Murray Weidenbaum

Restoring Public Confidence in American Business

The private enterprise system in the United States is under severe attack, not from people who advocate socialism or another philosophical alternative, but from many citizens appalled by widespread reports of unethical and illegal decisions made by high-level business executives. The initial response has been by government officials—through new legislation from Congress and enhanced enforcement of existing laws by the Securities and Exchange Commission (SEC) and the Department of Justice. Government action is a very good start, but it is not enough.

Many of the governmental reforms have been necessary to address problems in corporate finance, ranging from the accuracy of financial reports to the role of auditors and audit committees. The government actions are valuable to improve the information on corporate performance on which investors rely when making their decisions.

Legislation, however, cannot deal with the fundamental problem: poor judgment and bad decisions by individual business executives. Some of those decisions have had a tragic impact on employees and shareholders who have lost their jobs or their retirement funds as a consequence of business leaders' actions. Macroeconomically, these decisions have had serious, negative effects on the national economy. Business investment has not recovered from its recession lows in part because the disarray in the stock market limits the ability of corporations to raise new investment capital. Sluggish rates of business investment, in turn, prevent a strong recovery in the economy. Restoring public confidence will not rebuild those lost retirement accounts, but greater confidence in business is a key to economic prosperity.

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Restoring public confidence in the conduct of American business is most fundamentally a challenge for business leadership itself. Until recently, corporate governance, or the way in which company business is conducted, was primarily the province of lawyers and other technical specialists, each of which continue to play an important role. A number of voluntary, private-sector actions in the area of corporate governance could also help restore public confidence in capitalism in the United States. The problems of corporate governance, however, are fundamental, and their solution requires more than a technical response.

Government action to restore public confidence is a good start, but it is not enough.

The actions of American business leaders—not just shortcomings on the part of technical specialists—have generated the loss of faith on the part of the American people. Only sustained changes in the way that business is conducted—not talk but action—will convince the public that the reforms are real and enduring. Voluntarily yielding some of the powers of what many now call the "imperial presidency," so common in the private sector, is clearly a matter of enlightened self-interest on the part of top business management. The alternative—sooner or later—will be a new round of pervasive government regulation of business, arbitrarily reducing the discretion of management.

Reforms by American Business, for American Business

Corporate governance in the United States is facing an unprecedented variety of pressures to change. Although some of the shortcomings have endured over recent decades, several dramatic bankruptcies, most notably Enron in December 2001, triggered the current wave of concern. More recent reports of companies such as Tyco paying for millions of dollars of personal expenses of CEOs demonstrate that changes in accounting procedures do not suffice. The key issues that have been raised in the national media, as well as in a flurry of congressional investigations, focused too much on auditing firms, financial reporting, audit committees of boards of directors, and similarly important but essentially technical matters. Fundamental reforms in corporate governance surely must deal with financial issues, but they must extend beyond that to the role of the top management.

A typical corporation starts with a board of directors elected by the shareholders. That board, in turn, selects the top management to conduct the day-to-day activities of the enterprise. The board also forms committees

to deal with specific matters such as audits, executive compensation, and nomination of board members and officers. A board may consist of “inside” directors (the chief executive officer [CEO] and other management) and “outside” directors, who only serve part-time. The typical board is chaired by the CEO and is comprised primarily of outside directors. Combining the roles of chief executive and board chair generates the potential for, and often ends up with, a very powerful leader who at times can intimidate a dissident board member.

Yet, none of the governmental actions to date address fundamental shortcomings of corporate governance such as the excessive concentration of power in the CEO, nor should they. In an economy organized mainly on the basis of private enterprise, correcting those shortcomings is primarily a task for the private sector itself.

Beyond Legislation

Many companies have been well managed and can produce extremely positive economic as well as financial results. Their senior executives, boards, and outside legal and accounting firms do the effective and honest job that is expected of them. The history of corporate governance in the United States clearly demonstrates the substantial ability of business to reform itself. For example, in 1869 the New York Stock Exchange (NYSE) cracked down on the practice of “watering” stocks (issuing shares in secret). More recently, the NYSE in 1977 required each listed company to establish an audit committee composed of outside directors. In the 1980s, most companies, responding to the critics of the corporate governance then taking place, voluntarily shifted the composition of their boards to a predominance of outside directors.

These and many other voluntary improvements in corporate governance support the notion that not every problem requires a solution based in Washington. Currently, many companies are beginning to treat the issuance of stock options to their executives as a business expense, rather than just burying the information in an obscure footnote to their financial statements. Yet, recent events confirm that serious shortcomings still exist and must be addressed.

Scandalous decisions in giant corporations operating beyond the effective control of their boards of directors appear to have drained public confidence. All business, not just corruptly led ones, could benefit from the types of necessary internal change proposed here. These reforms focus on particular aspects of company management including the CEO’s role, the selection processes for various boards and committees, and the specifics of the audit-

ing process. More fundamentally, they aim to meet the challenges that any and every business driven by competition and individual self-interest—those characteristics of American capitalism that at the same time can be credited for its unparalleled success—can expect to face.

How can public interests be protected in an environment dominated by neither sinners nor saints, and how can that protection be provided without inhibiting the efficiency of the private enterprise system that currently generates abundant goods and services, employment, income, wealth, innovation, and progress? Achieving those multiple objectives is a tall order. It surely requires humility in recommending specific courses of action. Unlike the media and congressional coverage of these matters, however, it seems more appropriate to start at the top of the corporate hierarchy rather than in the middle or at the bottom.

Reconsidering and Revising the Role of the CEO

As noted earlier, the CEO, as the corporation's leader, is the focal point of its governing power. He or she sets the organization's tone and runs day-to-day operations. The CEO also controls the resources to support management's ideas. Ninety percent of the time, CEOs chair the board of directors, conducting meetings according to agendas they set.

This procedure makes opposing the recommendations of the chairman/CEO, much less pursuing other approaches, difficult for individual directors. The CEO also often recommends the candidates for the board and frequently contacts potential directors. Board nominating committees that will recommend a new director whom the CEO opposes are most rare. Equally unusual are shareholders who reject the nominations contained in the annual proxy statement submitted for their review and approval.

On the surface, this operation may resemble the structure of an efficient operation. In fact, this model often works quite well. Many dedicated CEOs use this system in an honest attempt to build an effective, profitable organization that produces goods and services that meet the needs of the public and does so in an ethical manner. CEOs can be quick to point out that they may have spent a lifetime with a company while directors, at best, are part-timers and shareholders are often mere transients.

Centralization of power in the CEO, however, has led to a variety of abuses. Skyrocketing CEO compensation is a dramatic symptom of the shortcomings of the status quo in corporate governance. An effective response must go beyond dealing with technical questions such as the accounting treatment of stock options or the adequacy of financial controls on reimbursement of the

CEO's personal expenses. The issue boils down to the personal motivations of the CEOs themselves. Expecting subordinates to limit the fiscal appetite of a determined, greedy, and/or ethically insensitive CEO is folly.

The answer to this basic problem in corporate governance must come from above the CEO—from the board room. The British adopted such a system a long time ago. Many U.S. companies may find it appropriate to adopt the British tradition of appointing an outside director to chair the board and to conduct board meetings. The chairman is usually a very experienced and often prestigious person who is at the stage of life where he is not viewed as a management challenger. Although usually occupied with his own professional matters, the chairman devotes sufficient time and effort to the position so that he or she is not merely a figurehead. For example, Lord Alexander Trotman, retired CEO of Ford Motor Company, now serves as board chairman of Imperial Chemical Industries.

Fundamental reforms in corporate governance must extend to top management.

Few U.S. CEOs, of course, can be expected to welcome with enthusiasm such a dilution of their customary authority. The outside chairman, however, is not an unknown phenomenon in the United States. Major investors at times serve as board chairs of new enterprises. During transitional stages, outside directors have been designated chairman, at least for a limited period of time. Moreover, nonprofit organizations—hospitals, museums, and universities—that often have comparable numbers of employees and annual revenue as large corporations have an outside member typically chair the board of trustees.

The views of John G. Smale, retired CEO of Procter & Gamble and former outside chairman of General Motors, are quite instructive. Smale notes that as a CEO/chairman he would not have welcomed a diminution of his authority and that he saw his outside chairmanship at the time as merely a transitional appointment. Reflecting back, he now believes that the board should be chaired by an outside director:

> If the purpose of a board is to represent the shareholders in overseeing management's conduct of the business, such a structure [an outside director serving as chairman] seems considerably more logical than having the board chaired by a manager who is also the subject of such oversight.[1]

Although granting too much authority to the CEO can be dangerous, the constraints that should be placed on the ultimate leader of any business also have limits. An effective enterprise still requires a strong CEO. No committee—and that is the organizational form of any board—can or should try to

run a business. Every director should understand that the CEO is the day-to-day leader of the enterprise and provides its public face. That recognition does not, however, require a weak or passive board.

Strengthening the Board of Directors

As a longtime corporate director, I can attest from experience that boards of directors often seem asleep at the switch. In the midst of rising public criticism of business, the truly independent members of corporate boards can play a more vital role than ever to assure shareholders and society as a whole that business is being responsibly managed. Most directors take their role very seriously. The lapses from good practice, however, attract public attention and give business in general a bad reputation.

When we consider the disgrace that has been heaped upon some Enron directors, it seems clear that exercising independent judgment is not just the prerogative of an outside director. Acting independently of management's interests—overruling a poorly thought-through proposal for expansion, for example—is a basic way of protecting the individual director's integrity as well as that of the enterprise.

Not every problem requires a solution based in Washington.

In this regard, several director-selection practices should be avoided because they limit the board's independence. Examples include celebrity directors who do not understand the basics of corporate governance; overly committed directors who serve on eight or ten or more boards while holding down a full-time job; personal friends of the CEO; and those directors who simultaneously serve as high-priced consultants or suppliers to the corporation.

Successful board members avoid the extremes of becoming either sycophants or rivals to the management. The board's basic task is oversight—advising and questioning management rather than blindly issuing approvals or independently trying to run the business. No legislation can mandate such wisdom on the part of directors but more public attention to the conduct of boards may encourage a greater dedication to the task.

To improve corporate governance, key board committees must be bolstered. Quite properly, attention has been focused on the audit committee; its watchdog functions should be enhanced. Yet, the role of the relatively recently emerging governance committee (which increasingly replaces the nominating committee) likewise should be developed. Governance committees now regularly review the CEO's and the board's performance. The re-

sults of those reviews should be a high-priority item on the full board's agenda. Similarly, if CEO compensation has at times become excessive, that development is an indictment of the compensation committee, which also deserves more notice.

Compensation committees and audit committees of boards of directors would benefit from a greater degree of independence. A compensation committee should consist entirely of truly independent directors, and oftentimes it does. But the selection and pay of outside compensation advisers, whose advice is usually given great weight by the committees, should be determined by the committee and not by the management whose compensation is being decided. This situation is an example of the inability of corporate legal advisers to detect and blow the whistle on what, at least to a layman, appears a blatant conflict of interest: management selecting the individuals who draw up management's compensation plans and then advise the board on those same compensation matters.

Waking Up the Audit Committee

Key committees, especially the audit committee, do much of the board of directors' work. A recent analysis revealed the extent to which these financial watchdogs did not bark. In 207 publicly traded companies that filed for bankruptcy in 2001, the audit committee in a dozen cases did not even meet during the year prior to bankruptcy. Another 28 met only once. In a few instances, current or recently departed company executives served on the committee.[2]

The NYSE has rules prohibiting most of these practices. For example, it requires each listed company to establish an audit committee consisting entirely of outside directors. Nevertheless, the effectiveness of audit committees is clearly, to say the least, uneven. Enron's audit committee met all of the formal NYSE and SEC requirements. Yet, it failed to blow the whistle on the outrageous financial practices that were perpetrated on unsuspecting shareholders.

A well-functioning audit committee is truly the conscience of the corporation. Its members review the work of the organization's own internal auditors as well as the activities of the outside accounting firm, which conducts an independent audit of the company's finances. The external audit, when complete, enables the accounting firm to certify that the corporation's financial statements represent its financial position fairly and conform to generally accepted accounting principles. Audit committees have a broad charter to question and investigate the various operations of the company to ensure their financial integrity.

In a world of increasingly sophisticated financial techniques, Enron's audit committee as well as the entire Enron board seems to have violated one of the most elementary rules of management: if you don't understand something, don't approve it. No new legislation is needed for audit committee members to show a greater spirit of inquiring independence. An arm's-length relationship between the audit committee and company management is essential to establish and maintain that independence. As the NYSE proposed, that means no former executives of the company, no consultants to the company, and no employees of companies that sell significant amounts of goods and services to the company should serve on the audit committee.

Should the CEO also chair the board of directors? No.

A reasonable extension of the auditing committee's power is their assumption of the sole authority to hire and set fees for the outside auditing firm. Presently, management tends to make those decisions, subject only to the approval of the committee. Such a seemingly technical and operational shift would help both to bolster the audit committee's authority and strengthen the external auditors' independence.

Refocusing the Role of Accounting Firms

In practice, the accounting firms that conduct the outside audit devote a substantial amount of their resources to ensure integrity of the company's financial reporting and control system. In recent years, these firms have often devoted much less attention to auditing individual transactions.

The practice of using a firm that conducts a company's outside audit to perform a variety of other services for that company has fallen out of fashion. A great many companies—perhaps the majority—are phasing out the nonaudit functions of their external auditors. In some cases, these ancillary functions were never substantial or are now much smaller than a few years ago. The new corporate reform law quite substantially reduces the array of additional services that an auditor can perform for its client.

Nevertheless, a client trying to eliminate its reliance on its customary auditor to perform other advisory functions faces serious difficulties. For example, the overlap in the knowledge needed to audit a given firm and in the ability to assist in the preparation of its tax returns is considerable. Where should the line be drawn? In any event, the era of nonaudit dominance of auditing firm activity is ending.

Yet, there are other troubling aspects of the role of the accounting firms that remain. For example, an outside auditor that also performs all or a large

part of the internal audit function is not unusual. Apparently, this was the case at Enron. Despite talk about Chinese walls separating the two functions, this practice is highly undesirable. Having employees of the same firms conduct the internal audit and then perform the outside review may not be considered a technical conflict of interest. Nevertheless, this practice reduces the effectiveness of the formal checks and balances designed to protect the financial integrity of the enterprise. Here, government can get a jump start on reform; the SEC should revoke its ruling that an outside auditor can perform up to 40 percent of the internal audit.

Moreover, too much of today's auditing seems to focus on the computer systems that generate the accounting data, downplaying the traditional review of individual transactions. Both tasks need to be performed. The outlook in this area is now quite positive. In response to the need to bolster the independence of outside auditors, Congress has authorized the establishment, under the auspices of the SEC, of an independent organization to review the practices of the auditors of public companies. It has the power to maintain quality control by disciplining those who fail to maintain adequate accounting systems. That prospect should provide the necessary backbone to accounting firms faced with overly aggressive financial actions by the senior management of their client companies.

Holding Lawyers Accountable

Lawyers have been remarkably successful in ensuring that so much of the liability for current corporate governance problems falls on the accounting profession and so little falls on the members of the bar. To add the proverbial insult to injury, at the same time that attorneys are so actively urging accounting firms to rid themselves of their nonaudit functions, they are campaigning vigorously to expand and strengthen the multidisciplinary practices of their own firms.

Concern for maintaining high levels of legal ethics should extend to the poor advice that some lawyers provided to the corporate decisionmakers who did such a great disservice to investors, employees, and the public generally in the cases of Enron, Worldcom, Tyco, Adelphia, and so forth. The concern extends beyond the notion that what is sauce for the accountant goose should also be administered to the lawyer gander. The point is far more fundamental: many of the highly criticized financial-activities actions by management and auditor alike had been blessed in advance by their house counsel, outside law firm, or both. There is enough criticism to go around, and the onus for bad performance should be shared fairly and more widely, including with Wall Street stock analysts and bond-rating agencies.

Restoring Public Confidence

Corporate governance in the United States is being challenged for good reason. If American business wants to minimize the likelihood of yet another round of burdensome regulation, top management—boards and the most senior corporate officers—must take the lead in cleaning house. Another incentive for such action may be even more basic: to maintain the confidence of the investing public. Fortunately, the history of corporate governance in the United States is one of voluntary change by individual companies in response to developing circumstances. The shift in board-of-director composition from mainly management directors to outside directors is a cogent case in point, as is the rise of independent audit committees.

Fortunately, the history of U.S. corporate governance is based on voluntary reform.

At its best, the U.S. system of private enterprise delivers an unparalleled combination of rising living standards, attractive employment opportunities, and technological innovation. If uncorrected shortcomings obscured the powerful benefits of the business system, the nation's future would be most adversely affected. Government has responded sufficiently. The onus now is on business leadership.

The hallmark of strong management is the ability to respond to serious problems promptly and proactively; any management can react to the crises that inaction permits to develop. The challenge to American business now is to respond constructively to the severe challenges to corporate governance that it faces. An effective and timely response, more than any government action, will help to maintain investor and public confidence in the private enterprise system.

Notes

1. John G. Smale, "Where Was the Board?" *Across the Board* (May/June 2002): 11–12.
2. Andrew Countryman and Janet Kidd Stewart, "Conflicts in Audit Oversight," *Chicago Tribune*, February 17, 2002, p. 1.