporate mainstay. In a 1972 release, the SEC recommended "the establishment by all publicly held companies of audit committees composed of outside directors." Then, Stanley Sporkin, director of enforcement at the SEC, began to insist that companies establish audit committees comprised of outside directors as a condition to settling enforcement proceedings.

In 1974, the SEC required issuers to disclose in their proxy statements whether they had an audit committee in place and, if so, to state the names of the committee members. Finally, in 1977, the NYSE issued rules requiring all listed companies to establish audit committees "comprised solely of directors independent of management and free from any relationship that . . . would interfere with the exercise of independent judgment." The NASD followed suit with rules requiring Nasdaq-listed companies to establish audit committees comprised of a majority of independent directors.

At this initial stage, outside

directors satisfied the then-prevailing definition of "independence," which was far less rigorous than the current standard. Since then, our report, the NYSE and NASD listing rules, the Sarbanes-Oxley Act and SEC regulations have further refined audit committee requirements.

The development of requirements for independent audit committees in the UK and continental Europe has generally lagged behind the US. In the UK, audit committees comprised of non-executives were recommended in the 1992 Cadbury Report. This recommendation has since become part of the Combined Code, according to which UK listed compa-

**"It is important to bring back attention to the substance of financial reporting or risk even more regulation"**

nies are required to "comply or explain". In continental Europe, audit committee requirements generally have not developed to the same extent, although many European codes of best practice recommend that independent audit committees be established.

The current wave of reforms in the wake of recent scandals has necessitated audit committee members training the bulk of their attention towards mechanics and structural improvements. However, it is clear that technical compliance with GAAP is not, by itself, enough to ensure quality and fairness in financial reporting.

Audit committee members should now take a step back from the detail and refocus on ensuring that the substance of financial reports is true and fair, and reflects the performance of the company. To achieve this, audit committees should select outside auditors with whom open and candid dialogue can take place in relation to earnings management. Committee members should view the outside auditor as an information resource so that inappropriate earnings management practices can be either vetoed or ferreted out before the books become "cooked". This approach should reverse the trend of restatements and corporate fraud, and result in a higher degree of integrity associated with financial reporting. If this happens, we may ward off even more regulation.

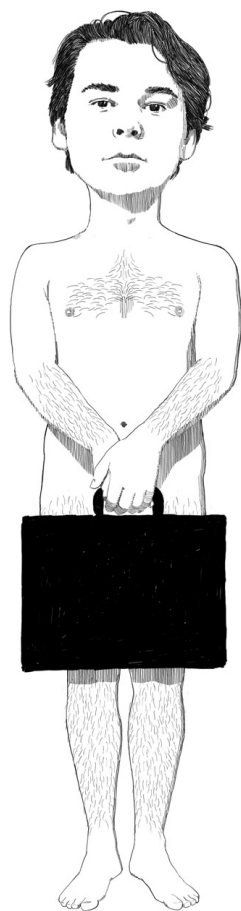


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Your guide to **Mastering Corporate Governance**

<p><b>Week 1</b> May 20</p> <ul style="list-style-type: none"> <li>● Introduction</li> <li>● The role of the CEO</li> <li>● Shareholder activism</li> <li>● Governance decisions</li> </ul>	<p><b>Week 3</b> June 3</p> <ul style="list-style-type: none"> <li>● Corporate social responsibility</li> <li>● Mergers and acquisitions</li> <li>● Family businesses</li> <li>● Executive compensation</li> <li>● Governance in emerging markets</li> </ul>	<p>Editor: Rob Mitchell Deputy editor: Ravi Mattu Design: Tony Mullins Business development executive: Kate Harris Cover illustration: Alastair Taylor Director: Richard Foster <a href="http://www.ft.com/masteringcorporategovernance">www.ft.com/masteringcorporategovernance</a> Back issues +44 (0)20 8763 6363 or e-mail: <a href="mailto:ft@remember-when.co.uk">ft@remember-when.co.uk</a> Books of previous FT Mastering series: all good bookshops or +44 (0)1279 623928</p>
<p><b>Week 2</b> May 27</p> <ul style="list-style-type: none"> <li>● Board composition</li> <li>● Governance and global strategy</li> <li>● Corporate governance and performance</li> <li>● Role of the audit committee</li> </ul>	<p><b>Week 4</b> June 10</p> <ul style="list-style-type: none"> <li>● Board performance evaluations</li> <li>● Diversity in the boardroom</li> <li>● The role of non-executive directors</li> <li>● Risk management</li> <li>● Governance and non-profits</li> </ul>	





### **How much detail do you give your stakeholders?**

It's easy to take internal controls for granted. When you've got clients to cater for and shareholders to please, they're often the last item on your agenda. But there are some very serious questions that need to be asked.

Should your internal controls be narrow, but deep, or broad, but shallow? The cost of detailed processes can be extremely high – so what value does this kind of internal control create? How can you monitor any return on investment? How can improving the controls on what you did help improve what you do in the future?

Companies are currently spending on average, \$8 million each every year on internal control reviews in response to Section 404 of Sarbanes-Oxley. And our research shows that ongoing expenditure could be as significant – as much as 75% of the first year's implementation costs. Is your organisation ready?

We think it's critical that people start talking about their control procedures and the impact the many other aspects of corporate governance are having on the way they do business. Effective governance can lead to better controls, better market understanding, and ultimately, better performance. At Ernst & Young we believe a proper dialogue with all stakeholders is the key ingredient to delivering that value. And we think that's a conversation worth having.

To carry on the conversation, visit us at [\*\*www.ey.com/change\*\*](http://www.ey.com/change)