

FRAUDULENT FINANCIAL REPORTING DETECTION: CORPORATE GOVERNANCE RED FLAGS

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Abstract

The recent fraudulent financial reporting by Enron, Qwest, and other companies was facilitated by poor corporate governance. As shown in this paper, ten timeless factors of corporate governance helped detect such reporting. Weak corporate governance facilitated both classic and recent financial reporting frauds, particularly the following factors: all-powerful CEO, weak system of internal control, focus on short-term performance goals, weak or non-existent code of ethics, and questionable business strategies with opaque disclosures. These factors implied ineffective boards of directors and audit committees. New corporate governance guidelines for boards and audit committees by the U.S. stock exchanges and the Sarbanes-Oxley Act appear to have good potential for strengthening corporate governance to help prevent earnings manipulations and fraudulent financial reporting. These new regulations should continue to strengthen strong corporate governance and control systems, especially in relation to the ten timeless factors for fraudulent financial reporting. If corporate governance guidelines are not followed, then, these stock exchanges can delist the offending companies.

Keywords: financial reporting, corporate governance, CEO, frauds

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Introduction

History has shown that many financial regulatory reforms were motivated by crises. For instance, the U.S. Securities Exchange Act of 1934, which established the Securities and Exchange Commission (SEC), followed the U.S. stock market crash of 1929. The Foreign Corrupt Practices Act of 1977, the SEC Practice Section, and the Financial Accounting Standards Boards (FASB) were all established following the classic U.S. financial reporting frauds of the 1960's and 1970s, such as National Student Marketing, Stirling Homex, Equity Funding, W.T. Grant, and Penn Central. History has repeated itself with the passing of the Sarbanes-Oxley Act (SOX) in July 2002 after Enron, WorldCom, and other U.S. companies collapsed.

SOX also created the Public Company Accounting Oversight Board (PCAOB) that establishes standards, performs quality reviews of auditing firms, and investigates and disciplines audit firms and individuals. This Board is composed of five members, only two of which can be CPAs. They have to serve full time and cannot receive payments, other than their retirement pay, from public accounting firms (Felo and Solieri, 2003).

SOX poses remedies for the perceived ineffectiveness of corporate governance and external audits. SOX is also applicable to the 300 European companies that are dual-listed on U.S. stock exchanges since they are being required to follow SOX by the SEC for their U.S. listings. Also, there are now 1,300 foreign firms registered with the SEC versus only 500 firms in 1992. The SEC's resolve to enforce SOX with foreign firms has been reinforced by recent major European cases of fraudulent financial reporting, i.e., Parmalat, Cirio, Ahold, and Adecco. In the European Union (EU), the need to use international accounting standards became a priority after the Enron and Parmalat financial reporting scandals. Beginning in January 2005, International Financial Reporting Standards (IFRS) must be followed by large public European Union companies. Both the IFRS and U.S. generally accepted accounting principles (GAAP) can be considered as forms of corporate governance.

To emphasize the importance of the SOX regulatory reforms in reducing fraudulent financial reporting, the major sections of SOX have been matched with ten timeless deficiencies in corporate governance that facilitated previous financial frauds in Table 1. These ten factors appeared to have facilitated financial reporting frauds as far back as the 1960's

(Grove, Selto and Sorensen 1982). As listed in Table 1, these ten factors were an all-powerful CEO, a weak system of internal control, short-term performance focus, CEO uncomfortable with criticism, senior management turnover, insider stock sales, weak or non-existent code of ethics, independence problems with auditors, independence problems with investment bankers, and inadequate, opaque disclosures.

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This approach also integrates components of corporate governance that have been historically treated in isolation of each other in research, teaching, and practice. Based upon the results of board evaluations conducted in many different countries for companies operating in various industries, including banking, insurance, chemical, pharmaceutical, biotechnology, information technology, and airline services, guidelines for a new corporate governance approach were developed (Hilb, 2004). This approach is an integrated framework based upon the reverse KISS Principle: Situational, Strategic, Integrated, and Keep it controlled. Key aspects of these four corporate governance principles are matched to these ten prevalent factors of fraudulent financial reporting.

These corporate governance factors are elaborated with observations from Warren Buffett, the CEO of Berkshire Hathaway, a multi-billionaire investor, and the second richest person in the U.S., just behind Bill Gates, who was just elected to Buffett's board. Recently, Buffett has included a corporate governance section in his annual CEO letter to shareholders (2002-2004). He has been on 20 public-company boards, interacting with 250 directors over the last 40 years.

Various corporate governance factors are also elaborated with the New York Stock Exchange (NYSE 2003) listing standards for corporate governance. (The major listing standards for corporate governance for the Nasdaq stock market are virtually identically.) The SEC approved both sets of listing standards on November 4, 2003. Both the NYSE and Nasdaq require that all their listed companies adopt and discuss these listing standards. Also, listed foreign companies must disclose any significant differences from these corporate governance listing standards. Companies not following such corporate governance requirements can be de-listed by these stock exchanges.

Corporate Governance Empirical Research for Fraudulent Financial Reporting Detection

Almost all of the recent fraudulent financial reporting frauds were facilitated by weak corporate governance as cited in recent empirical studies. The following variables were significant for companies with financial reporting fraud or earnings management

problems, as identified by the SEC in its Accounting and Auditing Enforcement Releases (AAERs) from 1982-1992: percentage of insiders (company managers) on the Board of Directors, percentage of total Board holdings held by insiders, insiders having greater than 50% control of the Board, CEO also being chairman of the Board, CEO being the company founder, and lack of an audit committee (Dechow, Sloan, and Sweeney, 1996). Beasley, Carrello, and Hermanson (1999) found similar deficiencies in their study of AAERs from 1987-1997. In a more recent study of fraudulent companies cited in AAERs from 1986-2001, the following three corporate governance variables were significant for fraudulent companies: percentage board holdings held by insiders, insiders having greater than 50% control of the board, and the CEO being the chairman of the board (Basilico, Grove, and Cook, 2005). Various short sellers, fund managers, investors, and financial analysts have used corporate governance factors to help make their investment decisions (Bryan-Low and Opdyke, 2002; Mulford and Comiskey, 2002; Schilit, 2003; Willis, 2002). Bears Stearns (2003) has cited the importance of such non-financial factors:

"Fundamental financial statement analysis is necessary but not sufficient. Probably the most important lesson to be learned from the accounting scandals of the recent past is that fundamental analysis is absolutely essential to a sound investment decision. Unfortunately, the corollary to that lesson is that fundamental analysis is not sufficient for distinguishing between poor-quality reporting, poor-quality earnings, and fraud. Often, fundamental analysis detected problems but not the depth or breadth of the problems, resulting in the inefficient pricing of the company's stock until it was too late."

Do you agree? A summary of key events, including corporate governance issues, is provided for both Enron and Qwest. For Enron, many of these events had surfaced by early September 2001 when its stock price was still trading in the \$30 to \$35 range (off its all time high of \$90 in Summer 2000) but before November 30, 2001 when it dropped to near zero after exposure of its financial reporting fraud. For Qwest, many of these events had surfaced by December 31, 2001 when its stock price was still trading in the \$13 to \$17 range (off its all time high of \$63 in Summer 2000) but before late 2001 when it dropped to under \$4 after exposure of its earnings manipulation. How many corporate governance problems can you identify for Enron and Qwest from the following key events?

Enron Key Events

1. October 1999: the German firm, Veba, rejected a proposed merger with Enron, citing huge off-balance-sheet debt and other aggressive accounting practices by Enron.
2. Last half of 2000 through the summer of 2001: large amounts of insider trading occurred. The

former CEO (Lay), and the current CEO (Skilling), the general council, and other chief executives, including the CFO (Fastow), all sold large blocks of stock totaling \$1.1 billion in profits. Also, both CEOs were also chairmen of the board of directors while serving as CEOs.

3. August 2000 to October 2001: Short-selling positions increased from 2 million shares in August 2000 to 8 million shares by year-end 2000 and to 33 million shares by October 2001.

4. March 31, 2001: Enron continued to have opaque and complex financial reporting, especially for the related party transactions with special purpose entities (SPEs). As the short seller Chanos said, "We read the SPE disclosure over and over and over again and we just didn't understand it—and we read footnotes for a living." Enron seemed to go out of its way to obfuscate. When pushed to reveal more, Enron management was uncooperative and pleaded confidentiality concerns.

5. March 31, 2001: The CFO Fastow was the managing member of three SPEs. McLean (2001) found the following information in SPE marketing materials: "The Enron board of directors has waived 'Code of Conduct' for Fastow's activities relative to the SPE." She concluded: "At the very least the SPE partnerships demonstrate horrific judgment by people other than just Fastow. Enron's board, for example, gave its okay." Also, Enron had 3,500 subsidiaries, affiliates, tax entities, and partnerships, like the SPEs.

6. March 31, 2001: McLean (2001) noted that the use of the mark-to-market accounting method for pricing Enron's derivative securities in illiquid markets with no fair values was very problematic. She said, "Enron often relied upon internal models which created serious potential for abuse." Former Enron managers said that salespeople used wildly optimistic assumptions about the forward price of commodities and other factors to value their contracts so profits would be inflated and their bonuses would be bigger. In a retirement party video, Skilling bragged that he could add a "kazillion" dollars to Enron's bottom line anytime he wanted by using mark-to-market accounting.

7. April, 2001: Skilling was aggressively questioned by a hedge fund manager during the quarterly conference call on why Enron had not published more detail on its finances, such as one-time sales of power plants and pipelines. Skilling responded by calling the manager an obscene name and pointed out that Enron always made its quarterly revenue and earnings targets.

8. June 30, 2001: Cramer (2002), a hedge fund manager, said: "Fastow allegedly created a fictitious arm's-length entity that was really run by him. Then, supposedly, the entity was promised Enron stock if it lost money. That's potential securities fraud—you can't secretly issue millions of shares of stock. Finally, Fastow charged Enron an outrageous amount of money for doing nothing. The board appears to have known and approved all these SPE transactions."

9. Summer 2001: Enron's auditor, Arthur Andersen (AA) had consulting fees with Enron that were slightly larger than its audit fees of \$25 million. AA was also consulted on the accounting treatment of the SPEs and earned \$5.7 million fees for its advice. Many former AA auditors worked for Enron which also outsourced its entire internal auditing work to AA.

10. Summer 2001: The sell-side financial analysts who worked for the investment bank firms that earned significant fees from Enron continued their buy recommendations on Enron's stock. Typically, investment fees are very lucrative but equity research is provided free by investment banks.

11. August 14, 2001: the Enron CEO, Jeffrey Skilling, resigned only six months after being promoted to his "dream" job, and called it a "purely personal" decision, saying that he wanted to devote more time to his family.

Qwest Key Events

1. October 2000: The German company, Deutsche Telekom, rejected a proposed merger with Qwest, citing Qwest's business model and its aggressive accounting practices as major reasons.

2. February 2001: CFO Robert Woodruff, who helped lead Qwest's IPO in 1997, quit to "spend more time with his family."

3. May 2001: The financial press reported that insider stock sale profits for the top eight Qwest executives were \$2.177 billion over the last twelve months. Over \$2 billion went to just two people: \$1.85 billion to company founder, Phillip Anschutz, and \$0.161 billion to CEO, Joe Nacchio. At the time Anschutz was the chairman of the board of directors and had hand-picked Nacchio for the CEO position.

4. June 2001: Morgan Stanley financial analysts criticized Qwest's accounting practices and downgraded Qwest's stock to neutral performance. They were particularly critical of the use of fiber optic swaps with Global Crossing, Enron, and other companies to make quarterly revenue growth targets.

5. June 2001: Nacchio said these Morgan Stanley analysts were "not the sharpest knives in the drawer" and called their report "hogwash." He pledged not to talk to them again and terminated Qwest's investment banking business relationship with Morgan Stanley. Also, Nacchio pointed out that Qwest always made its quarterly double digit revenue growth targets and implied that these swaps were part of regular business sales, not one-time or infrequent transactions.

6. July 2001: A top level Qwest marketing manager was again asked to leave the quarterly marketing meeting for several minutes. Once he realized that the other Qwest managers were discussing the quarter-end fiber optic swaps in his absence, he quit his job in protest. When a Qwest finance manager questioned the veracity of these swaps, he was transferred to an international division.

7. July 2001: Qwest reported the largest quarterly loss ever by a Colorado-based company. Qwest was sued by the New England Health Care Employee Pension Fund for improper accounting methods. Also, a class-action lawsuit was filed against Qwest, alleging the company's executives engaged in financial fraud to the detriment of shareholders. Nacchio called these lawsuits "nonsense."

8. September 2001: Qwest lowered its financial projections for 2001 and 2002 and announced 5,000 job cuts for the rest of 2001.

9. Although Qwest's board of directors extended Nacchio's employment contract for four years, it did criticize him for focusing too much on short-term performance goals.

10. December 2001: Arthur Anderson, Qwest's auditor, earned as much in consulting fees as it did in audit fees each year.

11. June 2002: At the urging of Qwest's Board, CEO Nacchio stepped down to "spend more time with his family."

Corporate Governance Detection Summary

Both Enron and Qwest had all-powerful CEOs who appeared to overrun intentionally weak systems of internal controls in order to achieve the short-term top and bottom line results that they desired. Both firms used aggressive accounting practices, like SPE transactions, mark-to-market accounting, and unusual sales (power plant sales and fiber optic swaps), to make their quarterly numbers. Also, both German firms, Veba and Deutsche Telecom, cited aggressive accounting practices as major reasons for rejecting proposed mergers with Enron and Qwest, respectively.

Both Skilling and Lay were also the chairmen of their boards of directors. Both Skilling and Nacchio appeared to be uncomfortable with criticism from outside sources, implying weak corporate governance with few, if any, corporate executives or board members challenging them. Both the CEO of Enron and the CFO of Qwest left their jobs unexpectedly, implying weak corporate governance as no succession planning was mentioned. The huge amount of insider stock sales implied weak corporate governance concerning a focus on excessive compensation packages for top management versus looking out for shareholders' interests. All the ethical problems at both companies indicated poor corporate governance concerning weak or non-existent codes of ethics. The independence problems with both auditors and financial analysts at both companies showed a weak system of corporate governance in dealing with both types of outsiders. The questionable business strategies, opaque disclosures, and manipulative accounting at both companies showed very weak corporate governance and poor supervision by both boards and audit committees.

Three examples of the relevance of poor corporate governance factors were provided by fund managers as follows. First, there was an observation from Jim Chanos, the hedge fund manager who was among the first to short Enron's stock when it was still trading around \$70 a share. He had been analyzing Enron's financial statements for almost two years trying to develop a case for shorting it. During a financial analysts' conference call, he heard Enron's CEO, Jeff Skilling, refuse to answer an analyst's question and, instead, call him a "donkey-related" term. Chanos said that was the final piece of the puzzle and starting shorting Enron's stock immediately thereafter. Second, another investment fund manager said that both Lay's and Skilling's continued selling of their Enron shares while telling everybody that the stock was headed higher was a "screaming red flag" in his decision to sell Enron's shares. Third, another fund manager said that Skilling's surprise resignation from his dream job of CEO to "spend more time with his family" was the worst excuse that he had ever heard and dumped his Enron shares immediately thereafter.

Conclusions

The recent fraudulent financial reporting by Enron, Qwest, and other companies was facilitated by poor corporate governance. Ten timeless factors of corporate governance helped detect such reporting. Weak corporate governance facilitated both classic and recent financial reporting frauds, particularly the following factors: all-powerful CEO, weak system of internal control, focus on short-term performance goals, weak or non-existent code of ethics, and questionable business strategies with opaque disclosures. These factors implied ineffective boards of directors and audit committees. New corporate governance guidelines for boards and audit committees by the U.S. stock exchanges (NYSE 2003) and the Sarbanes-Oxley Act (Felo 2003) appear to have good potential for strengthening corporate governance to help prevent earnings manipulations and fraudulent financial reporting. These new regulations should continue to strengthen strong corporate governance and control systems, especially in relation to the ten timeless factors for fraudulent financial reporting. If corporate governance guidelines are not followed, then, these stock exchanges can delist the offending companies.

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Appendix

TABLE 1. Ten Timeless Fraudulent Financial Reporting Detection Factors
With Corporate Governance Guidelines and SOX Sections

1. All-Powerful CEO

The CEO is also the Chairperson of the Board of Directors. Insiders (senior company managers) on the Board have majority control which is a failure of corporate governance.

- **Strategic Guideline: Effective Board Structure**

A small, legally accountable, well-diversified board should be comprised of a maximum of seven members, including an independent Chairperson, independent members, and the CEO. The board should conduct its activities through only two committees: an integrated audit and risk management committee and an integrated board management committee.

- **SOX Section 402:** Corporate loans to company officers and directors are now prohibited.
- **SOX Section 1105:** The SEC can ban, temporarily or permanently, individuals from serving as officers or directors of public companies if the individuals have committed securities fraud.
- **Buffett & NYSE:** Concerning this Strategic guideline for an effective board structure, Buffett observed: "true independence—meaning the willingness to challenge a forceful CEO when something is wrong or foolish—is an enormously valuable trait in a director. It is also rare." He looks for people whose interests are in line with shareholders in a very big way. All eleven of his directors each own more than \$4 million of Berkshire stock. They are paid nominal director fees. No directors and officers liability insurance is carried, not wanting them to be insulated from any corporate disaster that might occur. Basically, Buffett wants the directors' behavior to be driven by the effect of their decisions on their net worth, not by their compensation. He calls this approach "owner-capitalism" and says he knows of no better way to create true independence for board directors. The NYSE requires that its listed companies have a majority of independent directors and has defined independence as directors having no material relationships with the company over the past year after adoption of corporate governance listing standards.

2. Weak System of Management Control

The system of internal control (checks and balances; separation of duties, etc.) is so weak that senior management can override it anytime it wants. There is a failure of corporate governance.

- **Keep It Controlled Guideline: Board's Auditing Function**

To improve the quality of internal control, effective cooperation is needed between the external auditor, the board, the audit committee (to which it reports) and the internal auditor (which should also report to the audit committee). The effectiveness of the internal control system and compliance should be a central focus of the audit committee.

- **SOX Section 404:** The CEO and the CFO are required to discuss their firm's internal controls and procedures in place to prevent fraud. CEOs and CFOs are required to state that establishing and maintaining the internal control structure is their responsibility and to provide an annual assessment of the effectiveness of those procedures in annual reports.
- **SOX Section 407:** Audit committee members must be independent and are prohibited from receiving compensation, except for board service. Audit committees must have one member who is a financial expert.
- **Auditing Standard No. 2:** The Public Companies Accounting Oversight Board (PCAOB), created by SOX, required that the external auditor give two opinions on a firm's internal controls: one on management's assessment of internal controls and one on the actual effectiveness of the internal controls. U.S. external auditors are now required to give three opinions: two on internal controls and one on the financial statements.
- **Buffett & NYSE:** Concerning this Keep it controlled guideline for a board's auditing function, Buffett observed that many intelligent and decent directors failed miserably due to a "boardroom atmosphere." He elaborated: "it's almost

impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his advisors are present and support his decision." To avoid these "social" difficulties, Buffett has endorsed the NYSE requirement that outside directors regularly meet without the CEO. Also, the NYSE requires that every listed company have an audit committee of at least three members composed entirely of independent directors who must be financially literate. Every listed company must have an internal audit function.

3. Focus on Short Term Performance Goals

The overriding performance goal is to "make the numbers," for each quarter and each year, especially for executive compensation. More performance emphasis is given to revenue, or "top-line" growth, than earnings, or "bottom-line" growth. Aggressive accounting practices facilitate the achievement of such goals.

- **Integrated Guideline: Executive Remuneration**

The total compensation package can be divided into fixed (e.g. 40%) and variable (e.g. 60%) components. The variable component can be made up of several performance measures: 1) long-term financial performance over three years, 2) comparative value indices (e.g. 50% Economic Value Added, 20% customer loyalty, 20% employee satisfaction, and 10% public image), and 3) functional performance assessments (20% board committee performance, 30% individual board member performance, and 50% corporate performance).

- **SOX Section 302:** CEOs and CFOs are required to certify that they have reviewed all quarterly and annual reports filed with the SEC. Also, in a written report, they must state that, to the best of their knowledge, the reports present fairly the financial condition and operations of the firm and don't omit material information. Individuals can be fined up to \$5 million and be sentenced to up to 20 years in prison for violating this requirement.
- **SOX Section 401(b):** It enabled the SEC to adopt Regulation G governing the use of non-GAAP financial measures, including disclosure and reconciliation requirements. Many technology (and other) companies that used pro-forma (non-GAAP) accounting to make revenue and earnings targets in their press releases have to reconcile such numbers to GAAP financial statement numbers in an 8-K report to the SEC.
- **Buffett & NYSE:** Concerning this Integrated guideline for executive compensation, Buffett stated: "in judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging." He noted that when CEOs meet with boards' compensation committees, too often one side (the CEO) has cared much more than the other side about the pay package. The difference often has seemed unimportant to the compensation committee, particularly when stock option grants had no effect on earnings under prior U.S. accounting rules. He observed that such negotiations often had a "play-money" quality and said that directors should not serve on compensation committees unless they are capable of negotiating on behalf of the shareholders. Buffett noted that "CEOs have often amassed riches while their shareholders have experienced financial disasters. Directors should stop such piracy. It would be a travesty if the bloated pay of recent years became a baseline for future compensation." The NYSE requires that all listed companies have a compensation committee comprised solely of independent directors. This committee must have a written charter which includes objectives for CEO compensation and performance evaluation. Also, Buffett has argued that a red flag should exist if a company always does meet its quarterly and annual goals, like Enron did, since such performance ignores the reality of competitive environments and business cycles.

4. CEO is Uncomfortable with Criticism

When questioned by outsiders, like financial analysts during conference calls, the CEO is defensive and abusive to these outsiders. The CEO, senior managers, like the CFO, and even board members may wind up lying to outsiders.

- **Strategic Guideline: Constructive and Open Minded Team Culture**

To overcome the traditional, mechanistic, confrontational, and secretive board environments, an effective board culture must be created with five factors: an outward, learning orientation, an holistic perspective, a consensus orientation, a constructively open, trusting environment, and a mix of global effectiveness and local adaptability.

- **Buffett:** Concerning this Strategic guideline for an effective board culture, Buffett observed that when the CEO cares deeply and the directors don't, a necessary and powerful countervailing force in corporate governance is missing. He said: "getting rid of mediocre CEOs and eliminating overreaching by the able ones requires action by owners—big owners. Twenty, or even fewer, of the largest institutions, acting together, could effectively reform corporate governance at a given company, simply by withholding their votes for directors who were tolerating odious behavior." No applicable SOX sections existed for this factor.

5. Senior Management Turnover

The CEO, senior managers, especially the CFO, and even board members quit their "dream jobs" to "spend more time with their families."

- **Integrated Guideline: Targeted Executive Selection**

Potential senior managers and board members need to have the following four competences: 1) personality (integrity, independence and breadth of perspective), 2) professional (risk management experience, management and/or board track record, and international experience if necessary),

3) leadership (strategic thinking, planning skills, and controlling skills),

4) social (constructive openness, listening skills, and team role of coach).

- **Buffett & NYSE:** Concerning this Integrated guideline for board competence, Buffett commented: "in addition to being independent, directors should have business savvy, a shareholder orientation, and a genuine interest in the company. In my 40 years of board experience, the great majority of these directors lacked at least one of these three qualities. As a result, their contribution to shareholder well-being was minimal at best and too often negative. They simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation." The NYSE requires that each listed company have a nominating/corporate governance committee comprised solely of independent directors. This committee must have a written charter which includes the criteria and responsibilities to identify individuals qualified to become board members. SOX is not applicable.

6. Insider Stock Sales

Senior managers, especially the CEO and the CFO, are selling their own company's common stock at current prices, rather than holding these shares for the long term. At the same time, they are saying that their company's stock is undervalued and has a great future.

• **Integrated Guideline: Targeted Remuneration**

An effective company performance system includes four dimensions: 1) customer, 2) shareholder, 3) people, and 4) public company image. Then, targeted remuneration can proceed on the three dimensions previously discussed: 1) long-term financial performance, 2) comparative value indices, and 3) functional performance assessments, not just the granting of huge stock options to senior executives!

- **SOX Section 403:** It mandated that the SEC address executive trades of company stock. The SEC has now required that such trades be reported electronically to it within two days as well as being posted on the company's website. The old requirement was 45 days.
- **SOX Section 304:** It required forfeiture of bonuses and profits from equity sales by CEOs and CFOs when firms restate financial statements from material non-compliance with financial reporting requirements as a result of misconduct.
- **SOX Section 306:** Officers and directors are prohibited from purchasing or selling company stock during blackout periods when employees are prohibited from selling their company stock in 401 (k) retirement plans while plan administrators are being changed.
- **Balanced Scorecard & NYSE:** Concerning this Integrated guideline for effective performance systems, Epstein and Roy (2002) have advocated that Kaplan and Norton's (2000) balanced scorecard approach be used to evaluate, not only the company, but also the board's, performance since boards are rarely evaluated. One of the four strategic perspectives of the balanced scorecard would be slightly modified. The customer perspective for the company would be expanded to a stakeholder perspective for the board. The other three balanced scorecard categories would remain the same: financial, internal processes, and learning/growth. The NYSE requires annual performance evaluations of the board and its committees.

7. Weak or Non-Existent Code of Ethics

Company employees are encouraged to push their behavior and financial reporting to ethical and professional limits. The company's code of ethics (if one exists) is not taken seriously.

• **Keep It Controlled Guideline: Board's Auditing Function**

There are three main audit tasks of the board: 1) financial reporting—observation and realization of the financial targets, 2) operations—observation and assessment of operational targets, and 3) compliance—surveillance of compliance with laws, regulations, and guidelines, such as a code of ethics.

- **SOX Section 406:** Firms are required to disclose whether they have adopted a code of ethics for their CEO, CFO, and senior accounting personnel. Also, they have to file a report (8-K) with the SEC whenever there is a change or waiver in the code.
- **SOX Section 407:** Firms' Audit Committees are required to establish procedures, like whistleblower hotlines, to receive and act on anonymous complaints concerning accounting, internal controls, and auditing. Also, retaliation against whistleblowers is now a criminal act.
- **NYSE:** The NYSE requires that its listed companies have a code of ethics and promptly disclose any waivers of the code. Also, CEOs must certify annually that they are not aware of any company violations of NYSE corporate governance listing standards. CEOs must promptly notify the NYSE in writing if they become aware of any material non-compliance from these standards.

8. Independence Problems with the Company's External Auditors

The company often pays the audit firm additional consulting fees that may exceed the audit fees. Using the same audit partner as the lead or engagement partner is often a condition for retaining the audit firm.

• **Keep It Controlled Guideline: Board's Auditing Function**

The external auditor is the only external institution that can give an objective view of the financial condition of a company and effective cooperation is needed with board and its audit committee. In order to ensure the independence of the external auditors, both the auditors and the auditing firm should be changed periodically.

- **SOX Section 508:** Lead audit partners, but not firms, must rotate off an audit engagement every five years. Also, a company is prohibited from hiring anyone who has worked for its audit firm during the one-year period preceding an audit. The prohibited jobs are CEO, CFO, controller, chief accounting officer, and equivalent positions. Also, audit firms are prohibited from designing and implementing financial information systems, providing internal audit services, and providing valuation and appraisal services to audit clients. Basically, only the major services of audit and income tax preparation may be performed by a firm's auditors.
- **SOX Section 802:** Public accounting firms now have to retain documents prepared to support their audit reports for at least seven years.

9. Independence Problems with the Company's Investment Bankers

Favorable "buy" recommendations from an investment banker's financial analysts may be a requirement for a company to do any new business with an investment banking firm. Investment bankers' research may not represent an independent analysis of the company's investment potential.

• **Situational Guideline: Internal Business Context**

The majority of board members should be totally independent directors who have no vested interests. The board should not comprise 1) more than two member of senior management (ideally only the CEO should represent management and should have none of the following vested interests), 2) persons who have an active business relationship with the firm (such as suppliers, customers, vendors, consultants and auditors), and 3) representatives of the main source of debt and/or equity financing.

- **SOX Section 501:** It enabled the SEC to create rules governing research analyst conflicts of interest but the SEC has not yet acted on this section.
- **New York Attorney General:** In December 2002, the twelve largest U.S. investment banking firms agreed to pay \$1 billion in fines to end SEC and other investigations into whether they issued misleading stock recommendations and handed out hot new shares to obtain favor with corporate clients. These firms also have to pay an additional \$500 million over five years to buy stock research from independent analysts and distribute it to investors. New York Attorney General Eliot Spitzer, the lead negotiator of the settlement, said: "Hopefully, these rules will restore investor confidence by restoring integrity to the marketplace."

10. Questionable Business Strategies with Opaque Disclosures

An opaque disclosure strategy may exist for the company's business model and related financial reporting. The well-known investor, Warren Buffet (2004) has given the following advice: "If you don't understand what a company does, don't invest in it. If management refuses to fill in holes and keeps investors in the dark, run!"

- **Keep It Controlled Guideline: Communication Function**

The following two functions are most relevant: 1) the content function: to promote transparency of information at board level through the exchange of information that is comprehensive, true, understandable, and relevant to board members, top managers, employees, shareholders, customers, and the public and that relates to financial, market, and other performance measures, and 2) the relationship function: to create a real culture of trust and learning through a constant improvement of the relationships between board members, top managers, shareholders, and other stakeholders, to deal with conflict constructively and to avoid unnecessary confrontations.

- **Section 401(a):** It enabled the SEC to adopt rules requiring disclosure of all material off-balance sheet transactions and debt.
- **Section 409:** Firms have to report material changes in their financial condition on a "rapid and current basis. This section encouraged real time reporting, as opposed to the current 35 day and 90 day delays in quarterly and annual reporting to the SEC. It also encouraged continuous assurance and auditing which is already enabled by enterprise reporting systems (ERP), provided by software vendors like SAP, Baan, and Oracle.
- **Buffett & NYSE:** As the Enron short seller Chanos said, "We read the Enron SPE disclosure over and over and over again and we just didn't understand it—and we read footnotes for a living." Warren Buffet made a similar comment in his 2003 CEO letter to shareholders. The NYSE can issue a public reprimand letter for violation of any of its corporate governance standards in addition to the existing penalty of delisting. It can also list a flag next to the stock ticker of a company whose corporate governance policies are deficient.