Private Enterprise, Public Trust:

The State of Corporate America After Sarbanes-Oxley

EXECUTIVE SUMMARY

The highly visible accounting scandals that surrounded the collapse of Enron, WorldCom and several other major companies—together with the revelation of fraud and other acts of malfeasance by corporate executives—have aroused public outrage, called into question the values and ethics of business leaders, and undermined the public's confidence in public companies. CED, as a public-policy organization in which current and retired business leaders play a prominent role, is concerned about the reality, as well as the appearance, of corporate impropriety.

We are unwavering advocates for the free market system, but we are just as firm in our belief that businesses and their leaders must earn the public's trust. Perceptions that firms flout rules, behave unethically, and use deceptive business processes weaken confidence in, and support for, the free enterprise system. Executive compensation that is untethered to economic value and violates perceptions of fairness leads to mistrust and the prospect of a stifling regulatory backlash. The ethical failing of a small number of corporate leaders is infectious: it undermines the ethical standards of their own firms and affects the behavior of others and, therefore, must be cured.

This policy statement addresses governmental and corporate policies that affect the behavior of publicly traded companies, as well as the confidence of investors in them. We acknowledge at the outset that no laws or policies will ever be sufficient to end all corporate misbehavior (or, for that matter, misbehavior in any segment of public life). We are confident, however, that truly independent and inquisitive boards of directors will provide the best safeguard against corporate wrongdoing.

We observe and conclude the following:

(1) Audit Committees Must be Autonomous and Vigorous

In order to accurately present a company's position, the board of directors must have access to all pertinent data. This will occur only if a board's audit committee is competent, independent, and establishes effective control over both the internal auditors and the independent outside auditors. The relationship between the audit committee of the board and the outside and internal auditors is crucial. The audit committee should exercise the same tone of control over the internal auditor as it does over the external auditor, extending to decisions of hiring, firing, and compensation.

(2) Financial Information is Inherently Judgmental

Financial statements would be more useful if they were governed by fewer rules and displayed more of the judgment that lies behind estimated numbers. Stock analysts, the investing public, and regulators must recognize the inherently judgmental character of accounting statements and financial information. Ranges of values rather than precise numbers should be explained and understood as such. In addition, financial statements should be supplemented with non-financial indicators of value.

(3) Give Sarbanes-Oxley a Chance to Work

CED sees room to tailor the requirements imposed by Section 404 of Sarbanes-Oxley within the existing statute, and endorses the Public Company Accounting Oversight Board (PCAOB) and Securities and Exchange Commission (SEC) implementation guidance based on their evaluation of the first-year experience. The guidance, issued simultaneously by the two agencies in May 2005, should lower the costs and increase the value of Section 404 compliance. Moreover, CED does not recommend a broad exemption to Sarbanes-Oxley requirements for small-capitalization companies, but nevertheless supports the objective of mitigating the costs to smaller companies.

(4) **Excessive Executive Compensation Can be Tamed by the Compensation Committee**

In CED's view, the disparity of income between top corporate executives and average employees is a cause for serious concern. We are concerned that the differentials that exist today too often reflect neither market conditions nor individual performance. The procedure for determining executive compensation has been broken at far too many of our larger corporations, and we believe that the solution to excessive executive compensation must be regarded as a matter of *process and disclosure*.

To that end, we make the following recommendations:

- Compensation committees should adopt measurable, specific, and genuinely challenging goals for the performance of their businesses, and judge management by them.
- The compensation process must be run by compensation committees composed of independent directors. And compensation consultants, when used, must be entirely independent of management. The compensation committee should have direct authority over all terms of any management contract, including all forms of compensation.
- Management should have a substantial equity interest in their company.
- Management should make a full, timely, and transparent disclosure of its compensation to shareholders.
- Choices of forms of compensation should promote the long-term value of the firm, rather than exploit favorable accounting or tax treatment.
- Severance compensation, like all other forms of executive compensation, should be reviewed carefully against criteria set by the compensation committee of the board, and the board should publicly provide full details of awards and explain publicly to shareholders the reasoning behind such awards.
- Companies should have the right to recapture top executive bonuses if financial results by which they were justified turn out not to have been achieved when accounts are restated.

(5) **Directors Must be Selected and Appraised by Independent Nominating Committees**

A paradox of corporate stewardship is that, despite the principle that directors represent shareholders in the selection and retention of management, historically most directors have been selected by management. In our view, the best approach to building high-quality boards is to assign to truly independent nominating committees the responsibility for recommending new board candidates and for evaluating the performance of existing board members. The nominating committee should also have the responsibility of recommending committee assignments.

Conclusions

Relations between corporations and investors have suffered wrenching change in the last five years, from both corporate misdeeds and the legislative reaction to them. For all of the damage and pain, the potential exists for ultimate benefit to all parties, as better and more transparent information breeds renewed investor confidence and higher standards of behavior and openness.

In this statement, CED has recommended some changes in practice to hasten this beneficial adjustment. However, we would view such proposed change as modest, and within the scope of the recent revisions in corporate governance practices. CED believes that the wisest course now would be patience, to allow these new practices and institutions to be learned and understood, and to demonstrate their merit.

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