

**Lessons from Enron:  
A Symposium on Corporate  
Governance  
October 17, 2002  
Afternoon Session**

*MR. IDE:* Now we are going to get into more of the details on corporate governance post-Enron. Michael Rosenzweig will be our moderator. Michael, at age twenty-seven, joined the Michigan law faculty and was a professor there until age thirty-five, and then he saw the light and came into the private practice. The life-altering event for Michael was when, as an academic, a practitioner showed him a wonderful dynamic that was working so well in practice. Michael said, "That is fascinating. I wonder if it will work in theory?" That's when he realized it was time to switch over. So we're going to have a free form discussion of corporate governance. Michael is a partner in McKenna, Long, and Aldridge, a multi-city law firm in Atlanta.

*MR. ROSENZWEIG:* Thanks, Bill. I'm distressed that in telling that story you felt it necessary to reveal that I'm older than thirty-five now.

*JUDGE TENNILLE:* You've been in private practice four years, right?

*MR. ROSENZWEIG:* One of the great things about being on a law school campus is the vitality and the youth that one is privileged to witness, and one of the really depressing things about being on a law school campus is the vitality and youth with which you're confronted. It's very sobering.

*MS. JONES:* While you're up there, could you please explain to the audience who Freddie Prinze is?

*MR. ROSENZWEIG:* Freddie Prinze was the father, right? No, that was Freddie Prinze, Jr. You don't know who Freddie Prinze is if you know who Freddie Prinze, Jr. is. Freddie Prinz was a comedian, who, sadly, committed suicide.

*MS. JONES:* He had the "it's not my job defense."

*MR. ROSENZWEIG:* Oh, so that's the relevant part, "it's not my job?"

*MS. JONES:* Yes.

*MR. ROSENZWEIG:* I guess I've done a great job so far. I want to thank Bill for inviting me to be on this panel, and I wanted to thank my colleagues on the panel, who I think have provided a very interesting, and very stimulating, and high level discussion thus far.

The title of this segment of the program is "Proposed Corporate Governance Reforms," and I suppose the implicit suggestion is that since it's got a different title from the first two segments of the program, it must be different. And in some respects, to be sure, I think the discussion will be a little bit different. I think, among other things, we'll try to drill down at a greater level of detail into some of the corporate governance reforms that form the current debate and form the current landscape. But in a very real sense, I also think that this discussion is very much a continuation of the conversation that we started this morning. In particular, I do hope that we'll come back to some of the themes that we began to discuss this morning because I think those are the themes that are really pervasive in this arena, and I think they're the themes that form the debate and will continue to do so for some time. So while I do think we'll talk at some level of detail about specific governance reforms, I'm also hopeful that we'll be able to continue to talk about some of the broad issues that we talked about in such a stimulating fashion this morning.

You've heard a number of times, I think, already, and if you haven't heard it before now, I'm sure you've read this: that the Sarbanes-Oxley Act<sup>1</sup> represents, in many respects, the most sweeping federal regulation of public corporations since the federal securities laws were enacted some seventy years ago. And many would argue that in many respects Sarbanes-Oxley is an even more sweeping set of reforms than the federal securities laws.

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

Both before Sarbanes-Oxley, and certainly since the adoption of that law, we have seen various proposals in the corporate governance arena from the so-called SROs, the self-regulatory organizations. The New York Stock Exchange had proposed rules, NASDAQ had proposed rules, the SEC itself had proposed corporate governance reforms, and of course, more reforms from the SEC are expected under the legislation, both because the SEC has been given authority, and in certain cases, as you know, the SEC has been mandated to adopt rules under Sarbanes-Oxley.

I think a very interesting and legitimate question that we should ask ourselves about all of this is: Is there a common thread that we can identify with respect to all of these reforms? If we look at Sarbanes-Oxley, proposals from the SEC before and after Sarbanes-Oxley, proposals out of the New York Stock Exchange, [and] out of NASDAQ, is there a common thread? I would argue that there is very much a common thread, and I think the common thread is that governance matters. I think if you look at all of these reforms, the message, loud and clear and repeatedly, is that governance really does matter. What I mean by that is that the implicit, indeed, perhaps even the explicit assumption, that I think one can identify in all of these reforms is that good corporate governance tends to produce better, more socially desirable corporate decisions, and conversely, bad governance produces, or at least facilitates, bad corporate decisions.

Now, what do we mean when we say that? What do we mean when we talk about “good” and “bad” in this context, when we’re talking about corporate decisions? Well, I suppose in a certain sense good corporate governance presumably causes corporate decisions that recognize and promote the fiduciary duties of corporate actors, duties that require those actors to subordinate their own interests to those to whom their fiduciary duties run. And I want to say this again because I think this in many ways is the over-arching theme that we can identify in all of these reforms, and certainly in Sarbanes-Oxley, that in a certain sense what we’re trying to do, what Congress presumably was trying to do, and what the SEC and, to a certain extent, the New York Stock Exchange and NASDAQ are trying to do, is adopt reforms, adopt rules that promote the fiduciary duties of corporate actors that facilitate subordination of the interests of those actors, their own self-interests, to the interests of those to whom their fiduciary duties run.

In this sense I would argue that Sarbanes-Oxley is, among other things, an attempt really to codify, to a certain extent, standards of good governance; that is, an effort to adopt specific requirements, specific, concrete requirements that give detailed content to what would otherwise necessarily be, and is as a matter of state law, a broad concept that we call “fiduciary responsibility.” There was a speech recently given

by SEC Commissioner Cynthia Glassman, and I think she said this rather well. What Commissioner Glassman says that Sarbanes-Oxley and the SEC's rules are aimed at, and I'm quoting here, is "insuring that those who act on behalf of a company give life to the corporate conscience."<sup>2</sup> Now, that's very interesting when you think about it: the notion that we should have federal legislation, the central purpose of which, in the view of at least one SEC commissioner, is to give life to the corporate conscience.

I think the overriding question here, apart from those very interesting federalism issues that we talked about this morning and to which I hope we'll return in this conversation, is whether or not this is all really true: whether or not corporate governance will really involve a paradigm shift with respect to the responsibilities of corporate directors. We know that we've heard lots of talk about that. We know that we have heard lots of good intentions about that, but the real question is—are we witnesses to such a paradigm shift? Will corporate directors in this CEO-centric world in which we find ourselves really begin to act in demonstrably different ways in the discharge of their responsibilities, and will that, in turn, have the effect that's intended? Will that, in turn, in the final analysis, lead to a strengthening and augmenting of the duties of those fiduciaries and the way in which they perform?

Let me begin, before I turn to the panel with a series of questions, by reviewing briefly the basic landscape of the recent reforms. I know that we've referred to a number of these throughout the conversation this morning, but I want to begin by making sure that everybody in the room is on the same page, simply by reviewing some of the basic reforms that constitute this landscape, and then I'll raise some questions, and we can have some conversation with the panel.

A number of people observed that you can make a statement, and I think it's true, that in a general sense most of these reforms are aimed at independence. I think that's true. I think, however, that it's worth looking at some of the details. You have in your programs an excerpt from the preliminary report of the ABA Task Force on Corporate Responsibility.<sup>3</sup> Exhibit A, which appears on page forty-four of your programs, is a good source, not the only source, but a good source for beginning to understand the landscape of proposed governance reforms. I want to look at that very briefly and literally just read some of that so

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2. Cynthia A. Glassman, *Sarbanes-Oxley and the Idea of "Good" Governance*, Address Before the American Society of Corporate Secretaries (Sept. 27, 2002) available at <http://www.sec.gov/news/speech/spch586.htm>.

3. *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 54 *MERCER L. REV.* 789 (2003).

that we have that in front of us as part of the basis for our discussion. So what are the recommended standards? These are all corporate governance recommendations.

Number one, a board of directors should include a substantial majority of independent directors. Number two, a corporate governance committee composed entirely of independent directors should be responsible for identifying and contacting potential independent directors. Three, the audit committee, about which there is a lot of interest and attention, should consist entirely of independent directors and should have authority to recommend or take action with respect to engaging and removing the outside auditor, engaging independent accounting and legal advisors when deemed necessary or appropriate, and establishing policies relating to non-audit services by the outside auditor. Four, the compensation committee should also consist entirely of independent directors and should have authority to recommend or take action with respect to determining senior executive officer compensation and engaging independent executive compensation and legal advisors. Five, the corporate governance committee, yet another committee, should recommend a corporate code of ethics and conduct, something that some corporations have, many don't, including establishing a mechanism for communication to independent directors of information about material violations of law and breaches of duty to the corporation. Six, a committee of independent directors should approve all material transactions with any director or executive officer. And, seven, the board should adopt procedures for routine executive session meetings between the corporate governance and/or audit committees and the corporate officers responsible for implementing internal controls.<sup>4</sup>

And then, and I won't read the rest, there are recommended governance enhancements, not quite the same as recommended standards, but very much along the same lines, considering the use of a lead independent director, policies establishing term limits, director training and education, and so on.

As Bill Ide mentioned earlier, hearings are taking place around the country to discuss, and probe, and learn more about ways in which those preliminary report recommendations might be modified. They're by no means final, but it's a good starting place to understand what the landscape is.

It's also worth at least briefly reviewing the provisions of Sarbanes-Oxley and the New York Stock Exchange and NASDAQ proposals that speak specifically to these questions of corporate governance. So what

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4. *Id.* at 820-22.

about composition of the board of directors? Well, both the New York Stock Exchange and NASDAQ, like the ABA Task Force, would require a majority of independent directors, not necessarily a substantial majority, as would the standards of the ABA Task Force, but both the New York Stock Exchange and NASDAQ would require a majority of independent directors. No such requirement, by the way, in Sarbanes-Oxley. I won't go into the definitions of director independence except to note that they are different in those two sets of rules, and it's worth looking at because they are considerably more stringent in some respects under the New York Stock Exchange proposal.

What about the requirement of having nonmanagement director executive sessions? The New York Stock Exchange rules propose that nonmanagement directors would be required to meet in regularly scheduled executive sessions without management present. NASDAQ proposes that independent directors would be required to meet in executive sessions as well, although as Sol mentioned earlier, controlled companies would be exempt from that requirement.

What about the requirement of a nominating or corporate governance committee? No requirement under Sarbanes-Oxley, but again, both the New York Stock Exchange and NASDAQ effectively would require that mechanism.

Audit committee member qualifications? Here we have Sarbanes-Oxley and the New York Stock Exchange and NASDAQ all imposing rather stringent requirements with respect to additional independence requirements that would have to be satisfied by audit committee members. All, Sarbanes-Oxley, New York Stock Exchange, NASDAQ, propose audit committee charters, which I won't go into in detail. The New York Stock Exchange and NASDAQ would separately require that shareholders approve certain equity plans, equity compensation plans.

What about corporate governance guidelines? No requirements under Sarbanes-Oxley, but under the New York Stock Exchange's proposed rules, listed companies would be required to adopt corporate governance guidelines. And those guidelines would have to address a variety of subjects, including directors' qualification standards. How do you decide whether an individual is qualified to be a director, responsibilities of directors, compensation of directors, access to management and independent advisors, and management succession? Interestingly, NASDAQ has no similar requirement for corporate governance guidelines.

All three of these sources, Sarbanes-Oxley, the New York Stock Exchange rules, and the NASDAQ rules, to varying degrees, would effectively require companies to adopt codes of business conduct and ethics. So that's one that we're very likely to see.

And I think that's the basic landscape. I think that those are the basic kinds of governance reforms that we can expect to see. Now, a number of questions are raised by all of this, and I want to come back to an observation that Judge Tennille made this morning. I think he observed quite correctly that, in a certain sense, when we look at Enron, and WorldCom, and Adelphia, and Tyco, and all the many other corporate scandals that frankly led to a political climate in which Sarbanes-Oxley could be adopted, it's fair to say that we can trace those to four kinds of failures. One is a failure with respect to director independence. The second is really a failure with respect to our capital markets, the capital markets bubble, the urge, the perceived need on the part of corporate managers to manage earnings. Third is a question of the adequacy of information available to directors for their decision making and a perceived failure with respect to the adequacy of information. And finally, is a failure of analysts and others to shine the spotlight correctly.

So we have these four areas of failure. We have this landscape of proposed reforms that in theory, at least, one hopes are intended to deal with those fundamental failures. What's the over-arching question? I would submit that the over-arching question, the one that I want to begin by posing to the panel, is: Can we realistically expect regulation, whether it's regulation at the federal level or at the state level, to address effectively these kinds of failures without, at the same time, seriously undermining the flexibility and the dynamism that are necessary in a vibrant capitalist system? And to the extent that we can, is it really necessarily the case that the federal solution is the optimal solution? So, let me begin with that question and throw that out to the panel, and then we'll move on from there. Can regulation really effectively address these failures?

*MR. WATSON:* I'll certainly support the purpose behind the New York Stock Exchange requirement that listed companies have corporate governance principles. However, my recollection is that Enron had what one would call a "model" set of corporate governance principles. And I point that out simply to say whether a standard is in a statute, a rule, regulation, or a written code of ethics, the writing in itself isn't controlling. It's the value system of the organizations and the individuals that are within the organizations which I think are controlling.

*MR. ROSENZWEIG:* Any other thoughts on that? Bill?

*MR. IDE:* I agree with Sol. I think Congress passed Sarbanes to show concern for reform, but it is a real hodge podge. Parts of Sarbanes

smacks of micro management, but to me, it gives a signal that corporate America better reform itself or other such cumbersome acts will be passed. The self-governance approach of the SROs with independent directors and their committees is the way to go in my view. But this assumes that corporations will step up and be serious about independent director oversight. What you find in unregulated areas is most people carrying out trust, but if there's room for abuse then somebody abuses. To go to the extreme of total regulation doesn't work because no one feels any sense of responsibility or accountability.

The answer is to find middle ground. We have good corporate governance laws in place. There isn't anything that's come out of any of those frauds that state law doesn't cover. The missing ingredient has been proper independent director oversight of management.

I put my hopes on the independent director processes that have been put in place by the SROs because they're saying: "Look, if you're going to be an independent director, you've got to be accountable." I think it's important that state law supplement the business judgment rule<sup>5</sup> with a procedural duty for independent directors to make the three committees bring all important decisions in those areas to them for decision. If they make the wrong decision in good faith, they should be protected by the business judgment rule. They cannot, however, totally abdicate to the CEO on governance, audit, and compensation.

*MR. ROSENZWEIG:* Well, how do we deal with the recognition? I think we all recognize this to be true: that in all of these cases these were by and large garden variety breaches of fiduciary duty pursuant to customary long-standing state law standards. Now, Judge Tennille this morning in talking about this favored the state law solution rather than a federal solution, arguing that the benefits of diversity [and] the benefits of competition among various states should suggest to us that if we had to choose here, really the federal solution is not the optimal solution. We ought to be solving these problems, seeking to solve these problems, at the level of state law.

I guess one question that this raises, particularly in light of what Bill says is, can that really work? What about the so-called race to the bottom? You know, we all know that there's two sides to most argu-

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5. "The presumption that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest. The rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, with due care, and within the directors' or officers' authority." BLACK'S LAW DICTIONARY 192 (7th ed. 1999).

ments, and when one thinks about the perceived benefits of regulating or attacking these problems at the level of state law, to be sure, as Judge Tennille suggested this morning, there are certain benefits to diversity and competition.

On the other hand, many would argue, citing exactly the Delaware experience, that when we have regulation at the state level and we have the possibility of fifty different approaches, what we often find in the final analysis is a race to the bottom. Another example of this that a lot of folks point to is the competition for listings between the New York Stock Exchange and NASDAQ. Bill made some interesting comments about the political climate in Washington and how most of us who were looking at it would have predicted, as late as June really, that there was very little chance for Sarbanes-Oxley to be passed. And then lots of stuff happened, the political climate shifted, and lo and behold, it was a steamroller.

Well, similar things were going on at NASDAQ. When NASDAQ announced its first set of rule proposals in the corporate governance arena, I think in May, most people perceived that it was a fairly watered-down set of standards, certainly as compared to the proposals that were announced by the New York Stock Exchange. Then everything hit, Sarbanes-Oxley was embraced by Congress. Suddenly NASDAQ, in July I think, after the adoption of Sarbanes-Oxley, came up with a new set of proposed rules. And if you were to compare the NASDAQ rules that were announced in July with those that had been announced in May, you would find that, remarkably, the proposals announced in July are much closer to the New York Stock Exchange proposals, much more stringent, much more restrictive from the point of view of corporate management and other fiduciaries.

That is a very interesting phenomenon when you think about it because just as we have witnessed at some level a race to the bottom among the states, states tripping over themselves to provide more and more flexibility to corporate managers, more and more liberality in an attempt to attract companies to those jurisdictions, attract those franchise fees, attract those companies that will need to be retaining lawyers in those states, we witness the same thing at the level of SROs. And yet, what we found because of this seismic shift in the political climate over the summer is an abrupt about-face on the part of NASDAQ. Well, how does all that play out in the arena of state regulation of corporate conduct?

We know the black-letter law. We know that as a matter of black-letter law, the question of fiduciary duties, the question of the relationships among the various corporate constituents is not appropriately a matter of federal law. Traditionally, in our legal system it has always

been a matter for the states. And yet, we have what we have. Do we think in the final analysis that the federal solution is not the right solution? That we can really rely, as Judge Tennille suggests, on the benefits of diversity and competition among the states? Or, is this finally a recognition that there's a limit to that? And one could argue, just as we've seen in the area of federal securities regulation, we're now into an era of recognized, if not de facto, federal regulation of the law of fiduciary duty.

*MR. IDE:* I'll take the first crack and then let the other two. I think we've reached a point where society is not going to support a system of sorting things out after the fact. That's the way our judicial system has worked. In other words, if a corporation is defrauded, the wrongdoers are convicted and sued in civil actions. I think part of what's going on today is driven by the new complexity facing corporations. The average life of a CEO is four years in corporate America. The business dynamics are so different. WorldCom was [a] fast-moving telecom, rolling up all kinds of communications businesses. Enron entered energy trading, an unregulated frontier land. With technology moving so fast, and globalization of businesses moving so fast, there is much more volatility and uncertainty. Plus, you've got Wall Street demanding increases in earnings every quarter. In most of the recent frauds, such complexity surpassed the ability of directors (and perhaps some CEOs) to keep up. But the public does not want a system that allows such fraud opportunities to occur with retribution at the back end. They want more front-end protections. That is the challenge that self-regulation and state law must meet.

*JUDGE TENNILLE:* Part of the problem that Bill has just alluded to is complexity. When you think about, not only the complexity in the markets but how rapidly they change, rapidly whole industries can appear and disappear, not just companies but whole industries. When you think about trying to create an ex ante set of regulations that can anticipate that change, it's practically impossible. The business world and free markets are simply too creative, and they're not going to stop being creative. They're going to change constantly. And there's no way that a group of congressmen sitting in Washington is going to anticipate what's going to happen in the business world a year or two years or three years from now. It is almost always going to require that ex post determination of corporate conduct.

I think what we're seeing now is an effort not to get to an ex ante regulation but to raise the bar where we start. We can say we want a substantial majority of independent directors. That provides absolutely

no guarantee that those individuals are going to act independently. They may fit the initial qualification, but when they get in there and start taking the jet to the board meeting in Boca Raton and having all the other perks, and we start paying them more, as we're probably going to have to, then they become a little less independent than they were when they first filled that free pigeonhole that we had for independent people. So I think what we're doing is we're trying to raise the bar as to where we start. But, in the end, we're going to have to come back to that ex post determination of whether these people actually acted in good faith with the proper motivation and whether they were well-informed.

And the other thing that we're trying to do, in addition to the independence, is to focus on that informed part of the decision making process in saying we are going to do whatever we can, be it with audit committees or regulation of accountants, that we're going to try to make that information flow more effective, more open, more visible. We not only want investors to know what they need to know to make investments, but we want directors to know what they need to know to make decisions. And we're trying to find the ways to open up that information pipeline and make it flow more freely and be sure that the directors have the information that they need.

So, I think our effort here is trying to raise the bar from where we're starting with the anticipation that we can't do it all ex ante. We've still got to have the ex post review.

*MR. ROSENZWEIG:* Following up on that, Judge, do you think you could make an argument that maybe one way of thinking about this whole question of whether a federal solution is the right solution, or the optimal solution, is to look at Sarbanes-Oxley and recognize that Sarbanes-Oxley really does a number of different things? Sarbanes-Oxley, on the one hand, as you're pointing out, can be seen as an effort in certain provisions to adopt mechanisms that enhance the independence of the actors without necessarily seeking to regulate their conduct. As you put it well, how they will act is a different question. Whereas, there are other provisions of Sarbanes-Oxley, and these various reforms that really do seek directly to regulate the conduct itself.

For example, and this is just one of many, the provision in Sarbanes-Oxley that flat-out prohibits loans to directors and executive officers. One could argue back and forth whether that's a good thing or a bad thing, but there's no disputing that that's a different kind of legislative approach than simply saying we want to enforce independence.

And I guess I'm asking this question of the panel: Is one way of thinking about this, perhaps, that we know we have, and have always

had, as a central feature of corporate law at the state level, the notion of the business judgment rule? We talked about it this morning. And it's well understood why we have that rule at the center of our corporate jurisprudence. It's because courts don't consider themselves particularly well-equipped, certainly not better equipped than corporate managers and directors, to make these kinds of business decisions, and so the notion is that as long as a business decision is made with reasonable business judgment, it's made in good faith, [and] it's made independently, the courts are going to respect those decisions. They're going to stay out of those kinds of decisions.

Perhaps one way of thinking about some of these reforms is that they're intended to leave the business judgment rule alone, leave that as the centerpiece of our corporate jurisprudence, but recognize that sometimes we need a little bit of help to ensure the independence and good faith of the decision-making process, the decision-making mechanism. And maybe one possible observation in that light is at that, in that limited sense, maybe it was time for a kind of federal solution. Not that we want or would be comfortable with federal legislation across the board, *ex ante* as you say, with regard to corporate conduct, but the notion of having stock exchange rules and SEC rules that are designed to ensure the basic independence and good faith of the decision making doesn't seem so far-fetched in that regard. Is that a less intrusive, perhaps less offensive way of thinking about this federal legislation?

*JUDGE TENNILLE:* I don't think the federal legislation in that sense does anything different from what the state common law has been in the past. If you go back and you look closely at all of the significant takeover decisions in the 1980s, the courts were focused on the procedure. They looked to see if the board had good governance practices in place, whether they had followed the right procedure in the transactions, whether they were getting independent advice from investment bankers, whether they had the information that they needed to make the decision. And where they didn't think the board had the right information, they enjoined the transactions. So that's what's been going on consistently. And that's not going to change.

I think what the legislation is doing is saying more to the public [that] you can have confidence that there are certain procedures there. It's not up to the court to look back at it, but from the public standpoint we're going to be sure that there are procedures in place that you know by law or regulation are there. Those same protections have been there at least since the early 1980s, if not before. And they've been enforced by the courts.

Bill Allen wrote a wonderful article,<sup>6</sup> which is cited in the *Wachovia / SunTrust*<sup>7</sup> opinion, and he's got what I've always referred to as Footnote 56, and basically he says in that footnote that if you look at all of the takeover decisions in the 1980s, there's one common thread.<sup>8</sup> And that is whether the court thought that the action of the directors was properly motivated. And if you'll look at every one of those decisions in terms of the motivation of the board of directors, you can determine what the outcome of the court's decision would be. That had nothing to do with the creation of any kind of regulations. That was the bottom line to those decisions.

*MR. ROSENZWEIG:* Well, I guess the fundamental question that has to be addressed, and I think it's raised squarely by those decisions, is whether in hindsight and with the benefit of the most recent events, we think that by and large the courts got that right because, in a very broad sense, as I think we said this morning, when you look at those decisions that grew out of all of that takeover activity in the 1980s, the overarching theme is: We want to trust management. We want to trust the board to protect the shareholders' best interests sometimes even more than trusting the shareholders themselves.

And I guess one question that's legitimate is: Did we get it right? Was it appropriate to repose that kind of trust and confidence in those boards, as reflected in those decisions in the 1980s?

*MR. IDE:* I think the dynamics are different because our problems today came from situations where the CEO ran the show, dominated the board, and the boards did not provide oversight. Those take-over cases were about whether we would trust the board to make a decision instead of the shareholders. Now I think our challenge is: How do we get the board to provide proper checks and balances over management? How do we have management run the business but have directors independently assuming that management is doing a good job?

That's I think the hard nut that we have to crack. I'm not too concerned that the independent directors pay themselves a lot of money and jet down to Boca Raton if they get the job done. They don't have the conflict that management has. When you look at the abuses manage-

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6. William T. Allen, *The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, in CORPORATE GOVERNANCE: THE STATE OF THE ART AND EMERGING RESEARCH (Klaus J. Hopt et al., ed., 1998).

7. *First Union Corp. v. Suntrust Banks, Inc.*, No. 01-CVS-10075, 2001 WL 1885686 (Mecklenburg County Super. Ct. June 26, 2001).

8. Allen, *supra* note 6, at 325 n.56.

ment made, undisclosed spending for personal benefit or hiding financial matters off of the balance sheet, that's what leads to criticism of: "Where was the board?" I think that's our core issue.

*AUDIENCE:* I just wanted to pick up on that. The board functions according to an agenda. And when the directors come together they're focused on the agenda. If management is setting the agenda, then you don't have effective governance because there is no independent determination by the board themselves as to where they want to go with their meeting. Now, admittedly, if there's a transaction to be considered, that should be on the agenda. But it starts with the board agenda itself and the direction that the board chooses to take each and every year as it moves through its governance process.

*MR. ROSENZWEIG:* Excuse me, I think it's a very interesting observation. One of the things that I think you can detect in these various reforms is a recognition that when you control information and you control the agenda, you control an awful lot. If you look at a number of these reforms, they're aimed at exactly those issues. The notion of a lead director [and] the notion of perhaps requiring that the independent directors meet separately in executive session without management present is aimed precisely at that kind of concern.

*MR. WATSON:* I'm sorry, could I make a general counsel and corporate secretary's response?

*MR. ROSENZWEIG:* Sure.

*MR. WATSON:* It's true that the corporate secretary meets with the CEO and the chairman and outlines a standard agenda: the Chairman's opening remarks, the president talks about operations, the CFO talks about financial reports, the general counsel talks about lawsuits won or lost or major transactions, there are typically reports from the chairs of committees on the actions of committees since the last board meeting, and there may be a presentation from an operating unit or a discussion of strategy. That said, I think in most well-run corporations it's understood that any board member who wants to raise an issue, either during the board meeting or in an executive session, has the right to do that.

Now, each of you is correct that the stock exchange standard requiring regularly scheduled executive sessions presided over by an outside director might give more encouragement for outside directors to raise issues. But clearly, in a well-functioning board, the chairman does not

with an iron fist control the agenda and say, for example: “Mr. Smith, you raised an interesting point, but it’s not on the agenda; it’s something that might be of interest to the shareholders, it might increase shareholder wealth, but it’s not on the agenda, and we’re not going to talk about it today.” Good directors would not abide such iron-clad control.

*MR. ROSENZWEIG:* Although, Sol, would you agree, maybe you wouldn’t—

*MR. WATSON:* On the one hand, I might, and on the other hand, I might not.

*MR. ROSENZWEIG:* Would you agree that one effect that Sarbanes-Oxley and these various proposals at the SRO level have is consciousness raising, or, perhaps, to a certain extent, having an impact on the culture of the corporate board room? You know, those of us who have counseled corporate boards generally understand that until now there’s been a pretty clear sense of the way these clubs operate. They are CEO-centric; the agenda is determined. Sure, no one would suggest that anyone is barred or restricted from raising issues that are not technically on the agenda, but the reality of that culture, the reality of that club, has always been that if you want to stay a member of the club, you understand what the rules are and you don’t rock the boat too much.

One thing that I’ve observed, and this is obviously purely anecdotal, since all of this has happened, is that directors tend to be a lot bolder. They’re a lot more willing to speak out both at board meetings and outside of board meetings. And, indeed, to some extent, they’re afraid not to.

*MR. WATSON:* Yes, I certainly agree that the legislation and the proposed listing standards have raised consciousness. And I do understand and appreciate, and do not necessarily attack, the general view of boards as having some degree of clubiness about them. However, let me step back for a historic view. At least back in the old days, the 1980s and the 1990s, the theory of board membership was that a CEO would attempt to attract to his or her board other CEOs or major CFOs who could provide a substantial role in looking at the oversight of the business affairs. And I think to some extent the clubiness claim has evolved from the fact that there was a view that if one CEO was on a board, he would scratch the back of the other CEO and so forth and so on. The extent to which that’s true in practice isn’t clear to me, but I do recognize that it may have happened from time to time.

Keep in mind the folks that some are describing as being, taking the extreme position, the “Casper Milquetoasts,” the folks who would go along with doing things adverse to the shareholder interest, are or have been themselves successful as captains of industries themselves. So at least to my mind it’s not a hundred percent clear that CEOs will just lay down and play dead for another CEO. And I say that realizing that it may make me appear to be a defender of the system.

*JUDGE TENNILLE:* I think that has impact in different ways. I think the primary problem area that has been created by that clubiness is the one that sticks in all of our craws, and that is executive compensation where you have other CEOs determining what the compensation of the CEO is, being advised by consultants who are hired by the vice president of human resources, who reports to the CEO, and who make their living finding that every CEO is above average and therefore needs more compensation than the average CEO. That is the one area where that’s created a significant problem.

On the other hand, Sol is right, if you want professional directors, you want people who understand your business and can help you create wealth for your shareholders, you want other good businesspeople on your board who can do that. So I think that’s part of what we’ve tried to do is getting an independent governance committee or an independent compensation committee to try to impact that one particular area.

And I want to emphasize that I think Bill is absolutely right, that the issues from the 1980s are not the issues that we’re fighting today, that they are two different issues. The only impact is going to be, I think, a much stronger argument on the part of people who have always argued that shareholders ought to have more rights in certain takeover situations, and that this failure of boards will have some added weight for those arguments going forward.

*MR. ROSENZWEIG:* There were a couple of hands I saw.

*AUDIENCE:* Assuming you can impanel a group of independent directors, who would be charged initially with the responsibility of selecting those directors? Because if it is driven from existing interests, or if the existing interests are the ones that select the new directors, how do you guarantee independence?

*MR. ROSENZWEIG:* Well, you know, it’s an interesting question. I think that, again, one of the themes that one can detect from all of these reforms is putting a tremendous amount of emphasis on the value, the perceived benefit, of independence. And I think that’s the answer to

your question as well. I mean the notion is that one of the committees that you would have to have that would be composed entirely of independent directors would be your nominating committee or your governance committee. And it would be that committee that would have responsibility for nominating those director candidates who would be elected. The theory is if they're truly independent, with all of the various definitions of that term, then good results will follow. But I think your point is well-taken: Who is selecting them and how independent are they ultimately?

*MR. WATSON:* Can I ask an academic two-part question of my panel mates and the audience? That is, what is the goal of independence, and how do we see that the goal of that independence [is] being played out every other month or every two months when this board of majority independent directors meets with the CEO-centric management (as Bill would say)?

*MR. ROSENZWEIG:* Well, let me take a shot at that.

*MR. WATSON:* And that's an academic question, a hypothetical, not necessarily a position I support.

*MR. ROSENZWEIG:* Yes, but I think it's a very important question. Actually, it takes us into the next set of questions that I wanted to pose to the panel, so I think it's a great segue because it really raises a couple of issues. One is the basic point that you're making, which is, what in the world do we mean by independence, and why is it necessarily a good thing? What does it accomplish? What is it we're expecting independence to accomplish?

I think buried in there is perhaps another question, or perhaps an assertion, that there's a real tension in terms of defining the effectiveness of a board of directors. If a board is truly independent, I suppose in the extreme it means they may not know a whole lot about the business. They may not know enough to function in the way boards have historically functioned.

I think related to that is a whole set of questions that I want to make sure we come to in this discussion: where do we get all these independent directors, how we attract them in the first place, what's the incentive for them to serve? You know, if they're truly independent, that probably means that not only are they independent from management and from the CEO, but they're not looking to the company for substantial compensation; they're not looking for consulting fees; they're not lawyers who are looking to represent the company as a client; they're not

investment bankers looking to be paid transaction fees for deals; they're truly independent.

Well, why would these independent, professional, capable individuals want to serve on these boards when one remembers that in this new world of corporate responsibility, they've got dramatically increased authority, dramatically increased responsibility, including, by the way, spending lots more time, especially if you're lucky enough to be on the audit committee, or the compensation committee, or the nominating committee, and, bottom line, significantly increased exposure, therefore, to liability? And when you add to that mix the observation that it's increasingly difficult to secure adequate directors and officers liability insurance coverage, and that once it is secured those D&O companies increasingly deny coverage, or seek to deny coverage, when claims are actually made, you sort of step back and say to yourself: What does independence actually accomplish? Why is it worth accomplishing? And, if it is, where are we going to get these folks anyway?

*MR. IDE:* I can give Sol's academic question as to what is independence a real world answer. There are two situations I can think of. In one, I chaired a board committee of independent directors examining a related party transaction involving members who were significant shareholders. Management was in a tough situation, but they and the shareholder/directors gave us the deference to do what we had to do. Our determination wasn't popular with the proponents, but I'm convinced that it was right and one management would not have been able to make.

In the other situation, I was counsel to an independent board committee doing a special investigation. I felt pressure from management, and the chairman of the independent directors committee stepped in to assure the needed independence for the special investigation.

What some of us are advocating is the need to set corporate culture in support of independent director oversight. Most CEOs understand this need and selflessly lead to such an approach. Their message is, "You're not rocking the boat and you're not out of etiquette if you say, 'I want to independently look at management compensation and performance.'"

*JUDGE TENNILLE:* The cultural change that I think we're trying to accomplish at this particular point, and it relates to the culture, is that we want directors to protect shareholders. And being independent is a substantial indicia of their ability to fulfill that function of protecting the shareholders. I think that, from a public standpoint, is what today our emphasis on directors is. That may be different next year, but right now

we want directors to be independent because we want them to be able to protect the shareholders the best they can.

*MR. ROSENZWEIG:* Do we think the expectations that we are placing on these independent directors are realistic? All things considered, are we going to be able to attract enough of them? Will they be sufficiently capable? Will they be sufficiently interested? Because it seems to me, as we think about [it], this system that we are in the process of creating really depends on certain assumptions, and do we really have reason to believe those assumptions are valid?

*MR. IDE:* I think it's going to depend a lot on how the law evolves. Will new law be made in the current environment as to director liability? What are directors going to be held liable for? My own view is that courts should stick to the business judgment rule, but follow the *Caremark*<sup>9</sup> suggestion that one can't look the other way. One can't sleep through meetings. But if one [is] procedurally diligent, then the business judgment rule ought to protect you. Additionally, the federal securities fraud law should not be expanded. There are plaintiff's lawyers who are going to try to expand director liability and seek to make them insurers. That would be a huge blow to the ability of attracting good people to boards of directors.

*MR. ROSENZWEIG:* Well, let me put the question to you. In many ways, Bill, you would be the textbook ideal candidate that the board of directors of a public company would want to attract. You've got the right credentials, the right experience, you're a lawyer, you bring all that that brings. I know you've served on at least one board of a public company. Hypothetically, if you were approached today to serve on a couple of boards as an independent director, is it something that would appeal to you in this environment?

*MR. IDE:* I'd do a lot of diligence. I'm going to stay on my present board because I believe in management, and I think they're wonderful people. I would clearly do an awful lot of diligence before I joined another board.

*MR. ROSENZWEIG:* And, ultimately, assuming that you've done the diligence and it's satisfied you in all the respects in which you'd want to be satisfied, what would be the determining factor? What would be the

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9. *In re Caremark Int'l, Inc.*, 698 A.2d 959 (Del. Ch. 1996).

fundamental attraction to you in this environment of serving on the board of a company? You can't produce much fees for your law firm.

*MR. IDE:* I can't produce any fees for my law firm.

*MR. ROSENZWEIG:* You're exposed to liability potentially. You're operating in an environment in which it's harder to get insurance and in which coverages are denied once claims are asserted.

*MR. IDE:* You sound like my lawyer.

*JUDGE TENNILLE:* Michael, I've thought about that a lot, and I think it comes down to where you come out basically on your belief in human nature. People who sit on boards of directors, particularly in major companies, have an opportunity to create both shareholder and societal wealth, and it is that opportunity to create and to have an influence that will, I think, continue to get people to serve in those positions because that's their motivation for being there anyway. They're not necessarily there for the money. They're there for the personal satisfaction that they get out of being able to see something created, for the organization to get bigger, to get better, and they're benefitting individuals; they're benefitting employees; they're benefitting the community; they're benefitting society as a whole if that corporation is successful. And there's a tremendous psychological reward for doing that, and I think people, if we don't make it absolutely incredibly onerous, people will continue to serve for that very reason.

*AUDIENCE:* That's most of what I was going to add, so I don't want to say the same thing, but I think there's an understanding that boards produce unconflicted oversight on behalf of the public, the owners, and to that extent, independence is really almost a misleading term. It's almost an unfortunate term because we, I would expect, want directors who would very well understand the business depending on what that company is engaged in. But what we want, I think, is unconflicted oversight on behalf of ownership, and I, it's not words from me but I heard it well said not long ago, supported by unconflicted advisors. And a lot of what we're seeing in the legislation it seems to me to be affording those directors the opportunity to be served by independent CPAs, their own counsel, if need be, or whatever it is. But I think to me the word "unconflicted" says it a little bit better than independence because independence could also be equal irrelevance, I think.

*MR. WATSON:* I think that's a good point.

*AUDIENCE:* My question also had to do with independence. If you were to take the board at Enron or WorldCom or any of the recent cases, would you identify the board as having been negligent in these cases? You know, would you say that this situation would not have occurred? Or are we proposing solutions [when] we're not sure what caused the problem? Independence has been the mantra certainly here today, but if you have a conflicted auditor, then, isn't the situation still going to occur?

*MR. ROSENZWEIG:* Well, you know, I think you have to get sort of specific when you ask a question like that. For example, if you look at Enron, a lot of things went wrong there. Some of those were within the purview of the board, arguably, and some were not. Certainly the board waived the company's policy with respect to conflict-of-interest transactions when asked to do so to approve some of these off-balance sheet special purpose entities with the company's CFO, Andrew Fastow. One could argue that a different board, a more alert board, might have responded differently and could have produced a different outcome.

To the extent you're talking about a WorldCom situation or a rather straightforward management of earnings, if you will, I guess you're talking about a different kind of problem. And what Congress would say, I suppose, is that we have different provisions of Sarbanes-Oxley to deal with that. That's why, for example, a feature of the law is to require certification by the CEO and CFO of financial statements even though that's not typically something you would expect the CEO to do. But there I think the understanding was that a different board at Enron probably wouldn't have made a difference with respect to that, but it sure would have prohibited Skilling and Lay from getting up in front of Congress and saying: "Gosh, I can't be expected to know anything about the financials. They are much too complicated." That's just something that I think Congress just decided we can't put up with.

*MR. IDE:* And, Michael, if you read the Powers Report,<sup>10</sup> it is very damning for the Enron board.

*MR. ROSENZWEIG:* Let me follow on one point that I think Judge Tennille just touched on, and I want to come back to this for a second because you painted a very appealing picture of what might motivate individuals who are asked to serve on boards, and I think one wants to

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10. William C. Powers, Jr., Raymond S. Troubh & Herbert S. Winokur, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., available at <http://news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf>.

believe that's true. One wants to believe that that's the motivation and that we can optimistically rely on that in this great new world of corporate responsibility.

*JUDGE TENNILLE:* You certainly want me to believe it as a judge.

*MR. ROSENZWEIG:* But to be somewhat cynical for a moment, what role do we think director compensation plays in all of this? Realistically, if we can stipulate that we have a greater need for directors in this world than there are those who will serve in the spirit in which you have suggested, what role do we ascribe to director compensation? How should we be compensating directors in this new world? Should they be given stock? Should they be given stock options? Should they be given dramatically increased directors' fees? How does all that shake out in the world of these new reforms?

*MR. WATSON:* And just to give folks a frame of reference, I can talk about the New York Times Company. The directors are paid an annual retainer of \$30,000 a year. They get a per meeting fee of \$1,000 per meeting. They get an annual grant of 4,000 stock options. And their expenses are reimbursed. And I think that's probably a middle-of-the-road director compensation package.

*JUDGE TENNILLE:* You get what you incentivize, and the way you structure director compensation has got to be based on what you want to give directors the incentive to do. If you want them to spend more time, you pay them for the time they spend. If you want them to be focused on short-term stock price, you give them stock incentives. I think you have to be very careful on how you structure the incentives.

*MR. ROSENZWEIG:* To what extent do we think that when you look at all of the stuff that's been going on, what's at the core of an awful lot of these problems is the way in which officers are compensated? And in particular that the problem is stock options? To what extent do we think that's true? And if that's true, what can be done about that? We didn't talk about that when I listed the various reforms that seemed to constitute the landscape with which we're currently confronted. We didn't say anything about stock options or other compensation of officers and directors.

*MR. IDE:* Well, it was alluded to earlier. In the past, the compensation approach was bubbled up through staff, so HR would go hire the consultant, and the HR job is to make the CEO happy, and so a package

is taken to the CEO, and the board had no real independent data. And now what we're talking about is having an independent compensation committee that hires its own consultant. And I think you raised a very good point. Compensation incents behavior. I think there's a real pressure now to say we want long-term behavior by CEOs, we don't want short-term behavior.

Furthermore, you'll start seeing performance options being much more en vogue where if you can produce a certain result for the corporation over an extended period of time, then you're entitled to more. That aligns management better with the shareholder. There is also the question of how long should management be in the game on options? Can they bail out anytime they want, or do you want to lock them in for an extended period? Those are the questions that compensation committees of independent directors need to get into.

*JUDGE TENNILLE:* One other point that I think it's important to keep in mind is that on the basis of state corporate governance there are certain things that we can't do. And if we look at our friends in Congress who don't want to take a whole lot of responsibility for what happened up until this point, they are the ones who determine what the tax treatment of options are. They are the ones who determined what the tax treatment of excess compensation is. And corporations and directors and management are going to be guided in substantial part by what the federal government says the tax impact of operating in certain ways are. That's not a state law function. That goes back to the very basic responsibility that Congress has, and they can basically use their taxing power to significantly influence corporate governance if they choose to do so.

*MR. WATSON:* A couple of observations on this stock option issue, which are meant to provide some perspective. First, there was a time not so long ago when commentators were very much enthusiastic about managers being compensated with stock options because that was deemed to align the interest of shareholders and management. Also, it's not wholly clear to me that today's average shareholder is, in fact, inextricably linked into long-term wealth creation by the corporation; that is to say, the days in which a shareholder would be deemed to buy a stock, put it in a box under the mattress and hold onto it for a very long term may have gone by the wayside (behold AT&T, etc.).

It is clear that, in many instances, compensation committees have given the senior executives of a company excessive grants of options. Some of the executives who got options from the telecom companies, WorldCom and others, just exercised the options as soon as they were

available to exercise, immediately converting equity to millions of dollars in cash. A number of compensation committees in the last several years have come up with a program, whereby executives are required to hold some large portion of the shares they get from exercising options for a period of time. In those cases, one cannot exercise the options on day one and sell all of the shares on day two. And I think those stock retention programs are going to increase in prevalence over the next period of time.

Additionally, in terms of the Tax Code, there's a section of the Code, 162(m),<sup>11</sup> which says that in order for a corporation to get a tax deduction for compensation for the top five executives greater than a million dollars, that compensation has to be somehow performance-based; and, also, the committee that approves that compensation plan has to be a committee of "outside" (versus "independent") directors. Though the goals are somewhat the same, "independence" is defined differently in the Tax Code than in the corporate governance area.

*MR. ROSENZWEIG:* Well, you know, that's a very interesting example of something that's pretty basic and we all know to be true, but the examples make it real, and that is that details really matter. As Judge Tennille suggested a moment ago, when you devise a compensation system, you have to ask yourself very carefully and precisely what kind of behaviors we are incentivizing with this particular system. So, for example, when you have the Internal Revenue Code, Section 162(m), that says that if a corporation wants to deduct compensation paid to an executive in excess of a million dollars, it's got to be performance-based, one effect that we've observed actually happens is a lot of the compensation tends then to be in other forms rather than in straight salary. For example, by the way of stock options. And when you look at the way the stock options themselves are structured, again, you've got to examine the effect that's going to have on the incentives thereby created. So, if stock options have a stated exercise price and those options can be in the money without regard to the performance of that company simply because the stock market generally is rising, and you provide an incentive to exercise and you don't require the executive to retain the stock that's obtained upon exercise, what you have created is a system in which there is a potentially obsessive focus on the part of those executives on what's going on that quarter, what's happening with that company's stock price that quarter and that day, and a very short step from that is having to worry about managing analysts' expectations

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11. 26 U.S.C. § 162(m) (2000).

because that's, of course, what moves stock prices. Each of these things is incremental, but when you look at them in the aggregate, it's not difficult to understand how you can have a WorldCom or a Sunbeam.

*MR. IDE:* Michael, there's another aspect on compensation. It's not just the senior managers. The system that you put in for the behavior of the whole company is a strong policy consideration. Some of the studies back on the GE price fixing cases in the 1960s show that with the compensation system in place, the only way the salesmen could make money was to fix prices. So as these compensation committees pull together with experts, they have the ability to impact the corporation's culture and behavior. And I saw it as a general counsel. When we felt diversity was important, we made a significant percentage of one's bonus dependent upon [] how one contributed to that goal, and people paid attention. So that's another area where I think a board input on shaping the direction of the corporation is important.

*AUDIENCE:* I want to propose another way of answering your question about the board's relative compensation: is it too high, too low, about right? We've heard some different techniques for trying to adjust the incentives for board members. But I just wanted to suggest what may be heretical, but a different way of thinking about it. And that is the hypothesis that board members are grossly underpaid by two measures. One of them, one measure would be in terms of management. Management, of course, as we have been discussing, everybody believes they're grossly inflated in their compensation.

*UNIDENTIFIED VOICE:* Not everybody.

*AUDIENCE:* Not everybody, okay. But, in any event, these are the people that are running the corporations; they value their leadership so highly that they're going to pay somebody these extraordinary amounts of money, well, then, certainly these relatively modest compensations for boards of directors have got to seem strange, strangely low. I suggest that we are grossly discounting the importance of the board.

Another measure is the free market in director compensation that has emerged in the venture capital industry. Basically what goes on in venture capital is that people agree to serve as directors and actually give management advice to businesses under the understanding that they're not going to take over the CEO's role, and they're going to bail out of the institution, in three, five, seven years, in return for a very, very attractive return rate of fifty percent on their money in, say, three years or something. That's the kind of money that's being talked about

when you look at the stakes involved. By two benchmarks, anyway, boards of directors are grossly under-compensated.

*MR. ROSENZWEIG:* Of course, the venture capital example is the ultimate illustration of an alignment of interests because they have a tremendous amount of skin in the game. They're interested in serving on the board because they have a huge ownership stake in the enterprise. I think Judge Tennille wanted to say something, and then I want to conclude with one question to the panel.

*JUDGE TENNILLE:* We started this morning with a comment from A.P., and we've ended with the same point from Sol. One of the important things that's going on today is change in ownership. And we expect different things from corporations today than we did ten, fifteen, twenty years ago. And I don't think we have a good handle on what corporate owners want just yet. That is one of the fundamental underlying questions that's going to dictate what happens in corporate governance is what owners really want out of business.

*MR. ROSENZWEIG:* With that, let me ask a final question of the panel, which I think follows perfectly from that observation, Judge. We have a panel of very distinguished, very experienced individuals from across the spectrum in the world of corporate governance. We've talked a lot about pervasive reform of a type we haven't seen in more than a generation. My question to the panel is: On balance, are you optimistic or pessimistic with where we find ourselves with respect to these issues today? Bill?

*MR. IDE:* Well, I'm always the optimist, but I'd put it about 50/50 that it will make a difference in the culture.

*MR. ROSENZWEIG:* Sol?

*MR. WATSON:* I'm an optimist. I think that the reforms will have an impact on the culture, at least in the short term. I'm not certain how long that impact will last.

*MR. ROSENZWEIG:* Judge?

*JUDGE TENNILLE:* I'm an optimist as well, and I believe that the major businesses in this country have always been run with an attitude that governance matters, and I think that will continue into the future.

*MR. ROSENZWEIG:* I want to thank the panel, and I want to thank the audience for your participation.

*(SHORT BREAK)*

*DR. AUSTIN:* Welcome to the fourth session today. I'm glad to see that most of you are still alive here and some even awake as well. We, the accountants, are the scallywags and the target of most of the Sarbanes-Oxley provisions. I would like to start by introducing our panel. We have Susan Jones from the American Institute of Certified Public Accountants (AICPA), and she represents the external audit function. We have Basil Pflumm from the Institute of Internal Auditors (IIA), who will present some of the reforms which the Institute is recommending. And then we have the loyal opposition, the critic from *Accounting Today*, Ed Ketz, who will give you his take on the issues involving Enron, corporate governance, and corporate responsibility. We'll start with Basil. He has a short presentation on the reforms which are being considered by the Institute of Internal Auditors.

*MR. PFLUMM:* Thank you, Walt. First of all, I want to thank you all for having me here today and to point out that it's not only lawyers who have problems with popularity; it's also auditors. But I don't really have a presentation. I just need to craft my comments so that I (a) stay in the ten minutes allotted to me and (b) don't forget where I am because sometimes I lose my place.

I wanted to open up with a few comments, first of all, just to make sure you understand what an internal auditor is. A lot of folks might not be able to do that. So in getting to that point, I think it's really wonderful that Mercer is sponsoring something on corporate governance here because my view is while we can do a lot of structure, processes, and things of that nature, the problems that are really in corporate governance are in hearts, minds, and attitudes, and that's the first place to start on all of this.

Secondly, I really believe that some of our publications, and for me it's particularly *Business Week*, have really been good at pointing to the soul of the issue. And a few months back they pointed out that the mistrust of business is great; they didn't liken it to the 1930s where most of us go back and point to the Securities and Exchange Commission reforms, but really they point to the turn of the century. They say it's almost the same sort of attitudes that fueled the Teddy Roosevelt trust busting of the last century, which I thought was an interesting observation.

Third, I wanted to identify that in my working life, which is basically the 1960s, 1970s, 1980s, 1990s, giving you an idea of how old I am, this

has certainly always been an issue, and I suspect it would be if I was working a hundred years from now. There's always something like this. And just to refuel your memories and make you know that it's not something in the last ten years, when I passed the CPA exam, the Equity Funding fraud was the hot issue of the day. And there are at least some of you out in that audience that know what that was all about. There was also a little later on the Foreign Corrupt Practices Act<sup>12</sup> that came out of McKesson/Robins irregularities which were equally as bad as what we have today. Then there was the savings and loan failures, resulting in the government bail out and the Resolution Trust Authority and some legislation (Federal Deposit Insurance Corporation Improvement Act)<sup>13</sup> that I think is an effective model today. And then more recently, and it didn't start with Enron, we can back up to Sunbeam, Waste Management, Cendant, Enron, WorldCom, and on and on, so we're not dealing with something that's new.

The common thread that I see in all of that, and I think most of my fellow internal auditors would say this, is that it's all tone at the top. When Equity Funding was the fraud du jour, I understood that the members of the company, the "in-group," were actually meeting and partying and printing up these false insurance statements [and] annuities that they would later present to the auditors, and they would have the champagne and the press going, and it became a company thing to do. And I heard, we had some relationship with Enron, and when the Enron people that I was able to talk to spoke, they talked about a trading mentality; in other words, an attitude, a way of existing in that company that I think led to the issues that unraveled the company.

So, let me get on with my topic. First of all, the Institute of Internal Auditors has made a public statement on effective corporate governance, and we do not look to any one area to solve this problem. We really view it as creating a partnership of different people, and the people are presented on this particular chart: directors, external auditors, executives, and internal auditors. We think internal auditors play a key role in governance, and many of you will know that one of the requirements that's come out of the self-regulated New York Stock Exchange is that they've asked for all organizations to have internal audits.

Directors are key without doubt, and I use the words that I liked best during a prior presentation, provide "unconflicted" oversight on behalf of owners. That's the best way that I know that we've heard that. Also, there's no doubt that the tone at the top set by corporate CEOs has a

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12. 15 U.S.C. § 78(dd) (2000).

13. 12 U.S.C. § 1831(m)-(t) (2000).

great deal, probably more, to do than anything else, with the way in which companies are administered. And, finally, there are external auditors. They're not part of the organization like the internal auditors are. They sit from afar, and they come in with the benefit of what they learn from the outside from multiple clients and are able to give that attestation that the investing public needs.

We view all four of those elements as essential to good corporate governance. And this is a personal view, but I believe that what we heard here earlier, the CEO-centricity of companies in the recent years, and one of the articles I saw in *The New York Times* referred to it as the imperial CEO, simply became out of balance over the last few years. We do need checks and balances. The Judge referred to that earlier, and I loved that reference. You can see the bottom item of this chart specifies the key being a good set of checks and balances.

Now, I want you to know about internal auditors. The total membership of the Institute of Internal Auditors is 80,000 members now and growing rapidly. We've had a lot of growth, and it's mostly tied up with the sort of issues we're talking here today about. But we're a global organization. We use the same set of standards around the world. Our standards have been translated into about twenty-three languages now. The U.S. is still the predominant place where we have internal auditors, but the United Kingdom has 6,000, Germany, all the industrial countries, and developing countries have internal auditors.

What do we do? Well, there's a lot of people that don't realize that we have our independent set of auditing standards. We have a certification. I am a CPA, but I am also a certified internal auditor, which is different from the certified public accountant.

We presented three recommendations to the U.S. Congress on the 8th of April, but we've been pretty consistent in recommendations in this regard. First of all, we do think that all publicly-held companies should have a uniform set of governance principles. Now, what do we mean by that? Well, the one that we like best and have endorsed is produced by the Center for Corporate Governance at Kennesaw State here in the State of Georgia. They pronounced a set of ten principles that we believe does a very good job of defining a baseline of corporate governance within an organization.<sup>14</sup>

Since we're involved in most of the countries of the world, the Enron issue in the U.S. is not unique to the U.S. The British markets have had the same issue. You'll remember GCI and the Irish Bank. And I

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14. Kennesaw State University, 21st Century Governance and Financial Reporting Principles, available at <http://ksuemail.kennesau.edu/~dhermans/principl.htm> (Mar. 26, 2002).

was in Australia a few years ago, and I just happened to hit there when the Australian United Way, or whatever it's called there, was going through the same thing. I recall that in New York our United Way had a similar problem about five or six years ago. So it's not unique to corporations; it's not unique to charitable organizations; it's not unique to government. We're all faced with running organizations for the common good, and I think that's probably what we're all about.

Now, we have two more recommendations. The board should disclose an assessment of the effectiveness of internal controls within their organization. We feel very strongly about that. But I want to caution you that we do not think that it starts with internal controls. Basically, governance processes must recognize the risk that any organization faces, and you do that at your house. You recognize the risk of your premature death and the need you have to educate children, so you buy life insurance. All organizations must look at the risk they face, including your individual self and your family.

So we start with that, and then we look at ways to mitigate those risks or reduce them as much as possible, and all organizations do the same thing. Controls are simply a way of doing that, but that's a basic responsibility, at least in our view, of company directors. And we have recommended that company directors provide that public assessment about the sufficiency of internal controls.

Now, where can that come from? You've probably guessed, it's coming from an internal audit, which leads you to the third recommendation, we think that every organization, every publicly-held organization, should establish and maintain a competently staffed internal auditing function, which leads me to want to tell you what an internal auditor is.

You might view us as accountants or CPAs that work for the company. That's true to some degree. But the most important credential for an internal auditor is to know the business because we will not so much rely on the ability to determine the value of the external reports, the financial, the reliability of financial reports, but we're going to want to evaluate operating efficiency, compliance with law and regulations, and safeguarding of assets in addition to the financial reporting. Often you'll find internal auditors know very little about accounting, but they'll know a great deal about information technology, or some operating subject like that.

Okay, just very quickly to the end. I wanted to give you a definition of both internal control and internal audit because I think it really is important for this discussion because we get down to the responsibilities of senior management and the officials in the company. The definition of internal control is that broader definition given to us by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)

about ten years ago now, and you can see that it's much more than just the public reporting on financial results, it actually addresses how well the company is run. So it's not limited to control over financial statements, but goes further. And, finally, what's internal auditing? This isn't a new definition that we just concocted to bring to Mercer University today. This is a definition adopted by our Board in 1999, which brings internal auditors into the governance risk management and control processes. So we do consider these elements all part of our charter and something for which we're responsible.

So where do we go from there? The basic issue is that structure, process, regulation, legislation, policy, all that sort of thing are probably good and necessary, but they do not replace the basic need we have, the need for people with integrity and sense of responsibility for the public trust that they hold. And this will not replace the idea that controls are everybody's business. However, I think it starts with "tone at the top" within the companies.

I heard just yesterday, and it was really good for me to hear, Hank McKennel, who is the Pfizer CEO, say that he really didn't view his job as creating value for the shareholders, although that was part of it; he thought he was creating wealth for customers and employees, and he went on the broader thing, and that was also discussed here earlier today. So I'll stop there. Thank you.

*DR. AUSTIN:* Susan.

*MS. JONES:* Okay. Let me start by asking are there any accountants in this room? (Hands raised). All right. For the rest of you, I'm going to give you a little Accounting 101 lesson. You accountants can tune out a little. Do you all understand the difference between accounting and auditing? Yes? No?

*MR. WATSON:* No.

*MS. JONES:* No, you don't, okay.

*MR. WATSON:* Well, I do, but for purposes of pedagogy, let's assume I do not.

*MS. JONES:* All right. Let's say Sol here wanted to start his own company, and he decided that he was going to sell mustard. And so he had a great formula for great mustard, and he decides that he's going to go do this. And as part of his marketing campaign, he drops a twenty-five-cent coupon in the newspaper. Now, what accounting would require,

and what accounting standards would require, would be for Sol to decide and record in his books the liability that he's going to owe on that coupon to the people who are going to redeem it at the supermarket.

Now, let's say that there's fifty million coupons out there in the Sunday newspaper, and let's say that Sol has reason to believe that ten percent of those will be redeemed at the supermarket, so that would be out of fifty million coupons, he's expecting ten percent, or five million, to come in, okay. And the coupons are, what did I say, twenty-five cents, let's choose an easier number, a dollar. So he's expecting that his liability is going to be five million dollars. And, so, he's going to debit an expense for five million dollars and credit a liability for five million dollars. And that is accounting, making that judgment to decide how much that amount is going to be and recording it in the books.

Then what happens is the auditor comes along. What the auditor does is takes a hard look at that number and decides whether or not it seems to be materially correct. Now, the auditor is going to look at things like Sol's estimate of how many coupons are going to be redeemed. Is ten percent a good number; is it a bad number; how many coupons have been redeemed in the past; does the weather have any affect on the sales of mustard? You know, for example, if it's a good barbecue weekend when the coupon drops, maybe sales will be high and more coupons will be redeemed. There's all kinds of things that go into that number. So the auditor is going to look at the assumption; he's going to look at the number, check the calculation, and decide: "Yeah, that looks materially correct to me."

But the thing that you have to remember is that there's a lot of judgment in that number. And there's a lot of judgment in almost every single solitary number on the financial statements. And it's up to the auditor to determine whether or not the statements are materially correct. The accountant does the calculations and the reporting and the disclosures, and the auditor comes in and checks it out. So that's the difference between the two.

And I've been distressed in the past year at how little the world understands about accounting and auditing, and I'm taking this as an opportunity to educate you all. So there's our Accounting 101 lesson.

I've been listening for the last day, and I would like to—well, let's go back to the auditor now checking Sol's numbers. The auditor is presumed at this point to be independent. We've talked a lot about auditor independence. And I would like to make some exception to Mr. Carlton, and I'm sorry he's not here right now, because I would like to take exception to his assertions that the accounting profession, you know, he's using other third party professionals. He means the accountants when he says that. And he has basically asserted that we

have wholesale thrown all of our values, you know, core values, out the window in search of these consulting dollars. And I would say that that's not really true.

I don't want to sit here, I'm not in a position to defend what happened in Houston and what Arthur Andersen did or did not do, or what they should or should not have done. I'm not privy to all the facts there. But I do challenge you to go on the SEC web site and read through some of the 8-K's, and it won't take you long; it won't take you long at all, to find examples of every single large accounting firm either being fired or walking away from a client based on an accounting dispute. Auditors are walking away from these clients. It's happening all the time. I, just as an exercise, did that, and I was astounded by how many are.

So I would also like to point out that we've done a lot of digging around in this issue, and there is no academic research or no research otherwise that indicates that consulting fees cause an independence problem. Furthermore, two years ago there was a public oversight board panel on audit effectiveness that actually found that in twenty-five percent of the cases consultants improved the quality of the audit. Nevertheless, what we have here, I think, is a red herring. And I'm kind of glad that Sarbanes-Oxley has taken consulting off the table because I think now we can really focus on the issues.

The reality is in the Arthur Andersen case, I would argue, that the consulting fee was irrelevant. You know, they're saying, "Oh, \$50 million, half of it was an audit fee, half of it was a consulting fee; how could it possibly have been independent?" Well, Peter Duggan (phonetically) probably wasn't independent because the \$25 million fee, the audit fee alone, was a career making or breaking fee for him. If he lost that client, even just the audit, his career would have been over. And as to Arthur Andersen, as a whole the fee was irrelevant because when you look at Arthur Andersen's bottom line, it was nothing. It was an insignificant number.

What I would suggest, if anybody would like to listen to what I would have to say on that subject, Arthur Andersen's national office should have been the one to make the decision on whether or not they should keep that client based on the risk. It should not have been left in the Houston office. And I think that's one way to insure independence.

So, anyway, Sarbanes-Oxley, I've spent the last year thinking about this because, quite frankly, my job is on the line. I set auditing standards, which is why I know the difference between accounting and auditing standards; I'm the one who sets the standards for the auditors, the ones that have to go in and check the work. And if you read Sarbanes-Oxley, what it does is it takes away auditing standards from the AICPA. The responsibility now goes to the new public company

Accounting Oversight Board, so my job literally is on the line. So I have spent quite a bit of time thinking about this. And I spent some time going out on the Internet, and I just was researching, searching around on some different words, searching around on some different terms, and I found a set of lectures called the Sachs Accounting Lectures. Have any of you ever heard of this?

*AUDIENCE:* Yes.

*MS. JONES:* They're great, aren't they? They're fabulous lectures. I was reading these lectures, and I thought: "Oh, my, this is great." They're exactly describing why I should be setting auditing standards. They're exactly explaining everything, describing the situation perfectly, and it's, you know, these are fantastic. I'm going to plagiarize them extensively in my defense. But the interesting thing about these lectures is that they were all given in the 1970s. So I will join the chorus of all you've heard today. There is nothing new here. We have seen this all before.

We've all seen this greed before. We've seen this short-term focus. You know, in the past I think there's been a strong interest in letting the markets work itself out, but now all of a sudden we've got this legislation, and it is sweeping. It's huge. For me, it's life altering, this legislation. And, you know, what's different this time?

And I think what distinguishes this particular set of corporate scandals is that all of the market institutions that are in place to prevent all of these things from happening, they all failed. It was, they just all failed. Investment bankers, the buy/sell analysts, the lawyers, the rating agencies, even, yes, the auditors, the officers, directors, we've all failed to varying degrees in this situation. In this preliminary task for preliminary report, they say the 1990s can be seen to have created a potent recipe for failures of corporate responsibility. The ingredients of the recipe included investors' expectations of double digit returns, equity-based executive compensation, and the increasing pressures of consolidation and global competition for outside professionals.

These failures have had an unprecedented effect on the U.S. markets because what's different now than even twenty years ago is that over fifty-one percent of U.S. households are now individual shareholders. This wasn't always the case. So the American public has been damaged in a way that they have never been damaged before. And when you compound that with the fact that a lot of that money was in 401-K plans and stock purchase programs where people were invested in individual companies, they weren't well-diversified, so you have people not only

losing their life savings, but their jobs as well, and that's very devastating. And it really raised the stakes in markets today.

Then you throw in the fact that the year 2002 was an election year, and you have all of Congress under all of this pressure to justify to all of their shareholder constituencies that they are doing something about this mess. So what we had here was what I call the perfect storm. And this is the result. A market solution would not suffice. Legislation was required.

This Act was passed overwhelmingly by both houses. Only three Congressmen voted against this act in all of Congress and all of the Senate. And it was signed by the President on July 30th, 2002. There are many provisions of the Act with which I am prepared to take issue, but I will agree with the most important theme of the Act, and that is, and this has also been said before, that governance matters. And I do support the governance aspects of this act.

I don't know how much that I can say that hasn't already been said today. But I would like to have a discussion about it.

*DR. AUSTIN:* Okay, Ed. The loyal opposition. He writes for *Accounting Today*, an accounting newspaper.

*MS. JONES:* He's the dark lord of the evil empire.

*MR. KETZ:* I was going to start off by agreeing with you.

*MS. JONES:* Okay. He's a really good guy.

*MR. KETZ:* The interesting thing about being the person that goes last in the long day like this is that you can tailor your remarks and add and change things as you go along. The disadvantage is that you get to tailor your speech and make changes as you go.

What I think I'm going to do in my time is to talk about four issues that I hope will help supplement some of the things that we've talked about. The first thing is that, agreeing with a number of people that have talked today, I'd like to say that Enron in a lot of ways was not a new phenomenon. In particular, a case that took place in the 1960s bears remarkable resemblance to a lot of things that took place with Enron. And that case was *Continental Vending*.<sup>15</sup>

In this case, the president of the firm, the president of Continental Vending, decided to borrow money, and the way he did it was [] that he

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15. United States v. Simon, 425 F.2d 796 (2d Cir. 1969).

had the parent company lend money to the subsidiary, and you can read SPE, and then he borrowed the money from the subsidiary itself. When the firm made the accounts, when they made their financial statements, they basically offset the receivable and the payable that the subsidiary had, the receivable from the president and the payable to the parent company, arguing that they were somehow connected and they could offset it. So it was a way, it was structured in such a way that the liability did not go on the balance sheet. Beginning to sound familiar I hope.

What happened was that the president took the money and invested in the stock market; the stock market went down; the parent company went into bankruptcy. The investors got their plaintiffs' attorneys; they sued in court, and in addition, the SEC brought charges against the accountants. It's one of the few cases where the partner in charge, the manager, and the senior, were charged with criminal fraud.<sup>16</sup>

When that case went to court, it was interesting that they argued that what we did was to follow generally accepted accounting principles (GAAP). We followed GAAP. And that was the basis for their entire defense, that what they did was within the rules. When it went through to its conclusion and then went to appeal, they lost both times. And Judge Friendly's (phonetically) remarks provide some very interesting comments.<sup>17</sup>

And what Judge Friendly said in the case was that the auditors and the accountants have a higher duty than simply following GAAP, following the rules; namely, when a firm presents financial statements to the public, to the investment community, it's presumed that they're providing information that is accurate, fair, and useful to them in some sense of those terms. Admittedly, those terms have some inaccuracies to them. But in some sense fair to the users, what the users need to understand [about] what's going on. And Judge Friendly said you didn't meet that standard in this case. That was on the books, excuse me, that should have been on the books, was very important to the investors, and by omitting that liability, the firm basically defrauded the investment community.

It went on, just to give you the Paul Harvey rest of the story, the president of the company committed suicide. Enron had an executive that committed suicide. But unlike Enron, it does have another part of the story. Even though the accountants were convicted, they never served a day in court because President Nixon pardoned them. The firm

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16. *Wharton v. Lybrand, Ross Bros. & Montgomery*, 41 F.R.D. 177 (E.D.N.Y. 1966).

17. *Id.* at 178.

that did President Nixon's taxes happened to be the same firm. So there's the rest of the story on that.

The real point of what I'm saying, though, other than that side, interesting part, is that Continental Vending really covered a lot of the same ground that we faced and we saw in Enron; namely, we had a firm that decided it was not going to report the liabilities on the balance sheet, it wanted to provide a sense that their debt/equity ratio and other ratios that you might measure were very favorable. They wanted to influence the credit rating agencies and others in how they were evaluated, so they wanted to keep millions and millions of dollars off the balance sheet. Now, the interesting thing also with Enron is that in a number of their transactions the firm followed GAAP. Now, admittedly there are some places that they didn't, such as the Raptor transactions, but LJM, they followed GAAP. That was a legal way of doing it.

I would argue that even if they followed GAAP, the firm and the accountants had a responsibility to provide fair and useful and accurate information, and Continental Vending should have guided their actions. And, so, I take issue with even the aspects of Enron following the rules. And, so, I think that's something we have to keep in mind.

Very quickly on the other issues. Let me just mention [that] FASB is an organization; that's my second point that you should be aware of. The Financial Accounting Standards Board, or FASB, is the group that the SEC has delegated to, for the most part, to make the rules in this country; that is, the rules about financial reporting, not auditing, as Susan pointed out the difference. But in terms of financial reporting and accounting, FASB makes the rules. FASB, however, has really been a part of the problem. They've been very slow to act, and they've been impotent in a number of cases. For example, accounting for mergers and acquisitions was on their agenda in 1974. Twenty-five years had to pass before they ever got up enough courage to issue a standard on how to account for business combinations. And even then they had a questionable compromise in terms of how to handle goodwill.

A second issue is stock options. In my mind there is no room for any debate on this. I think it's very clear that stock options are given as compensation. They should be expensed. FASB has waffled on this point many times, and so, they really have not addressed this issue. And even now, when there's a golden opportunity to step forward, they still are not addressing the issues.

And then directed with Enron, they have been aware of special purpose entities for at least a decade. They've been aware of the accounting problems and the lack of disclosure in terms of what special purpose entities are about and the hiding of liabilities, but FASB never got around to taking care of that until after Enron. They have now

issued an exposure draft in dealing with that point, but it seems it's a little bit late in my mind.

The third point, very quickly, is that I think Congress has also been part of the problem. I could mention many, many things, but in terms, or to keep it relatively short, let me just say that the staff report that came out ten days by, the staff report to the Governmental Affairs Committee, chastises the SEC for not playing its part in terms of looking at Enron. For example, they say that last time that the SEC took a look at the filings was in 1997. But I find it a bit hypocritical because if you look at the budget for the last ten years, the Congress has either kept it static or they've cut the funds. And they don't want to take any responsibility for that.

The last point in terms of the Congress is that Senators Lieberman and Graham, among others, were given substantial campaign contributions by the accounting industry and by the high-tech industry as well primarily for the purpose of closing off the debate on stock options, which relates to the point I said earlier. But the point that I find very disturbing was not only did they take that stand, Senators Lieberman and Graham also came out with a threat that if FASB ever tried to introduce a rule that would expense stock options, they would work hard to kill their existence.

The last point I'd like to mention concerns whistle blowers. The one point I have not heard anyone say is that we need more in terms of the whistle blowing in trying to provide incentives to get these people to come out. And, in particular, in Enron a number of people have focused on Sharon Watkins and her role, but I find that slightly bothersome because she doesn't come into play until the body is almost dead. Even when she comes out, if she comes out a month or two earlier, you're still going to have a total collapse.

I find it much more interesting if you look at Vince Kaminsky (phonetically), who was the manager in charge of risk assessment and risk management for the firm. And in June 1999, Jeff Skilling walks into a meeting proposing the LJM transaction. Vince Kaminsky reportedly laughed and said, this is the stupidest idea, and it is fraud, to which Jeff Skilling basically demoted him and moved him to another office.

What I'd like to do is to see us comprise some sort of incentives that would have gotten Jeff, excuse me, to have gotten Vince Kaminsky to have reported it to somebody who would be in the power to do something. See, at that time LJM was simply a proposal, an idea, and if some sort of intervention took place then, then this disaster would have been averted. Thank you.

*DR. AUSTIN:* At this point, is there anyone who has questions for any of our panelists?

*MR. WATSON:* I'd just like to make a point on the whistle blowing issue.

*DR. AUSTIN:* Certainly.

*MR. WATSON:* My understanding now is that the Sarbanes-Oxley Act contains a provision which works to protect whistle blowers from retaliation on the basis of their whistle blowing to the extent that it deals with financial matters.

*MS. JONES:* It does.

*DR. AUSTIN:* Judge Tennille?

*JUDGE TENNILLE:* Two questions for the panel to address. One of them is, how effective can the national offices of these worldwide firms be in policing the activities of the local offices? Susan mentioned that the national office should have had the responsibility for the Enron accounting and not David Duncan. And the other problem I would like for you to address, or give us your opinion of whether it is a problem, it seems to me that over the last period of time as the industry has consolidated, we've had the major accounting firms being the ones to audit each other if a problem arose. It seems to me that that may be part of the problem that we're dealing with is that we've had the foxes guarding the hen house as far as the accounting firms looking at each other's problems and nobody outside or independent seeing those problems and bringing them to light.

*MS. JONES:* Well, I will say that Arthur Andersen, if I understand it correctly, was somewhat unique in the power that it gave to its individual offices. I think most of the other firms, if the national office makes a decision on an accounting policy, the local offices are not really in a position to override them. From what I understand with Enron, there was quite a bit of discussion back and forth between Chicago and Houston about the accounting transaction of the special purpose entities, and I think the national office told Houston to account for it one way, and then the Houston office overrode that. And I think the other firms are less like [that]; that is less likely to happen.

As for the peer review system, the firms, all the members of the AICPA and members that audit SEC practice or SEC clients, must

belong to the SEC Practice Section, and they are required to undergo a peer review process in which case one firm comes in and audits the work of another. That has been criticized as one hand washing the other, as opposed to actually auditing the other, and that to a certain extent may be true. When problems in peer review are uncovered, and they are, they are worked out through the AICPA processes to some extent. The AICPA in peer review doesn't have a whole lot of power because we don't actually license certified public accountants, the states do. And because of all the lawyers out there, we are not really in a position to do much investigative work until after all of the court processes are over. So the AICPA disciplinary processes have been declared to be slow and ineffective because it'll take ten years before it goes through all of its criminal and civil litigation before the AICPA can finally get on it.

Many of the states also don't have a tremendous amount of power to revoke accountants' licenses either. It's easy to grant the license because you can just [look at], you know, did you pass the exam, do you have the experience, fine, here's your license. It's much harder to revoke a license. You need to do a lot of investigation and go through a due process before you take away someone's license, and a lot of the states don't really have that power in their state boards of accountancy. I think in New Jersey, I'm licensed by the same people that license dog groomers, you know, so it is in our profession difficult to revoke a license.

The Sarbanes-Oxley Act does address this issue. The largest, in fact, all SEC auditors, auditors of SEC clients are now required to undergo a review, not by their peers, but by this new board. I don't know how this new board plans to pull this off. They're going to need a staff of thousands and thousands to do it. But the largest, it works out to about ten or eleven firms, will have to be reviewed annually, and all of the other firms below that will have to be reviewed once every three years at least and more frequently if determined by the board. So that problem has been solved.

*AUDIENCE:* I just want to comment on the peer review. There's another aspect of the peer review, which is the firm's own internal office reviews. You're probably familiar with that. And my experience goes back, well, I started in the 1960s at Price Waterhouse, and I was on several office review teams. And I can tell you in those days we took that work very, very seriously. And my son-in-law today is senior management at another one of the firms, and he's been on a couple of those audits, and I can tell you that he takes that work very, very seriously as well. It's probably taken more seriously perhaps than the external peer review kind of thing.

*MS. JONES:* Yes, I would. The AISC has 350,000 members, and I think ninety-nine percent of them go to work every day and do all of their work with a high level of integrity and diligence. It's awful to be all painted by this brush because the people that I've worked with in this profession, including the top partners in the top firms, have a whole lot of integrity, and they do take this very seriously.

*MR. PFLUMM:* It may be tangential, but a few years ago I had the opportunity to look at how some other professionals do peer evaluations. Doctors, for instance, assure themselves other doctors are meeting a certain level of practice. And we went through the business of going through the Joint Committee on Accreditation of Hospitals that goes through peer review, and it's not too different. But what I was really impressed with, and it kind of takes it out from the emotional loadings of Enron, to talk about it for a minute, is that when doctors review other doctors' work, they're not really slow to criticize. They, in fact, are very good about accounting for what they call untoward situations. So I think there is a principle that professionals can police other professionals. So I would think the peer review process, at least in my opinion, is a strong process for all professions to have.

*JUDGE TENNILLE:* That's something that doesn't exist in the legal industry.

*MR. PFLUMM:* I was going to ask.

*JUDGE TENNILLE:* It's a problem that I've mentioned to large law firms when I talk with them that I think that it's something that they better figure out how to do, and they better get busy trying to figure that out.

*MR. KETZ:* I would add on the peer review part that I have mixed feelings. I think that to the extent that you're talking about technical issues and issues of processes, the peer review process that we have can be good, and as one firm looks at another and critiques it, the reviewing firm can certainly come up with, and I think they do come up with some criticisms and suggestions for improvement. The one question I will have, and it's more of a question than an assertion, this is assuming that everything is going right with the profession. And some of the questions that come up, and I think that they were in a sense raised this morning, were questions of how close are the auditors with the management? Or, as A.P., the third party people. To the extent that there might be cultural problems or problems of the auditors being too close, I think

there may be a problem that they all have, and so, if you have that same problem, you're not going to be able to see it in somebody else because you're going to be saying that that's perfectly fine. So my take on the peer review process is that it's fine as long as we're dealing with technical issues. But as long as you're taking a look at, say, how is the profession doing overall, how is it meeting its responsibilities to society, then you need some outside guidance, some outside people. And probably the investment community might be the first place I would go at that stage. But you need to ask are we doing our job? And it's not necessarily checking up on one another.

*AUDIENCE:* I have a question of Basil regarding the internal auditors and whether you are seeing increased interaction between a corporation's internal audit group and the audit committee of the board these days compared with, say, five or ten years ago?

*MR. PFLUMM:* Yes. That's a phenomenon that's been going on now for about three years, that is, a very strong alliance between the audit committee and, particularly, the chair and the lead internal auditing person. We've recommended for a number of years, and I would say almost all lead companies do this, that the internal auditor functionally reports to the audit committee chair. By "functionally" what I mean is that the boards being what they are do not have the ability to administer wage and salary and personnel and all that sort of thing, so that's still done in the company. But the approval of what's going to be audited, the judgment about the risk assessment, the review of the results, [and] the judgment about is there sufficient audit resource here to do the job that we need done, is basically shifting very fast to the chair of the audit committee. The last survey we did showed that well over sixty percent of the U.S. companies surveyed were moving in that direction.

Now, in many other countries, remember we're dealing outside the U.S. as well, there's a requirement for internal audit[ors] to report to the audit committee in the corporate governance codes of a country. In South Africa, the Corporate Governance Board requires that, so anybody listed on the Johannesburg exchange will have that relationship. So it's uneven around the world, but that's a growing relationship.

*AUDIENCE:* I understand that you are a proponent for expending stock options?

*MR. KETZ:* Absolutely.

*AUDIENCE:* My questions for you are what methods you would use for exercising stock options? And a larger background question is, what you think the impact on the market will be if companies start expensing stock options?

*MR. KETZ:* I guess I would go back to the statement that Susan made at the beginning in terms of explaining accounting. One of the things that I think outsiders have to understand about financial accounting is the amount of estimates that goes into the numbers. Her example had a relatively easy example in terms of coupons and that you have to make estimates about how many are going to be exercised and go from there. So the idea of having some estimation about this doesn't bother me here because if you're going to not estimate, you would have to quit doing financial reporting.

Having said that and being more specific now, Black-Scholes Model is reasonably good, although it does have a upward bias, which you can't adjust for. I think the key point in my mind would be to provide either that or one of the alternatives, I guess another alternative would be the Binomial Pricing Model. But disclose in the footnotes what the method is you use, what the parameters are, and perhaps, even say, you know, if we adjusted this estimate by this what it would do to those numbers. And, in fact, I would do this on a variety of other things as well, including things like goodwill, foreign currency translations, and a variety of other places where estimates come in.

What impact would it have on the market? It's hard to say. It depends on to what extent the market is already impounding that. And I guess in the academic world we refer to that as the efficient markets hypothesis, and that is that markets act as if they take the information as publicly disclosed and include it in their assessment of the stock price. If you believe that stock markets are efficient, then the answer is there will be no impact because they're already doing it.

In my mind, however, I think there are some impediments to that because to process information that's not given to you completely involves some costs. And you may want to make some adjustments to that. And, so, there's an issue in terms of that adjustment process. The firms now are required under Statement 123,<sup>18</sup> if they don't expense it, to provide some pro formas where they give some numbers, so I guess my guess would be that the impact would be minimal.

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18. See *Wharton v. Roth*, 360 F.2d 116 (2d Cir. 1966).

*MR. PFLUMM:* I haven't seen the study that's quoted, but in the first report of the Conference Board on Public Trust and Private Enterprise<sup>19</sup> it addresses executive compensation. They quote a Merrill Lynch study that shows that expense, I'm going to read it to you, "That expensing stock options would result in a decline of approximately seventy percent in earnings per share in the high tech industry compared with declines of twelve percent in telecom industry, nine percent in consumer and materials industry, and from two to seven in other industries, and ten percent in the overall S&P 500."<sup>20</sup> That gives you some benchmark for information on that subject.

*MR. KETZ:* That would be the impact on the income statement though. That doesn't necessarily translate into the impact on stock prices, though.

*MR. PFLUMM:* That's correct.

*MS. JONES:* I take it you're not a proponent of expensing stock options?

*AUDIENCE:* I have no position on it currently.

*MR. KETZ:* One of the issues that has come up in the length of time, which you have alluded to, for the FASB on making opinions, at the recent AAA meeting there were presentations, and the Chairman of the SEC said that the FASB needed to do this faster, in a move for what is referred to as principles based opinions as opposed to rules based opinions. I'd like to put that one out in front of the committee now for their comments on that.

*MS. JONES:* It's a red herring. The argument is that rather than saying you follow GAAP exactly we should just present a true and fair view of the financial statements, but the principle is the financial statements should present fairly, and that's it. That's a principle. The problem is [if] you put a standard out there like that, the people who are trying to prepare the financial statements are going to say: "Well, wait a minute, we need some guidance on what that means. What do you mean by it? Can you give us some examples?" Whenever the FASB

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19. The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendation, Sept. 17, 2002, available at [http://www.conferenceboard.org/pdf\\_free/756.pdf](http://www.conferenceboard.org/pdf_free/756.pdf).

20. *Id.*

tries to do something principles based, they get all these comments back from all the preparers and all the auditors: "I need more guidance on how to do this."

One of the reasons that we need more guidance on how to do this is because there's a strong assumption that all of the companies in the United States, in order for you to compare them to each other, should be accounting for things in the same way. If everybody made up their own accounting principles, you wouldn't be able to compare Coca-Cola and Pepsi and decide which one you were going to invest in because you would never be able to figure out how they were doing their accounting.

The other thing is, quite frankly, preparers and auditors like to have something to hang their hat on when they get in a court of law, as we often do, and get nailed to the wall. We like to be able to say: "Well, this is general accepted accounting principles. We didn't just make this up." So I do think that for those two reasons, one is that there is a legitimate call from the preparer community that we do need guidance on how to apply these standards correctly, and the second is that the comparing auditors do need support for their work.

*MR. PFLUMM:* That's a tough question for me because when I hear the term principles-based I often relate it to something that's a goal. Something to aspire to. And that's the argument, that something that raises the sights is better than something that provides a minimum. And we've heard that dialogue all day. If you've listened between the lines, where they were talking about codes of governance or legislation or regulation, that's always the issue. But I've heard it defended this way, and I'd be interested in Susan's view of it, but it's that at its heart, U.S. GAAP, even though it's very rules based, and I think everybody would agree with that, has two over-arching principles that are pretty much principles based. In other words, the financial statements ought to have full and accurate disclosure, that anything which is included in the financial statements or omitted from the financial statements which would be useful or leading or misleading to a reader has to be included or omitted, whichever the case may be. So in that respect, that materiality principle, that principle of full disclosure to me is very much a principles based approach, although it isn't often thought of like that because most of the structure that's underneath it is very much rule oriented.

*MR. KETZ:* I would add that the *Continental Vending* case that I talked about before basically throws us already into a principles based accounting at least on issues where there is a consensus. So if you have something like Enron trying to hide its debts by use of SBEs, I think

*Continental Vending* already tells us that those things should be recognized. On the other hand, I think that there are many of other points in which different observers, different firms, are not going to have a consensus, and on those points I think the principles-based standard setting is simply not going to work, because all you're going to do is get financial statements that are not comparable, and you're not going to be able to know how well Company X is doing against Company Y because you're really not sure what the underlying economics happens to be. So in terms of where you lack a consensus, I think the principles-based standard setting does not work, and FASB, or something like that, needs to continue. But on the other hand, I think there are some other issues that are important enough and at least a consensus among the investment community as to what's needed to be done.

*DR. AUSTIN:* When I heard that, I thought about a comment by Groucho Marx when he said, "These are my principles. If you don't like them, I have some others." And I'm afraid that if we move to something like that with less specificity, that we're going to wind up in that situation. Then shopping for auditors will become even more prevalent than it is today. Find someone that has a principle that agrees with the CEO. We heard about the CEO-centric corporations today, and one of the points of discussion at a seminar I was in was how does the auditor stand up to the CEO when he says, "Show me where it says I can't do that."

*MS. JONES:* You can't believe how often that question comes up. I work at the AICPA, and we get phone calls every single solitary day. Show me. Show me where it says I can't do that. And I think that is the crux of the problem.

*MR. PFLUMM:* One of the solutions that I think has to be part of this discussion is the COSO framework on internal control, which is the definition I showed you earlier. The question: How do you exercise responsibility when you know something is absolutely wrong and you know that it's illegal, immoral, or whatever label you want to put on it; how do you do it when you're internal to a company? This is a real question for internal auditors. And one leading internal auditor said you've got to be willing to give up your job. And I think that that really is the answer. He could personally attest to two positions that he had left because his integrity would not permit him to go along with what was happening. Now, it's very difficult for an internal auditor because we're usually employees. We're employed by the company. And, so, it's a hard one to preach. Nonetheless, unless that certain, that's the value

of having that auditor report to the audit committee because it's not up to the whim of a CEO or a CFO or somebody within the organization. If you're going to take the boot and walk out, you're going to take it by a director that supposedly has the same interests that you have.

But I want to go a step further because you're never sure you're right. Everybody that operates in a professional mode, even though you make that judgment that it's immoral, illegal, whatever, knows that nothing is usually that black and white, so it's a judgment that you've got to be willing to make and also realize you may be wrong when you're doing it.

*MR. WATSON:* Following up on that, the New York Stock Exchange rule requires listed companies to have an internal audit function.

*MR. PFLUMM:* Yes.

*MR. WATSON:* Well, in the commentary it says that the company may choose to outsource this function to a firm other than its independent auditors. What is the practice? Are internal audit functions handled more internally or externally?

*MR. PFLUMM:* In the large companies that have critical mass, that have a sufficient size to support a fully staffed internal auditing organization, it would generally be internal. Almost all the major banks will be like that because of their specific requirements of the Federal Deposit Insurance Corporation Improvement Act.<sup>21</sup> So they will tend to have robust internal audit shops. But smaller organizations will often outsource part of their work. For instance, information technology, where the internal audit unit simply cannot keep expertise within the in-house staff to do the job, [will] acquire capability from the outside. In other organizations, and NASDAQ just commented on this yesterday with their usually smaller companies, they may have to buy almost all of it. What we usually recommend is that internal auditing is an internal management function so that somebody within the organization, somebody, CFO, CEO, must assume the job of internal auditing, even though they may out source all the resources needed to do the job. Usually the major accounting firms will agree with that judgment.

*MR. KETZ:* I'll add that part of Arthur Andersen's problem is that they were external auditors on a number of companies they also did the internal audit [for], so they created a culture within the firm that it's

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21. 12 U.S.C. § 1831(m)-(t).

okay to have that conflict of interest. And I think that built up over a variety of issues as well.

*MR. WATSON:* I would ask Susan if she would agree with your characterization.

*MR. KETZ:* Of Arthur Andersen?

*MR. WATSON:* Would a firm's being both internal auditor and external auditor necessarily create a conflict of interest?

*MS. JONES:* I think it could be. I don't think it necessarily has to be. And I would suspect that in a lot of cases if the external auditor were also the internal auditor the quality of financial reporting would be improved.

*DR. AUSTIN:* On the other hand, I think that the appearance is very bad.

*MS. JONES:* The appearance is very bad. I think, you know, when we were discussing before the independence and what we're looking for. What we're really looking for is objectivity or a nonconflicted person. And you can't measure objectivity. You can be completely unimportant but also be very objective. But you can't measure that, and you can't see it, and you can't, you can't judge whether somebody is objective or not. But in the accounting profession [and] in the auditing profession, we have rules of independence, and you can measure somebody against those rules. You know, is their brother-in-law the CEO, is their, you know, blah-blah-blah-blah-blah, the degrees of separation between the auditor and management. And what we're trying [for], what that's a proxy for is objectivity. But it's not a perfect match.

*MR. KETZ:* So what I hear you saying is that there's a conflict of interest, but whether that conflict is exercised or not is up for debate?

*MS. JONES:* Well, I don't know what a conflict of interest is. I could imagine, I could very easily imagine a situation where you have internal audit out sourced to the same organization that does the external audit. And I can imagine that the quality of the audit would increase more often than not.

*MR. PFLUMM:* The quality of the financial audit?

*MS. JONES:* Yes.

*MR. PFLUMM:* Or the total audit?

*MS. JONES:* Well, the total audit.

*MR. KETZ:* I guess I hear you saying, though, I'll put it in my own words, is that it can go either way depending on how the people actually exercise their professional jobs?

*MS. JONES:* Right.

*MR. KETZ:* If they exercised it in such a way that they maintain objectivity, then you can have improvement.

*MS. JONES:* Yes.

*MR. KETZ:* But at the same time, if you are looking at the work that someone in your firm did, some friend of yours, for example, then you may want to turn and look away in terms of what the problems might be. So it really depends on the reaction. And I guess I referred to it as a conflict of interest because you're getting a situation where you are judging your firm's own work.

*MS. JONES:* Yes.

*MR. KETZ:* Whether that actually breeds problems is a different issue.

*DR. AUSTIN:* I think that the same is true of consulting with the knowledge that the audit firm can gain through its consulting activity is certainly enhanced from the firm which comes in and does not have access to the same information.

*MS. JONES:* If you consult with an organization and help them develop their internal controls, that would definitely make you less independent, but it would also give you a lot more information on the operating effectiveness of those internal controls, and you'd be in a better position to do a more analogical audit.

*MR. PFLUMM:* It's probably an issue that we do have a mixed constituencies or views, so you have to recognize that, and I'm sure you do from the questioning. In the sense of what is the responsibility of the

attestation of the public accountant, we're really usually talking about the financial reporting that is available to the investors, the signature on the financial statements. Usually that is not, does not overlap what the internal auditing organization does. In fact, we preach that there has to be collaboration between the internal and external. Let's take a robust company where they have a robust internal audit organization. So we would expect audits to be coordinated so the audit committee is not buying the same audit twice. The traditional audit model that we would see is that the internal auditors would be looking at the risk associated with operations, efficiency of operations, effectiveness of operations, performance issues, information technology issues, compliance with law, those sorts of things that are more the management side. And that's traditionally been the domain when they're both robust. Really, the rub comes in when the companies become smaller and really have to maintain some kind of efficiency and decide how that interface works.

*DR. AUSTIN:* Susan has an airplane to catch.

*MS. JONES:* Yes.

*DR. AUSTIN:* So we bid her farewell and Godspeed. One last issue here, and it's brought up somewhat whimsically as we close this. I wonder if the legal profession, as accountants, consider the rotation of auditors and the rotation of general counsel?

*MR. WATSON:* While I have no hard evidence, my sense is that the longevity of in-house general counsel these days is in the seven to ten year range, to some extent reflecting the decreased longevity of CEOs because any CEO who comes in is entitled to have his own executive team. I think typically, while general counsel may come and go, it's not unusual for outside counsel sometimes to remain the same.

*JUDGE TENNILLE:* The truth is it's a burnout job.

*DR. AUSTIN:* Were there any other questions? Basil, Ed, any closing comments?

*MR. PFLUMM:* I'd like to address the one that the previous panel ended on, and that is whether we are optimistic or not. I really am very optimistic. I just think that that's why we're paid the big bucks. We need to deal with the issues of our times. That's what we're about is dealing with the realities of the day. There to me have been some really

severe wounds inflicted, some real losses in wealth. And people have been hurt, and so, it doesn't do us a lot of good to play the blame game a lot. I think we've simply got to craft as best we can, as professionals in the financial and legal businesses, we've got to craft the things that seem to remedy it the best we can. And I believe we'll do it.

*MR. KETZ:* We have great challenges, but also opportunities in the business school. At the MBA program that I'm associated with, for example, these types of questions have come up quite a bit, and it's interesting to debate them and talk about where we're going to be going from here. So it's a great time.

*DR. AUSTIN:* Thank you all for giving us the opportunity to present the accountants' case here. Thank you.