Effective Investors, Directors, Boards, and Audit Committees Monitor Fundamentals

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To avoid remaking the well-publicized corporate mistakes of the past, investors, directors, audit committees, and boards need to go beyond basic financial statements to monitor financial health and assess risks. Effective audit committees will begin to experiment with broader systematic disclosures of both financial and non-financial information to improve transparency. Investors need to demand more transparent systematic disclosures and learn how to use new metrics like credit ratings and governance quotients in their investment decisions. The passage of Sarbanes-Oxley and the related SEC regulations is the legislative response to lapses of the past. However, only management can make the necessary and substantial changes needed. Yet, institutional investors can encourage directors and boards to be more thorough and vigilant.

Corporate governance and the role of the audit committee will never be the same. The year 2002 will go down in history as a year of record bankruptcies and the year corporate governance became subject to increased regulation. The Sarbanes-Oxley Act of 2002 contains numerous provisions that increase both the legal risk and compliance requirements for both directors and management. Corporate governance, and the audit committee in particular, has a new set of rules and guidelines which are detailed in over 60 subsections of the bill and thousands of pages of new rules. The changes are massive and some believe equal in magnitude to the original enactment of the Securities and Exchange Act of 1934, which it modifies. Legislation provided a wake-up call for corporate America, yet restoration of public trust is best accomplished by the boards of individual corporations and their board committees demonstrating how they will enhance their own corporate governance processes in 2003 and 2004. The new government regulation will promote change, but only disciplined action on the part of senior management and directors can both reflect the spirit of the law and produce the significant changes and benefits.

This article describes how boards of directors and audit committees can and should improve their early warning and governance processes. They must look beyond the financial statements into a much broader and insightful set of indicators that provide a more holistic view of the underlying business that creates the financial results. We include a variety of best practices and examples in the areas of finance, strategy, risk management, and corporate governance. These processes are already in place at some leading companies but need much broader acceptance.

> *You can't legislate good governance. You need the right people who are willing to ask the tough questions. Recent legislation will make it harder for small and mid-sized public companies to get the right people to serve.*
>
> —A CPA, Sitting CEO and Director

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BEYOND GAAP AND THE FINANCIAL STATEMENT NUMBERS

Financial statements prepared in accordance with GAAP are a reflection of the results of the business. They are not the business. Recent and dramatic corporate failures clearly demonstrate: "The bottom line is no longer the bottom line." Directors need to understand the business processes by which the bottom line is created. Yet despite these failures, board members in many corporations today would boast of a policy of full disclosure and transparency. Management might also boast of possessing some of the best financial systems and advisers around. Yet the reality—misperceived by many investors—is that GAAP requires most corporations to make many estimates and adjustments at the end of every quarter. Misestimates have been made. Errors were and will continue to be glossed over by materiality tests.

GAAP is not a perfect measurement system and will never be. In the past and in the name of materiality and judgment, boards often received only favorable cleansed numbers and management did everything possible to make earnings per share goals and estimates. "No Surprises" was the rule. Beating analysts' expectations by a penny sometimes required accounting magic. Independent auditors reported to and were paid by management.

Management dictated the information directors received and set the "time-compressed" agenda for audit committee and board meetings. Too many board meetings were filled with carefully scripted discussions and presentations by handpicked operating executives with little opportunity for deep discussion or questioning. Management would put its spin on every story, frequently denying or glossing over the underlying business facts behind the GAAP financial statements. Strong CEOs and charismatic chairpersons could focus the limited time for discussion on their agenda for improved near-term bottom-line results with little time allocated for true dialog and debate. Auditors limited the scope of audits to keep audit fees down. While few reporting transgressions are as spectacular as Enron or WorldCom, most management groups have occasionally relied on reserves, buried bad news in the name of "simplifying the financials," or shown trends in the most favorable light, sometimes dropping any mention of negative trends. The new disclosure and certification rules are designed to reduce the abuses in the selected and colored disclosures of the past.

> *I will not serve on a board of a public company, unless it is squeaky clean. I have turned down two situations after doing my own due diligence.*
>
> —Former CFO, Director and Investor

This type of narrow "financial focus" is like driving a car by looking through the rearview mirror. When things go bad, experienced turnaround professionals are often amazed at how poorly corporate directors understand the businesses they are supposed to govern and the degree of their surprise when financial results continue to deteriorate, even though the signs of corporate cancer abound. These signs include all the classic financial and non-financial early warning signs, like an obsessive focus on one performance measure, unhealthy trends in financial ratios, covenant defaults, disregard of business cycle planning, an autocratic management, customer bankruptcies, new competitors, excess capacity, quality problems, and customer losses.

If GAAP financial statements are such an imperfect measure of corporate performance, what is the solution?

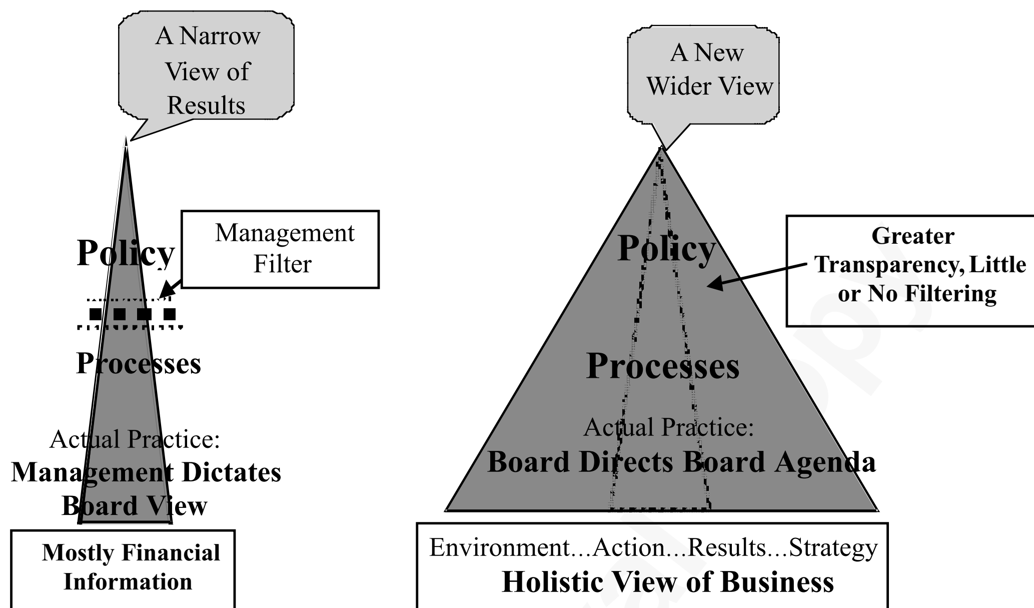
Good governance requires that directors and especially audit committees look beyond the numbers and consider the fundamentals of the business and as well as the GAAP-compliant results. An effective board must consider the broader environment in which a business operates, the actions and strategies that management proposes and implements, as well as the results that are reflected in the financial statements *(see Exhibit 1)*.

New regulations now impose requirements on boards and management. Management and directors (especially the audit committee) must now understand the processes by which the financial performance numbers are generated. Having a financial officer ethics policy and a vehicle for employees to report fraudulent activities directly to the board and protecting so-called whistle-blowers are practices that must be adopted by all public corporations. Legislators wanting a true "expert" in auditing and GAAP accounting as part of the audit committee was another new requirement designed to improve the depth of GAAP accounting knowledge available to the board. But even the rule makers eventually understood that a GAAP expert alone is no panacea. Practical industry knowledge and an experienced strategic and operational perspective must supplement accounting expertise. The definition of a "financial expert" was broadened by the rule makers in the current guidelines.

This wider environmental and strategic view will require the directors to set their own agendas and deter-

EXHIBIT 1

A Broader View Is Required



mine what information they want and need to see on a regular basis. Increasingly, they will want to engage independent advisors for special studies as the new law empowers them to do. The law now requires private executive sessions for independent directors to probe and discuss company policy, strategy and current practices, risks and results outside the presence of management. Yet only the individual director can make them meaningful.

In the past, boards have mostly received historic carefully "cleansed" information about the results of the business. Most boards lacked insight and visibility into the early warning signs of decline and were surprised if results continued to deteriorate despite the actions and promises of current management. Independent accountants provided narrowly focused, carefully worded, and occasionally watered-down management letters and claimed the ability to discover fraud was outside the scope of the audit. In the new environment boards must proactively seek a broader range of information on both financial and nonfinancial measures. Yet they must also strike a careful balance between the information needed for good governance and the potential for micromanagement. Auditors must now perform additional procedures for additional fees to understand and comment on internal controls. The world of financial reporting will undergo significant change. (For a look at the broadened future scope of corporate reporting, go to www.valuereporting.com.)

TAKE A BROADER, MORE HOLISTIC VIEW

If GAAP financials are imperfect, they need to be supplemented with alternative measures of business health and success. Researchers, business leaders, and students of corporate governance such as the National Association of Corporate Directors (NACD) and the Center for Effective Organizations (CEO) have long argued that the board take a more holistic view of the business. They advocate a more probing and active role in evaluating the business strategies and environment in which the business operates, to provide a better understanding of the true performance of the management team. Boards rate strategy as important, but most directors say insufficient time is devoted to discussing and evaluating strategic alternatives. What is lacking is a generally accepted framework for evaluating a business and the management group beyond what is presented in the GAAP financial statements.

In the hope of providing a wider perspective for investors and directors, we discuss some of the existing more holistic frameworks for evaluating corporate performance beyond the financial statements. These frameworks can be straightforward:

- a more detailed ratio analysis,
- a diagram relating the interdependence of financial, strategic, and operating health, or

- a simple scale balancing short-term and long-term results.

Unfortunately, accounting professionals are so preoccupied trying to repair the deficiencies of GAAP they have little time to consider better alternatives to supplement financial statements and improve business transparency.

FINANCIAL HEALTH AND BOND RATINGS PROVIDE A START

Moody's Investors Service, Standard and Poor's, and a variety of other rating agencies rate corporations on their financial capabilities. They publish bond ratings for well over 2,500 corporations that issue public debt. These bond ratings provide a strong signal of overall corporate financial health. Corporations with the AA or AAA rating are usually financially healthy, while those with a single B or C rating are considered financially challenged or potentially distressed.

The rating agencies look beyond financial statement performance and consider industry outlook, as well as company position and leadership in making their ratings. When the rating agency lowers a rating one or two grades, both management and directors get a powerful signal that something is wrong. Rating agencies are continually improving their financial health ratings by adjusting GAAP statements to reflect more consistent and reliable measures of earnings such as "Core Earnings" and incorporating more forward-looking outside data like accounting clarity, investor expectations, and stock price. (Go to www.coreearnings.standardandpoors.com for information on the adjustment process.) But bond ratings, while a better indicator of corporate health, are also lagging indicators.

Directors and investors should also understand credit risk. Standard and Poor's creates industry scorecards comparing the credit risk of industry players. (For a sample, go to www.SandP.com and search on "Report Cards.") Standard and Poor's framework for credit risk analysis includes multiple dimensions such as:

- Economic and industry risk
- Business model and position
- Business strategy
- Management reputation
- Earnings quality and performance
- Liquidity and cash flow
- Capital structure and financial flexibility

The thousands of corporations that do not have publicly traded debt have no easily publicly available signal of overall financial health. Directors should create and monitor one. There are a variety of surrogate measures for financial health.

Lender covenants impose significant discipline but are not considered objective benchmarks. As a result of the last cyclical bankruptcy boom in the late 1980s and early 1990s, bank lenders tightened credit standards, shifting higher-risk corporate borrowers to asset-based lenders. Banks and asset-based lenders impose the discipline of multiple financial covenants on their borrowers. Unfortunately, covenants are usually designed to signal adverse changes from a starting point (when the loan is made). They do not represent absolute measures of credit quality. Thus, while covenant default is a strong signal of near-term stress, it gives no clear measure of the company's financial health at the time of the default.

Unfortunately, once a company begins to break covenants, management's first reaction is often to blame bank conservatism or a changing environment, rather than to look inward for causes. Management typically avoids admitting that it failed to make the necessary changes in the business to meet the covenant objectives. Those who have dealt with companies teetering near financial distress know that management teams frequently turn to creative accounting to avoid the unpleasant experience of covenant default, postponing real solutions to underlying problems. This practice can rob the financial statements of credibility.

Management and the board also have the ability to use a surrogate bond rating such as Altman's four-factor Z-Score to set their own financial health objectives. Failure to meet the board-imposed "financial health" target should signal a new level of diligence and dialog on the board. The bond rating models as well as the surrogate four-factor Z-Score are based on multiple key financial ratios. The ratios in the four-factor Z-Score include: EBIT to total assets, working capital to total assets, retained earnings to total assets, and book value of equity to total liabilities (*see Exhibit 2*). Directors may be comfortable with an improving earnings per share number, but the Z-Score and bond ratings provide a much better measure of financial health, despite their dependency on GAAP financials. (For more detail and charts on these new techniques for monitoring financial health, go to http://www.stern.nyu.edu/~ealtman/zscorepresentation.pdf.)

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EXHIBIT 2

A. How to Compute a Z"-Score Bond Rating Trend

Altman's Z" is a four-factor model that predicts risk of bankruptcy for a broader range of non-manufacturing and private companies.

Z" = The sum of the following factors:

6.56*X1 => WC / TA
~ Working Capital to Total Assets, a measure of liquidity

3.26*X2 => RE / TA
~ Retained Earnings to Total Assets, a measure of cumulative profit

6.72*X3 => EBIT / TA
~ Earnings Before Tax to Total Assets, a measure of profitability

1.05*X4 => BE / TL
~ Book Equity to Total Liabilities, a measure of value to liabilities

+ 3.25 => scale factor to produce score of "Zero"
for a D– (default rated bond)

Note: Z" scores below zero are likely to go bankrupt. Alarms sound as companies trend toward zero. See bond ratings for comparison below. Directors and investors should monitor trends in these measures of financial health.

B. How to Compute a Z"-Score Bond Rating Trend

Z"-Scores can be related to corporate bond ratings and should be trended over several periods and benchmarked to the following ratings. Create a graph with these Z" rating benchmarks.

RATING	Z"-Score	Sample
AAA	8.15	8—Highest rating and ability to repay
A	6.65	42
B	4.15	115—Speculative: ability to repay uncertain
B–	3.75	95
CCC	2.50	10—Current high vulnerability to default
D (default)	0.00	14

Not all grades shown. Caouette, Altman, and Narayanan, Managing Credit Risk, *Wiley [1998, p.283]—a great update and summary of various early and evolving prediction practices and models. A significant July 2000 update on failure prediction is also available at: http://www.stern.nyu.edu/~ealtman/Zscores.pdf.*

Source: Sample based on 750 Corporate Debt Securities, with rated debt outstanding in 1994.

STRATEGIC HEALTH AND PROFIT BENCHMARKS DRIVE FINANCIAL RESULTS

While Altman's Z-Score is known to many bankers and turnaround professionals as an indicator of financial health, the Vital Signs from the PIMS Program have become generally accepted management "Profit Impact" benchmarks and are widely known to many marketing and strategy professionals. PIMS stands for the Profit Impact of Market Strategy, a program that grew out of General Electric and Harvard Business School in the 1970s. Similar to Moody's and Standard and Poor's bond ratings, the Profit Impact models identified the profit potential ranking of over 3,500 business units based on traditional financial statements and several non-financial measures. The non-financial metrics such as:

- served market growth,
- relative quality,
- relative price,
- relative market share,
- relative cost,
- investment intensity, and
- relative productivity—

or their derivatives like customer satisfaction and cost—have become the front window profit drivers displayed on many management dashboards.

> *I want to see a scorecard or dashboard in the monthly reports to the board. Management needs to highlight what has changed and what is in need of our attention.*
>
> —A Non-Executive Chairman

While the coefficients of the Profit Impact models are proprietary, a growing number of companies are measuring and benchmarking with similar non-financial variables in what has today become known as the Balanced Scorecard. Strategic health then is a function of not only current earnings, but also non-financial drivers such as quality relative to competition, size relative to competition, and cost or productivity relative to competition. These scorecards always provide multiple dimensions, because no single dimension is a reliable predictor of future profitability. (For an example of the Vital Signs Strategic Business Review metrics and dashboard, go to www.empirimetrics.com.)

Balanced Scorecard supporters take measurement one step further. In addition to identifying a relative

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ranking or measure for various non-financial drivers such as customer satisfaction and employee satisfaction, some companies implementing the balanced scorecard also identify the process or processes by which the measures will be improved. The use of a measure and a flow chart to describe the improvement process helps visually communicate a framework to understand and communicate a company's strategy and tactics. (To learn more about the Balanced Scorecard and how it is being used in a large number of public companies, go to the online free tutorial at http://www.bscol.com.)

Frameworks and tools such as the Balanced Scorecard and the Vital Signs frameworks provide directors and audit committees with a much broader and insightful way of viewing corporate performance and strategic direction than the GAAP financial statements alone.

OPERATING HEALTH AND INDUSTRY BENCHMARKS

Each industry has a variety of operating benchmarks that investors and management typically use to evaluate performance. It is always curious to note that companies near the top of their industry disclose these benchmarks more frequently than those at the bottom of their industry.

- In the retail industry, the measure is sales per square foot as an indication of retail outlet productivity.
- In the airline industry, revenue per passenger mile, fuel costs per mile, and load factors are key operating factors.
- In the restaurant industry, management may routinely measure food cost as a percentage of total bill and average check as a measure of restaurant operating productivity.
- In the hotel industry, occupancy rate is carefully tracked.
- In custom manufacturing, number of days' backlog is an important indicator.
- In the steel industry, man-hours per ton remains a key indicator.

Recognize that no single measure will do and multiple measures become complex fairly quickly, making it necessary to focus on the critical few.

> *Corporations have to reduce the liability issue for us directors. Many directors are really concerned about shareholder suits. Better information beyond GAAP is a start. The requirement to meet without management present is a simple change with major implications.*
>
> —Former CFO, Director

These key operating statistics are often tracked on a daily, weekly, or monthly basis and provide leading indicators of future financial performance. Where possible, estimates for competitors are also made. Some of the more progressive companies provide the directors with detailed models that are capable of tying key operating statistics to monthly financial results. As you might expect, operating statistics are most useful to the operating managers and employees who can control them. Directors and investors can easily get overwhelmed but should understand the key relationships between the operating drivers of short- and long-term financial performance and the processes management uses to monitor and improve performance.

In the past, sharing operating statistics with directors has not been a major problem. What has been lacking is an understanding of how operating statistics link to overall business value, how operating statistics compare with those of competitors, and how they impact the long-term strategic position of the business. For example, improving man-hours per ton of steel produced at 10% per year may sound good, but if your competitor is improving at 15% per year from a lower cost base, your competitive position will continue to deteriorate. More comprehensive models, exception reporting, and new frameworks are needed to bring better operating statistics into proper perspective for corporate directors and eventually shareholders and investors. Better board books that communicate performance drivers, strategies, economic performance relative to cost of capital, and contain commentary on key indicators and competitors as well as GAAP financials are critical to giving directors and audit committees a more accurate and transparent view of the business.

EVALUATION AND MANAGEMENT OF BUSINESS RISK FOR AUDIT COMMITTEES

Every business will face a crisis at some point in its life cycle. For example, businesses that are dependent upon weather, high growth, or an unproven technology typically face numerous crises. Directors and the audit committee must attempt to understand the risks of the business. In many cases directors will simply ask management to identify the most significant business risks. In

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some cases management will even attempt to quantify those risks and rank them. Directors should not stop there. Without micromanaging, directors can and should ask management to consider an independent evaluation of major risks and potential strategies that would mitigate those risks under a variety of different scenarios. While it is the job of management to manage, directors have a clear authority to question different scenarios and help management identify the best long-term strategy. Directors should encourage management to develop a framework to evaluate risk and alternative scenarios so that strategic discussions may occur on at least an annual basis.

> *There are many things, both hard and soft, that boards need to do well to be effective. Practically all boards need to do a better job of improving information flow and risk management. Getting better information that can be digested faster is a new challenge for all boards.*
>
> —Director/Professor of Management

Research sponsored by the Center for Effective Organizations and the executive recruiting firm Korn/Ferry indicates that effective boards usually find it valuable to dedicate a long board meeting or retreat each year for the sole purpose of evaluating risks and questioning the strategic direction of the company. (For an example of an independent risk profile, go to http://www.empirimetrics.com/risk.pdf.)

CREATING VALUE MEANS DIFFERENT THINGS

Creating value for shareholders was a mantra of the '90s for many corporations. Yet it was frequently misapplied. Corporate management focused on current earnings as the only visible—but imperfect—driver of short-term stock price at the expense of long-term future value. The shareholder value creation movement never really caught on because of the importance of other stakeholders—like employees, suppliers, and management—in creating value. Any tool or framework can be misapplied or taken to the extreme, and shareholder value was one of them.

Management of many companies driven by shareholder value theorized and operated on the premise that if current value was created for the shareholders, management should participate and have the potential to become rich. This led to the growth of stock options and management incentive plans that caused many management groups to become even more focused on "current earnings" and short-term "stock price," often to the detriment of long-term value. When results fell short of financial goals, some management groups became overly creative to the point of finding ways to inflate earnings through accounting tricks rather than the old-fashioned way of satisfying customers. The failure of the value creation movement shows that relying on one metric such as EPS or stock price to evaluate performance has significant risks in itself. A broader approach is needed.

Yet despite its weaknesses, the value creation framework does provide some meaningful benchmarks. Directors and management must understand the cost of capital appropriate for the company. Without an understanding of cost of capital, directors and management will not be able to properly evaluate major investment decisions and strategies.

Companies and businesses that are earning above their cost of capital are generally creating wealth if they grow. However, companies that are not earning their cost of capital and projects that are not likely to cover the cost of capital are likely to destroy value if they grow. Shrinking businesses is a tough thing to do, but good corporate governance dictates that businesses that are not likely to earn above their cost of capital must shrink to create value. While shrinking a business may create value for the shareholders, shrinking is not likely to create value for employees or an entrenched management group. Directors must understand when businesses should be grown and when they should be pruned. Despite all its abuses, problems, and misunderstandings, the shareholder value framework provides one of the best tools for evaluating major investments and disinvestments. (For a tutorial of one of the more popular shareholder value approaches, visit www.sternstewart.com.)

DIRECTORS CAN PROVIDE DISCIPLINE TO EVALUATE HUMAN CAPITAL

In his 2002 best-seller, *Good to Great,* author Jim Collins provides a simple framework for transforming companies. His research shows that it takes a combination of disciplined people, disciplined thinking, and disciplined actions to make a good company a great one. This simple framework is a list of three things that directors can work on without being accused of micromanaging. First, directors must be convinced that the right people are running the company. Selecting the CEO has always been a board responsibility but is even more important now than ever

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before. Deciding when a CEO must be replaced is probably one of the hardest decisions a director needs to make, yet regular annual disciplined evaluation of the senior leadership team and the succession plan is needed.

Second, directors should make sure that there is a "disciplined thinking" process in place. Using tools such as the Balanced Scorecard, value creation, and PIMS Principles provides an indication that a disciplined thinking framework or process is in place. Yet disciplined thinking is of little value without disciplined action, the third important factor. Directors and investors need to monitor whether management is experimenting with new ideas and taking actions that will lead to better results. Doing the same things that worked in the past is no guarantee of success in the future. Disciplined action and implementation are often believed to be more important than developing the best strategy, but why not be committed to disciplined thinking on the best strategy as well?

Succession planning is a good example for examining corporate discipline. At General Electric every executive is ranked relative to peers. There is a formal process for evaluating individual performance relative to others in the same job classification. The forced ranking puts individuals into three categories: the top 20% (performers), the middle 70% (keepers), and the bottom 10%. The bottom 10% are asked to leave every year. This is an example of a "disciplined process" that includes disciplined thinking about measurement and disciplined action. All are designed to keep the right group of people in the company. Every company could benefit from a systematic process of annual review of personal skills and performance levels. Directors should make sure that such a systematic process is in place.

BALANCING DISCLOSURE WITH COMPETITIVE RISKS

Corporations have long argued that disclosing detailed financial, strategic, and operating data to shareholders and employees will give competitors an advantage. The reality is that aggressive, disciplined competitors are currently making their own estimates without these public disclosures. The competitive risk of disclosing more detail on the business is overshadowed by the benefits gained when employees, investors, and directors have a clearer vision of business issues and future direction. Directors need to see that employees and investors have the information and processes they need to make better decisions about the company. With the dawning of the Internet Age, making these disclosures useful to directors and eventually to investors without compromising competitive secrets is a challenge that will be overcome. *Investors and directors must urge management to begin experimenting with a broader, more robust set of financial, operating, and strategic measures that can eventually be disclosed to all stakeholders in the future.*

SARBANES-OXLEY INTRODUCES A NEW DISCIPLINE

On July 30, 2002, Congress passed the Sarbanes-Oxley Act of 2002.

The law mandates changes that will ripple from the boardroom to the cubicles of the internal auditor and accounting clerk. To comply even minimally, companies must build a number of new procedures and processes.

At the board level, a "financial" expert will be either designated or recruited to join the audit committee. That committee will negotiate and supervise the engagement with outside auditors. *Large institutional investors that have a role in recommending directors and at some point hope to take a company public will need to observe new independence rules at a much earlier stage than ever before.*

Meanwhile, the outside auditors *will develop new procedures* that dig further into company controls and processes during their audits. In the past the standards required only that the auditor understand the controls well enough to enable the auditor to determine what level of testing would be necessary to proceed with the audit. What did not happen was an assessment of the quality of the controls. That task has been left to management. In many companies with sales below $1 billion there may be no formal internal audit function charged with continually checking the quality of the controls. One thrust of Sarbanes-Oxley is to close that gap. As a result, management and/or the board of smaller and mid-cap companies may engage auditors for special internal control reviews.

> *Governance legislation will impact the family owned or controlled firms as well. Yet accountability is more difficult when members of the family sit on the board.*
>
> —A Non-Executive Chairman

The "best practices" company response to Sarbanes-Oxley will be to view the law as a requirement to build a containing barrier around potential lapses in controls. The law accomplishes it by putting specific pressure on different players within the corporate structure.

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EXHIBIT 3
Highlights of the Key Deadlines for Rule Making and Compliance

Date	Requirements
Jul 20, 2002 President signs SO into law	• New loans to officers and directors prohibited • Bonus forfeitures for significant restatements
Aug 29, 2002 30 days after signing	• CEO/CFO certifications in effect • Reporting of stock trades reduced to two days
Jan 26, 2003 180 days after signing	• No officer/director trading during pension plan blackout period • Outside counsel to report violations of SEC laws or breaches of fiduciary duty
Apr 26, 2003 270 days after signing	• Audit committees must be independent • Audit committee must adopt procedures for accounting complaints and whistle-blower input • Public Company Accounting Oversight Board (PCAOB) to begin assigned duties
Jul 15, 2003 350 days after signing	• Companies must disclose "Audit Committee Financial Expert" for annual reports issued after this date
Jul 30, 2003 One year after signing	• Stock trades of officers and directors must be posted to company website and SEC within two days of trade
Jul 30, 2003 One year after signing	• Rules on analyst disclosure of conflicts of interest

- Directors must meet higher standards and take a more active role in overseeing management processes.
- Audit committees are to be enhanced, made more independent, and chartered with contracting with the outside auditor, and made directly responsible for receiving complaints and concerns from employees regarding accounting issues.
- CEOs and CFOs are individually tasked with certifying the accuracy of financial statements and the effectiveness of controls behind them. New codes of ethics for senior financial officers will be drafted, and the timing of reports to the SEC will be shortened.
- Auditors, aside from falling under an entirely new regulatory framework, are to be responsible for attesting to the quality of their clients' internal controls. Their spectrum of non-audit services is severely limited for audit clients of the firm, and partners may not become employees of their client companies until a year after they have rotated off their client's audit team. Audit partner rotation is also a new requirement.
- Employees of the company will be provided with a "confidential, anonymous" method of reporting violations of accounting standards and ethical practices.

Sanctions under the law are severe, and its implementation is substantially through the amendment of the Securities and Exchange Act of 1934, where penalties were already high enough to maintain the focus of most corporate executives. Sarbanes-Oxley has set in motion a cascade of SEC regulations, some of which require further rule changes within the stock exchanges on which companies are listed. The final details continue to evolve, and will do so for most of 2003 as noted in Exhibit 3.

For companies that execute well against the requirements, there should be a decrease in the incidence of fraud

and an increase in transparency. The intention is to restore confidence in the accuracy of performance reporting that investors depend on.

> *The average sitting CEO cannot afford to be on more than one other public board. The director time commitment of 120 to 200 hours suggested by the National Association of Corporate Directors is a significant amount of time.*
>
> —Director, Former CEO

This will happen only to the extent the new direction is embraced by boards and management. If not, compliance will become a perfunctory exercise of checking off the boxes. The telling point will be whether frauds of the future are attributable to a resurgence of control system lapses. As before, the ethics, diligence, and hard work of directors and management will be the ultimate determinant.

Companies have two choices:

- Create a laundry list of particulars and add each process independently, or
- Design a program to ensure financial transparency and protect against lapses in controls. If successful, they may be rewarded by experiencing lower risk, fewer claims against D&O insurance, and higher stock prices.

Forward-looking boards and management teams will also turn the new legal requirements into an opportunity to build a framework of cooperation between board and management. They will strike a clearly defined and productive balance of power and influence between CEO and board. This framework will protect the board and management, better define the separate roles, and allow the company to benefit from superior management performance guided by effective process oversight at the board level.

CORPORATE GOVERNANCE SCORES INTRODUCE A NEW METRIC AND DIMENSION

The governance services are monitoring corporate boards and directors for compliance and spirit. Institutional Shareholder Services (ISS), The Corporate Library, and others have been refining and/or developing new metrics to measure corporate governance. These new metrics are likely to have a greater influence on investor behavior in the years ahead as the links between corporate governance and corporate performance are better understood.

ISS, which is best known for proxy-related services, publishes its trademarked "Corporate Governance Quotient" on the front page of its proxy analysis reports. Details on the rating are provided on the second page of the proxy analysis for each company. ISS governance quotients are based on 61 variables grouped into eight core topics, which include:

- Board structure and composition
- Audit issues, such as audit fees and auditor rotation policies
- Charter and bylaw provisions
- Laws of the state of incorporation
- Executive and director compensation
- Qualitative factors, such as existence of succession plans, outside advisors available to the board, and board performance reviews
- Director and officer stock ownership, and
- Director education

Companies can view the ratings criteria, their ratings, and the ratings of their peers as well as submit updates on the ISS website. (For details on the ISS governance quotient, go to www.ISSCGQ.com.)

The Corporate Library produces a growing variety of rating tools for institutional investors including its "Board Effectiveness Rating" on more than 1,600 public U.S. corporations and a selection of 250 large non-U.S. corporations. The Board Effectiveness Rating is based on a smaller set of dynamic indicators based on the role of the board and its individual directors in monitoring and preserving—or destroying—shareholder value. Its ratings are based on a detailed analysis of proxy data and more than 10 years of governance-related investor experience. The ratings consider the details behind five broad factors:

- CEO employment contracts and compensation practices
- Outside director shareholdings
- Board structure and makeup
- Accounting and auditing oversight
- Board decision making

In addition to the ability to screen their databases, their website contains significant examples, timely governance articles, and the ever-growing Patterson Report.

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The Patterson Report summarizes the growing literature on corporate governance and its links to corporate performance. (For more information on Board Effectiveness Ratings, the Patterson Report, and hours of reading on governance, go to www.thecorporatelibrary.com.)

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Only time will tell how investors integrate these new non-financial metrics into their investment decisions. Likewise, only time will tell how corporate leaders and directors respond to the new governance regulations. Regulation, while a motivator of change, is no silver bullet. (Learn more about why regulation is no silver bullet at www.teamworktechnologies.com.)

APPENDIX

Many New Broader Metrics to Choose From

For additional information, consult the websites listed below:

- For a look at the broadened future scope of corporate reporting, go to www.valuereporting.com
- For information on the adjustment process needed to compute core earnings, go to www.coreearnings.standardandpoors.com
- For a sample credit scorecard, go to www.SandP.com and search on "Report Cards"
- For more detail and charts on these new techniques for monitoring financial health, go to http://www.stern.nyu.edu/~ealtman/zscorepresentation.pdf
- For an example of the Vital Signs Strategic Business Review metrics and dashboard, go to www.empirimetrics.com
- To learn more about the Balanced Scorecard and how it is being used at a large number of public companies, go to the online free tutorial at http://www.bscol.com/
- For a tutorial of one of the more popular shareholder value approaches, visit www.sternstewart.com
- For an example of an independent risk profile, go to http://www.empirimetrics.com/risk.pdf
- For more details on the ISS governance quotient, go to http://www.isscgq.com/
- For more information on Board Effectiveness Ratings, the Patterson Report, and hours of reading on governance, go to www.thecorporatelibrary.com
- Learn more about why regulation is not a silver bullet at www.teamworktechnologies.com

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