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Emerging Trends in Corporate Governance

Today's sweeping reforms herald the emergence of a new breed of director – one who must shoulder greater responsibility for business oversight while tending to the age-old business of exercising good faith and making decisions in the best interests of shareholders.

In this issue of Law & Governance*, we present to you the edited versions of Corporate Board Member Academic Council 2004 roundtable discussions to review the legal and regulatory environment surrounding corporate governance, director education, and the expanding scope of board responsibilities.*

Time Crunch: The Board Education Conundrum

An influx of first-time directors is invading the boardroom as the pool of traditional directors shrinks. Not only must they become well educated on their company and industry, they must parcel their precious time between staying on top of new regulations and fulfilling their regular board duties. The participants in this roundtable discussion were:

Duke K. Bristow, Financial Economist, The Harold Price Centre for Entrepreneurial Studies, Program Director UCLA Anderson School

Florencio Lopez-de-Silanes, Director, International Institute for Corporate Governance, Yale University

Stephen M. Wallenstein, Executive Director, Duke Global Capital Markets Center and Senior Lecturing Fellow, Duke School of Law and Fuqua School of Business, Duke University

Julie H. Daum, Practice Leader, North American Board Services, Spencer Stuart

T.K. Kerstetter, Corporate Board Member

How should directors get educated to perform their directorial duties?

Duke K. Bristow: There is a small presumption built into this question that most directors are not sufficiently educated and that they must become educated to perform their duties. There is little data to tell us whether most new directors have sufficient education to perform their duties. Beyond that, if we take what many pundits and politicians give as the standard for education – that directors simply need to do the right thing, as we often hear – then directors would need very little education beyond what they learned in high school, and perhaps Sunday school.

If we set a higher standard for what directors need to know to do their job, then we are faced with a much more difficult process. And much of that is highly situational. What a director at a venture-backed IPO for a biotech company needs to know to do his or her job well is quite different than what a director at Alcoa or Boeing or Coca-Cola needs to know. Foremost, if a company doesn't already have an education process for new directors, I would encourage it to start one. Some

INSIDE Calendar 66 | Newsworthy 68

of the director education programs can be a bit perfunctory. Many new directors extend director education into meeting with key customers and key suppliers. As long as those meetings don't disrupt the core business, that's a good way for new directors to become educated beyond the usual meetings with senior management and the general counsel.

Finally, I encourage those who have not previously been directors to sit on additional boards. Private company boards and serious nonprofit boards are good ways for first-time directors to gain experience dealing with board-level politics and other issues. For example, handling a harassment issue at a nonprofit [organization] may put one in a better position when a similar situation occurs at a for-profit [organization].

Stephen M. Wallenstein: There are three prongs to this issue that apply, to a certain extent, to both new and existing directors.

The first thing that is crucial for new directors to understand is the business model. They must read the *Wall Street Journal* and industry reports from equity analysts to get a really good idea of what the industry is all about. It is very important to meet with senior management and go through some of the same training programs that companies have for new employees. Companies train employees and put them through an educational process to learn about the company's business, but generally don't do so with their corporate board members.

Another prong is the sort of board education that comes from management and the general counsel passing along memos from law firms and accounting firms; bringing in experts to speak at a board meeting about recent trends in corporate governance, key issues of Section 404, and the role of the audit committee; and also bringing in a consultant to work with board members on how they work together.

And the final prong would be attending some of the open enrollment programs at UCLA or Stanford or Duke, where a large number of directors meet with policy makers, lawyers, regulators, judges, and representatives from the institutional shareholder community to give directors oversight about what different groups think and also to look at best practices and compare notes with board members from other companies. A lot of directors probably think they are already well educated, but we've found through our programs that they gain a lot from being exposed to other directors and experts.

Julie H. Daum: This will become more of an issue than people think. I'd like to focus on the new director. In the past, the path to the boardroom has always been fairly prescribed. CEOs were appointed and then invited to serve on other boards. Before they became CEOs, they may already have served on their own boards, but they had certainly attended meetings and learned about governance.

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What we are seeing now is an influx of brand new board members. Of the 300 or so people we placed on boards in 2003, more than 40% were first-time corporate board members. Some of that was a result of the *Sarbanes–Oxley Act*, which requires a financial expert be placed on the board, and many of those were CFOs or auditors who had not been on boards before.

Furthermore, there is a real inflow of first-time board members because of the shrinking supply of the traditional board member. So you are going to have a lot of people going into the boardroom who may have never even sat in their own company's boardroom. As Duke was saying, not only do they need to be fully educated about that particular company, but they need to know what governance is and what it means to serve on the audit or compensation committees.

I think most of them are embarrassed to go to a meeting not knowing that. They would like to be educated on how to be a director and on the key legal and financial issues. While some of them have served on nonprofit boards, which does help them learn about the dynamics in a group situation, there are still many issues about which they need to be fully informed. Many of the people we are placing on boards are asking, "What do I do? How do I get smart before my first board meeting?"

And then you have the issue of ongoing education, which never used to be an issue because there were so few changes in a given year. Now there are constant changes, and people want to hear what everyone thinks about them: What are the regulators thinking, what are the lawyers thinking, what is your board doing? And so there is an exchange of ideas as people learn how to comply with *Sarbanes–Oxley*.

Everyone is also trying to develop best practices, which is kind of an ongoing exercise that you can do only if you have exposure to people who are thinking about it and are doing it in a different context. There is a need for both, and they don't get delivered in the same fashion to the same audience.

It's a new era for board members, and no matter how long you have served on a board, you need to be part of the conversation in figuring out what is going on elsewhere.

Florencio Lopez-de-Silanes: Most of the points have already been touched on, but I will emphasize a couple of aspects that were mentioned. I also believe there are three basic characteristics in this process. First, there needs to be an awareness of what's happening within the firm and the industry overall. Why don't new directors get the same training as executives or new employees? They should get that at a minimum.

The second is the awareness for first-timers, and the reminder for oldtimers, that they have certain duties and responsibilities and need very specific information to make the decisions they are facing. It's also not a bad idea to remind them of how these duties apply in certain situations, so ongoing education on that front is very useful.

And finally, the continuous aspect of the process is a dynamic that goes back and forth because directors must keep up with changes in the law as well as with changes in the corporation. The corporation may go abroad and when it does, you are getting into a new ball game and a new set of rules and markets.

At the end of the day, these points are not to say that you must have prior qualifications, but to make sure that you become a more effective board member. With that in mind, it is much easier to think about what director education really is. It is about increasing the effectiveness of board members and helping them better perform their duties, and not so much about the right way versus wrong way.

Is certification a viable concept in the sense of being rolled out as a national program by universities or associations like the National Association of Corporate Directors (NACD)? If so, how would it work?

Lopez-de-Silanes: Sure, many countries require certification; China, for example. And the reason I mention China is that it immediately evokes something completely different from the United States. This is a country that has had state ownership for decades and one where there is very little business in the sense of publicly owned corporations. Thus, there is very little background to speak of, and in that context there may be reason to certify a director or, at minimum, make sure that that person is getting some kind of education, at least in the developmental stages of that market.

But that is not the case in the United States, which is rich in cultural history with regard to business and in human capital developed through centuries, so there may not be as big a need to certify directors. I tend to believe that for the United States, in particular, certification may not be necessary as a mandate, though I think the right thing to do is to ask companies to make sure they disclose whatever their directors are doing in terms of education, and then you let the markets help themselves.

And so I think that the problems that exist in the United States, with its very competitive market, lie in capturing all of the particular segments that have been mentioned where directors can go to get educated. Some directors may need more education on certain aspects, and some may need education in other areas. It is going to be a challenge to come up with a certificate that fits everyone and encompasses the requirements needed in a very developed capital market like the United States.

Bristow: I'd like to echo Florencio's comments. Certification shouldn't be mandated by the exchanges, by the SEC or, heaven forbid, by Congress. Since 1999, the UCLA Anderson School has offered a director training and certification program as part of a set of directorial continuing education initiatives that we call the Directors Institute. We offer it because our customers want it. They have the choice of sitting for the certification or simply going through the program and not sitting for the certification. Furthermore, I think the rigor of having a faculty decide what is going to be on an exam has a lot of value in terms of driving the content of the curriculum.

The problem with any certification program, whether it's CPA certification or the Bar Association, is you must decide what you are going to examine people on. And so certification is, in a sense, very hard work. What do directors need to know? Can you certify wisdom or honesty? The answer is, obviously, no. Can you certify competency? I think so.

UCLA's program focuses on the things that most often get directors into trouble. Using sophisticated databases, such as the Stanford database, we examined how directors have gotten into trouble, particularly through technical errors and missteps. We then built a program that, at a minimum, made sure that directors wouldn't be appointed without knowing that if they did certain things, it would get them into trouble. We are trying to overcome the presumption that general counsels are constantly looking out for directors and protecting them, as that creates a false sense of security.

Certification is a market response to some directors' wanting to differentiate themselves from others. Venture capitalists and others who encourage the directors of their portfolio companies to come through our program like the fact that, at the end of the day, we test whether or not we have educated them. I have attended programs where, at the end, I thought I knew less than at the beginning.

We give a pretest and a post-test. It's remarkable what discipline that [fact] drives into a system. For one thing, a pretest, which directors almost never get, provides some baseline as to what people in the class actually know.

"Can you certify wisdom or honesty? The answer is, obviously, no. Can you certify competency? I think so."

Wallenstein: When you think about it, so much goes into being an effective director, and high on that list is how you work and interact with others and what skills you bring to the table of a balanced board.

Given the wide range of industries, market cap, size and so on, I believe it would be very hard to come up with a certification program that would have any meaning for the 60,000 directors in the United States. *Sarbanes–Oxley* also has an extraterritorial reach, so you would run into the problem of imposing these same certification requirements on board members of foreign issuers, although that is a minor point. There are so many idiosyncratic requirements and so many things that go into making a good director; you have to understand the industry, you have to understand *Sarbanes–Oxley*, you have to understand roles and responsibilities, but in terms of certification, that is not something we think will grow.

Daum: In some ways, we're seeing a bit of the reverse. People are going through these programs, attend three days, and then say, "We're ready to serve on boards," and they are not. Just because you've gone through a program does not mean you will be a good director. You may be very smart and successful at what you do, but it doesn't qualify you to be a good director – it doesn't even qualify you to be a director.

But you have to be very careful about that qualification because if you say you will admit only certain people into a program, then the whole thing starts to be stretched unrealistically. Education is a great thing, and if you want to test people in the beginning and at the end, it helps them understand what they've learned. But I don't think it should be legislated in any way because there is no way to show that this makes you a better director.

The things that make good directors are, as Steve said, how they interact with your peers, as well as good judgment, wisdom, having been there, done that – a lot of things that can't be taught in a classroom. That doesn't mean you don't need to know the duties and responsibilities, but doing so doesn't make you a good director; it makes you a well-educated director.

Who are the most-qualified candidates to sit on corporate boards today, and how has that changed in the last two years?

Daum: First, there is a difference between qualified and educated directors. In the past, people didn't think about this distinction very much. A good director was an active CEO, and you assumed that with that [experience], you got wisdom: someone who was current in the market; someone who understood what it was like to manage multiple constituencies, including shareholders; and someone who had governance experience. When a board wanted to diversify, it brought on a woman or a minority, and that's how boards were structured. It didn't mean they were the most qualified or the best board members – I don't think people thought about it that much – it was just how boards were structured.

But the old model will not work anymore. Whether people want it to or not doesn't really matter, because active CEOs are being restricted by their own boards from serving on others or are just recognizing that they don't have the time to do so, so suddenly the ideal candidate pool of active CEOs is disappearing very quickly. People now have to think about what the board should look like, who is a qualified candidate, and what makes a good board member.

Over the past year, people haven't thought about it much because everyone has been looking for a financial expert to comply with the *Sarbanes–Oxley* rule. That was a big shift because that person may not ever be a CEO. But it was mandated, and people have accepted it. So people are grappling with this issue of what makes a qualified board member. Some boards will say, "I still want a CEO, so we'll get a retired CEO." Others will look at it differently, but, in general, most boards are starting to say, "We need a diverse board and that does not mean bringing on a woman or a minority, it means thinking about these nine to 11 seats differently and realizing we need people with different kinds of expertise."

However, you can't just recruit a marketing guy and a financial woman and a person who understands logistics, because then you will have a board composed of people who are not necessarily one-dimensional, but may really understand only one thing and not be able to support the entire board's activity. And if you go too far down into an organization to look for more junior people for the board, you have the problem we talked about earlier. They have never been in a boardroom, they don't know how to be a board member, and while they can grow into the job, you can't have too many of them in the room because then you can't do the business of the board.

This is a very complicated question right now because the obvious answer isn't available, and there hasn't been much research on the topic of what makes a good board member and how you select one based on the qualities you are looking for rather than the resumés.

> "The old model will not work anymore. . . . CEOs are being restricted by their own boards from serving on others . . . so suddenly the ideal candidate pool of active CEOs is disappearing very quickly."

Lopez-de-Silanes: Julie, you made the point that some people are starting to focus on the specific characteristics a candidate brings to the board: perhaps some industry expertise or special knowledge because he or she has a degree or experience in a certain field, or perhaps the company is global and you need someone who understands how the world works outside of the 50 states. I'll take a different tack.

There is some evidence of what kind of directors tend to be more effective, at least in terms of their fiduciary duties. Right now, there are two kinds of people you can appoint to a board – those who are there because they are supposed to be independent, and those who are there because they are not supposed to be independent – they are supposed to have the interests of shareholders at heart, and perhaps that's because they are shareholders themselves. The key is to understand that you must have someone who is supposed to be independent; you try to make sure that there are no conflicts of interest and everything is well disclosed, and that is what qualifies a person to be a good director. You should also realize that there are other types of directors who are very effective, and they are the ones that have a lot at stake.

When we talked previously about whether large shareholders can be qualified directors, there is no reason to believe that they are not qualified to be directors, particularly because they may suffer a lot based on what they do. Now, should they be checked? Yes. Do they have conflicts of interest? You bet. So what you need to do is make sure that you are aware of the costs and have mechanisms in place that will allow you to understand the problems they may present. Some are likely to be very aggressive, and to have primarily the interests of shareholders at heart. But others may not actually be like what people fear most in independents or outsiders in that they are not interested in taking huge bets because they just want to play it safe. So you may find some who want to limit risks and some who will want to take large risks, because that's what owning stock is about.

Bristow: Julie made an interesting point in that there's a sort of one-size-fits-all requirement built into that question, yet I think the answer varies by company. It is company-specific and even situational within a company. What challenges face a company that it can foresee, and what challenges will it face over the next year that it can't foresee? In some cases, figuring out which director is going to rise to the occasion would require clairvoyance. So we're stuck with the one-size-fits-all solution, and the one size that fits all is the best directors. And the evidence would indicate that the best directors are those highly experienced ones who are already on several boards, and are quite possibly CEOs.

What little evidence or objective data we have would be from watching venture capitalists, because they are highly motivated to make their companies successful as rapidly as possible. We often see venture capitalists sitting on 10 or 12 boards – which, in a public company context, we would think of as bad governance – yet they are clearly motivated to have perhaps the best governance. I'm not suggesting that everything that venture capitalists do is a model of good governance, but you can't argue that they are not aligned with the shareholders, which is a key principle on which we base much of what we say about good governance.

So using that model, it seems as though *Sarbanes–Oxley*, if anything, has taken us in the opposite direction, because the implication under *Sarbanes–Oxley* is that if you are on four or five boards, you probably are too busy to sit on an additional one, and perhaps you should even drop one of the boards you are already on, which is the point Julie was making about the qualified candidate pool shrinking. I think this is an unintended consequence that is going to have some detrimental effects that we will have a very hard time measuring.

But it is hard to imagine that a company in a basic industry wouldn't benefit by having Warren Buffet join its board and become a major shareholder in the company. I can't imagine in the current environment that Warren Buffet is looking to join more boards; he's probably being encouraged to join fewer. That is an important observation we didn't consider when *Sarbanes–Oxley* was drafted.

Wallenstein: Julie summed it up quite well. Two years ago, the ideal candidate for a board was a sitting CEO. That still may be the ideal candidate in a different kind of world, but that is not possible today because a large public board requires 200 to 250 hours a year of service, so it is no longer feasible for CEOs to sit on more than one board other than their own.

However, as there has been a tremendous rise in the need for financial experts on boards, that means full employment for many retired accountants and CFOs, a trend that will probably continue. It is becoming very tricky for people with full-time jobs to sit on boards, so we will likely see more retired people or semiretired people join boards, those with flexible schedules. Otherwise, how will they attend 12 audit committee meetings in a year? And, of course, you want independent directors, not just because they don't have conflicts of interest, but because when it is crunch time in the boardroom, they can be strong and stand up to the CEO. And some of those people are pretty acerbic, so you have to be careful. Can they interact well with others when things are going well, but stand up to the CEO when they aren't? It's not an easy call.

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Defining the Board's Scope

Boards must make sure they abide by their regulated agenda, while steering clear of a checklist mentality and, most importantly, determine what they will spend their time on.

The participants in this roundtable discussion were:

Charles M. Elson, The Edgar S. Woolard, Jr. Chair of Corporate Governance, John L. Weinberg Center for Corporate Governance, University of Delaware

Jay W. Lorsch, Louis E. Kirstein Professor of Human Relations, Harvard Business School, Harvard University

Garrett L. Stauffer, Partner and US Leader for Corporate Governance, Pricewaterhouse Coopers LLP

Steven N. Kaplan, Neubauer Family Professor of Entrepreneurship and Finance, Graduate School of Business, University of Chicago

T.K. Kerstetter, Corporate Board Member

How does a board go about determining its scope?

Charles M. Elson: First of all, a board's scope is legally determined. The board has a duty of care, which is to effectively monitor management for the benefit of the shareholder.

What do I mean by monitor? The monitoring role is two-fold. Phase one includes identifying the company strategy. Where is the company heading long term? Obviously that is something that management formulates with the board, and that the board must continually review. Phase two deals with how good a job management is doing in implementing that strategy. In short, is it headed in the right direction? And is it doing so effectively?

Those two obligations will shape the rest of the agenda and, in essence, dictate how the board functions. It is not there to micromanage, it is not there to run the company day to day, nor is it there simply as a policy-making body to set general policy or to support management's general policy. It is there to review policy, review how that policy is being implemented, and review operations. The board must set its agenda around the goals of policy review, strategic direction and operational monitoring, which collectively determine how board meetings should proceed.

Garrett L. Stauffer: Before a board can establish the scope of its agenda, it must understand the environment it is in. It has to understand the risks the company faces, it has to understand the regulatory requirements, it has to understand the strengths and weaknesses of management and the board and it has to understand the agenda of its investors. Once it puts those together, the board, with full consideration of the statutes that apply to it and the requirements that the articles of incorporation place on it, can sit back and formulate an agenda.

Jay W. Lorsch: It depends on how the word agenda is used. Typically, that term refers to the docket of a particular meeting. The law is pretty broad and unspecific about what boards are supposed to do. The Delaware statute basically says the board's duty is to manage the corporation, although it may delegate that responsibility to the officers. And then there are things like the business judgment rule, but that is also very broad. Some responsibilities are defined in the corporate bylaws or the corporate charter, some are within the board's latitude to effect – and it is in that regard that directors really need to think carefully about their role.

I agree that much of deciding scope has to do with the company's situation, but boards also have to determine the extent to which they are going to be an active participant with management in making decisions and the extent to which they want to be a watchdog. They need to figure out which decisions they will be involved in and which decisions they will leave to management, and how far down the line they want to act as a monitor. Do they want to monitor the results of every business unit in the corporation, or do they just want to look at total corporate performance? These are choices boards make and should make. My concern, frankly, is that most boards don't think about it. They just go in and do what they did last year and the year before, and they're caught in a rut.

Steven N. Kaplan: I agree with Jay, and I'd like to expand the point a bit. There is the monitoring piece of the board's scope, which Charles mentioned, as well as the advising piece, which Jay mentioned. Sometimes they conflict, sometimes they are complementary; it's tricky to manage.

The advisory role is a constant. Sometimes people say what the board should do is situation-specific. I think it should be less situation-specific than perhaps it is.

Boards often get more involved during a crisis, but they can create more value by getting involved when things are good rather than waiting for a crisis when a lot of value may already have been destroyed. The board's scope is constant diligence, constant advising and constant monitoring. The board's scope is nose in, fingers out. It should be looking at everything, helping where it can, monitoring where it must, but not running the company.

> "The board's scope is nose in, fingers out. It should be looking at everything, helping where it can, monitoring where it must, but not running the company."

Audit committee responsibilities have greatly increased. The phenomenon of the "audit creep" is making it more difficult for audit committee members to oversee effectively all that is on their plate, as new items are continually added to the committee agenda. What is the secret of the best-run audit committees?

Stauffer: Hard work. You are right, audit committee members are under a lot of stress with the new requirements and are spending much more time and meeting more frequently to accomplish their tasks. The question is, "How do they do all this and still maintain a normal lifestyle?"

First of all, you have to ask, "Is the audit committee overseeing things that it shouldn't be?" Over the years, audit committees have assumed more responsibilities that are outside the financial areas of the company. Compliance areas such as health, safety and environment have sometimes been pushed onto the audit committee's plate. It's time to remove them so the committee can focus on just the meat that it must deal with – auditing financial statements, internal controls, and handling all the communications and financial information that goes on in corporate America. So how do you do that, and how do you draw some reasonableness around the time needed to do that?

To start, the director of internal audit should be the audit committee's best friend. That person becomes the eyes and ears of the audit committee on a day-to-day basis. As that relationship strengthens, the audit committee will gain information and capabilities that it did not draw on before.

There also has to be a stronger relationship with external auditors and substantial participation by them in meetings. As we all know, the audit committee is now responsible for hiring and firing the auditors and determining their fees. This puts an auditor in a different position, and that relationship must be strong so that the audit committee can count on the auditors to provide them with all the necessary information and insights.

One other tool that is a leading practice and can be used at the board level is an annual meeting planner. There are so many things that must be covered by an audit committee due to the *Sarbanes–Oxley Act* that I fear it becomes form over substance. An item is checked off because it was covered in a two-minute discussion when, in reality, that item may have required an hour of discussion. This happens due to poor planning. Certain things must take place during certain periods of time by an audit committee. If that process and those time requirements are laid out in a proper meeting planner, it will keep the audit committee on track and keep it from going to a check-the-box approach.

Lorsch: Much of what has been said is correct. There is no question that Sarbanes–Oxley has required audit committee members to spend more time on their duties and to meet more often. It has also raised audit fees. All this extra work may be in the interest of protecting shareholders and providing more assurance that the financial statements are accurate and transparent, and that is probably to the good. As we gradually get more comfortable with what is being asked of audit committees, we're going to find that the time spent is going to diminish as people figure out better ways of managing the auditor relationship.

The thing that really needs to be worked through is Section 404. It's expensive. Over the last few weeks, I've interviewed 10 audit committee chairmen to try to get a sense of what is going on, and the news is pretty good. People feel like *Sarbanes–Oxley* may actually turn out to be a good thing, but they are still concerned about Section 404. The term mentioned, audit creep, is an interesting point. If the board can't figure out where to put something, there is a tendency to put it on the audit committee, and that requires some thought on the part of the other directors about whether or not these additional responsibilities must go to the audit committee or perhaps to a finance committee.

Kaplan: The audit committee's responsibilities will become less of a burden. When something changes, initially you put a lot of energy into it, and then you figure it out, so I'm optimistic that time and costs will go down.

First, there is a size issue that we have not yet talked about. There is a difference between multidivisional, multibillion-dollar companies and middle-market or smaller companies where you can get a better sense of what is going on inside the company and where there's less unknown. At both big and small companies, the best-run audit committees must start off with a CFO and an auditor that they trust, which may be a funny thing for an economist to say. It's important that you believe the CFO and auditor are doing the right thing, and that is a bit easier now because the outside auditor reports to the audit committee chairperson, thus he or she is naturally going to be more loyal and more open to the audit committee chairman than the CFO.

Second, what do audit committees do? They work through the processes with the auditor and the CFO. *Sarbanes–Oxley* has been positive in the sense that companies are going through their processes and understanding the business better than they did in the past. Audit costs are up, but on the other hand, you are getting new information, and some of that will turn out to be valuable.

Elson: I'd like to second everything that has been said. We've had some very perceptive views of the audit committee and its future. Prior to Sarbanes–Oxley, the audit committee chairman had a very important job – setting the committee's tone and agenda. Today it is a different story. With *Sarbanes–Oxley*, the audit committee's tasks and responsibilities have become federally mandated. The committee's agenda then is primarily dictated by federal law and from that perspective, there isn't much wiggle room for the committee chair, which is both good and bad. If you assume that the requirements of form lead to a better audit, then requiring everyone to go through the same form makes sense.

Our research reflects that the audit committee will see no relief as a result of Section 404. In fact, audit committees will face many challenges that will take more time and a lot more energy. What are your thoughts on Section 404 and the impending burden it places on directors?

Elson: The intent of Section 404 is to ensure that a company's internal controls are appropriate, and a review of internal controls is viewed as the way to do that. Unfortunately, that opens a massive can of worms because once you begin evaluating internal controls, the questions that come out of that review must be addressed, and no company is going to walk away from that saying everything is fine. Any time you review internal controls, something will be discovered. A telling sign is that new firms are emerging to advise companies on Section 404, which suggests that there is a lot of work to do. When these advisory firms come back with their recommendations, it will be a lot for the audit committee to review and consider. The Section 404 review is not an end in and of itself. It is the beginning, frankly, and the cost and time that it requires will be substantial. The big question is, once that review has taken place and problems have been identified, will the solutions result in a better audit and in better controls, or are we in just another form-over-substance review? I do know it will not be cheap, and it certainly will not be quick. It will be a challenge for everyone involved.

Kaplan: We just don't know what the effects of Section 404 will be, and that it is definitely a concern. The first concern is cost. There will be a lot of one-time costs, but the ongoing costs should be much lower. I'm assuming there are going to be some ongoing benefits as a result of Section 404. The second point is that the SEC and Public Company Accounting Oversight Board commissioners are aware of the challenges and if they become worse, then there will be some regulatory help. I would like to think that there would be, at any rate.

Lorsch: The difficulty in complying with Section 404, which is still a moving target to some extent, depends on the company. I just spoke with an accounting audit committee chairman who said, "We have a relatively good set of controls; the whole thing wasn't a big problem for us." But if you are running a company with inadequate controls, you've got a bigger problem. The larger companies presumably have better control systems, are in better shape, and will not find Section 404 so onerous. The companies that will really struggle with it are those without adequate controls. You may be getting complaints from them, but the fact is, maybe it's a good thing that they are complaining because they are fixing a problem that should have been fixed. Yes, it is going to cost money, there is no question about it, and it is going to be difficult – but once you get it right, it will be more manageable.

Calendar

ELECTRONIC HEALTH AND MEDICAL RECORDS
December 1–2, 2004
Vancouver, BC
Contact: Insight at 1-888-777-1707 or www.insightinfo.com

NATIONAL CONFERENCE ON QUALITY AND PATIENT SAFETY DECISIONS THAT COUNT
December 1–3, 2004
Chicago, IL
Contact: http://www.jcrinc.com/education.asp?durki=5961&site=5&return=5933

CRITICAL TRAINING FOR BILL 31: THE PERSONAL HEALTH INFORMATION PROTECTION ACT
December 2, 2004
Ottawa, ON
Contact: National Privacy Services at 1-877-PRIVLAW or info@privlaw.com

TELETRIAGE AND CALL CENTRE HEALTHCARE
December 8–9, 2004
Toronto, ON
Contact: Insight at 1-888-777-1707 or www.insightinfo.com

HEALTH INFORMATION PRIVACY
January 17–18, 2005
Toronto, ON
Contact: Insight at 1-888-777-1707 or www.insightinfo.com

4TH ANNUAL OBSTETRIC MALPRACTICE AND PERINATAL RISK MANAGEMENT FORUM
February 22–23, 2005
Toronto, ON
Contact: Insight at 1-888-777-1707 or www.insightinfo.com

Stauffer: From a first-year perspective, I think Section 404 is bigger than most people realized. I had a conversation with a controller of a Fortune 50 company who said it very well: "The more you know about 404, the bigger it gets. The more you know about 404, the less control you have." What is taking place for the first time in most of these companies, outside financial institutions that have had the fiduciary requirements for many years, is a deep dive into their internal control environment.

Control environments aren't developed overnight. They develop over 10, 15, 20 years; they develop through a number of different CEOs and CFOs, a number of different acquisitions, a number of different systems changes, and a number of different internal auditors and controllers. To put a stake in the ground and measure control environments at a specific point in time on a deep-dive basis will result in more concerns than people are actually focused on now.

One reason for that is the standard itself puts a very low hurdle on some of the areas that can trip you into an ineffective system over internal controls. So I agree that the larger companies have it a bit easier. Many of them are well controlled, which will help, although even they wouldn't be devoid of having potential problems in their systems of internal controls. The small to medium-size companies, the ones that either don't have internal audit departments or have small internal audit departments and haven't spent a lot of time developing good control environments, clearly will suffer in the early stages of developing controls and putting them into a proper framework. Time will tell, but if a company hasn't yet started the process, it will regret it because we are within seven to eight months of the deadline for completing the process, and there is a lot of work to be done.

Surveys show that original estimates of time spent on this effort have more than doubled in a number of situations. It's a big animal, though, and I think it will settle down after we get through the first few years. The idea is to find your control weaknesses, remediate them, and then you will have a good, strong control environment, which should make life easier as companies move forward. But early in the process is when there will be some surprises that people just aren't ready for.

As you look into the future at the effects of corporate reform, what concerns you the most? Will the checklist mentality put boards in a situation where they are not spending enough time on strategy? Will corporate reform end up pushing the board and management further apart?

Lorsch: There is no sense in sitting around, rubbing one's hands together and saying, "Woe is me, *Sarbanes–Oxley* is a bad thing," or "The new listing requirements are a bad thing." They have imposed additional work on boards, there is no question about that.

But they have also had a positive effect in that they have enhanced the board's power vis-à-vis management fairly clearly. With this empowered audit committee that *Sarbanes–Oxley* has created, any CEO who doesn't think the board is responsible for auditing and monitoring financial performance has his or her head in the sand.

There have been some good things happening, but boards are being asked to do more, and in order to get that extra work done or to do the same thing more carefully, whichever way you choose to think about it, boards need to be much better designed to use the limited time they have together. They need to be sure they have adequate information and are focused on the right roles and activities to get the job done. I'm worried because boards have never done that, and I think they need to.

The other thing that worries me is that we have a situation in which there is no question that if you look at who has the power and influence in the American system of corporate governance, the board's role has been enhanced. Shareholders are now complaining about that enhanced power, and the way they are gaining control can be counterproductive. Take, for example, the vote against Warren Buffet at Coca-Cola.

There are some crazy metrics out there. In that regard, ISS [International Shareholder Services] is as bad as any. It is measuring things that don't have a thing to do – or have very little to do – with board performance. Why? Because it can uncover them by reading proxy statements, annual reports and so forth. If you get boards and corporate secretaries focused on these things, you are wasting everyone's time because they have very little to do with what makes boards effective.

It worries me that the institutional investors feel disenfranchised and disempowered. It also worries me that they are continuing to pursue this really unproductive path to board improvement. In the end, they are doing the only thing they can, and I understand that; but it gets boards focused in the wrong direction.

Another thing I worry about is, given the American capital system where we have changing ownership and large institutional ownership by basically anonymous owners, can we find more constructive and positive ways for shareholders to express their voice rather than just sort of shaking trees and trying to irritate the board and management to see if they can get their attention?

Kaplan: I agree with Jay. *Sarbanes–Oxley* and the new listing guidelines have enhanced the board's power. The good provisions are those where you have a specific outcome or a process, but you also have a lot of leeway as to what you do within that process.

For example, executive sessions are required, but what you do in them is up to you. Signing off and certifying financial statements is required, but how you get there is up to you. The audit committee chair is responsible for hiring the auditor and has more power and should be able to do what he or she wants to do in that situation, which is good because it would have been very hard to get that to happen without an outside voice telling company management to do so.

As an example, Jack Welch, former chairman and CEO at General Electric, was once asked, "Would you have ever let your board meet in executive session?" He was quoted as saying, "No. The second they told me they wanted to meet without me, they would be telling me they don't trust me, and I'd resign." And so being told that you have to do this gives you cover to allow you to do it and break the equilibrium that you might have had.

The bottom line is that many of the provisions tell you to do something, but don't tell you exactly what you have to do in every situation. Overall, these have been positive and have enhanced the board's power.

Elson: The positive has been the broad acceptance in the last few years of the idea that an independent, long-term, equity-holding board as a counterweight to management makes some sense and that the way to create good monitoring on the part of the board and long-term, productive relationships with management comes from the idea of director independence and director ownership. They are both critical. And as you look at all the reforms, that's really the core.

That being said, there is a problem with form over substance that has gone hand in hand with these developments. Whether it's the listing standards or *Sarbanes–Oxley* or even some of the guidelines, they encourage people to look at the form. "Oh, we're complying with the ISS recommendations as to form, we must be OK. We got a high rating and we complied with the form, isn't that great?" Well, the issue wasn't complying with the form, it was the spirit behind the form, and if you are wrapped up in checking off boxes without understanding what they really mean and how each box is assembled into the broader picture, then you have gone far astray. But I'm heartened by the general direction we're moving in.

Stauffer: I pretty much agree with everyone. I'll focus on one area that concerns me that really comes out of the form-over-substance issue.

I don't believe you can rate a board unless you can sit in and watch it work – see the directors, hear the challenging and tough questions they ask, or see if they just sit back and listen and nod and raise their hand to vote yes. So rating concepts and rating boards based on form, as Charles has said, troubles me because you may have met the form or you may not have met the form, yet your board is the most challenging, thoughtful board out there.

That also raises the issue of when you get the independence, do you lose the knowledge of the business? Are you taking away knowledge from the board relative to the business and industry that it is in? Directors may not be as informed as they once were, and that concerns me. Not that the board shouldn't follow an independent process, but there is the fear that you are going to get marked down due to having a director who may not be viewed as independent.

And then the last thing we saw early on, and I'm still not sure we're over it yet, is the risk issue. The lack of willingness to take risk is a result of everything that has come down the ladder over the last year and a half, and early on, that was especially the case. There are some comforting signs that indicate that the willingness may be waning, but I'm not convinced we are out of the realm yet and that people are willing to take the necessary business risks, given the current outcomes and the shareholder activist groups, and the ratings and concerns they place on boards.

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Newsworthy

Where Is the Money Going?

Healthcare spending for cancer, heart disease, hypertension, mental illness and pulmonary conditions made up 31% of the overall increase in healthcare spending between 1987 and 2000, according to researchers at Emory University. For four of the 14 conditions studied, the majority of the cost increases were the result of increased treatment, not population growth or increased costs per visit. In another recent study by one of the Emory researchers, obesity accounted for 12% of the growth in healthcare spending between 1987 and 2001. (Source: *Modern Healthcare's Daily Dose*, October 25, 2004)

Hospital Utilization Declines, CIHI Reports

Inpatient hospitalizations dropped over 14% in the seven-year period between 1995–96 and 2002–03, according to a recent report by the Canadian Institute for Health Information (CIHI). Declines were recorded in every province and territory, but ranged from over 21% in Newfoundland and Labrador and Nova Scotia, to less than one per cent in Alberta. However, double-digit decreases were registered in every other province.

While the total number of days of hospitalization was also down, the average length of time patients spent in hospital increased – reflecting a trend toward hospitals admitting only sicker patients than in years past. The average length of stay in a Canadian hospital was 7.4 days in 2002–03, compared to 7.2 days in 1995–96. However, there was considerable provincial variation, with Saskatchewan being the lowest at 5.9 days and Manitoba the highest at 9.1 days. The Northwest Territories and the Yukon actually had the shortest stays at 4.8 days in 2002–03 (data from Nunavut were not available). (Source: *Health Edition*, Volume 8, Issue 43)

Newsworthy material should be submitted to
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