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The Decline and the Fall in the Wealth of Nations

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October, 2009 - The Decline and Fall in the Wealth of Nations explains why ineffective governance and conflicts of interest on corporate boards were instrumental in creating the financial crises that came to a head exactly one year ago. Burdensome government regulations that will inevitably have a "rear view mirror" approach will fail, just as Sarbanes Oxley regulations are failing us now, because they don't deal with the core issues of board governance and compensation.

Our comments and conclusions are based in part on our firm's engagement for over thirteen years to work with bankruptcy administrators in Europe and the U.S. regarding one of the largest frauds in UK history. The investigation and recovery of funds embezzled from company pension plans by Robert Maxwell in the early 1990s finally concluded in 2006. During this time, we encountered the same corporate model where each company in the Maxwell group had: (1) insulated boards, (2) poor board governance, and (3) outside professionals and advisors with conflicts of interest. These three problems facilitated the massive fraud. Following our audit and forensic engagement, we published several articles and gave a series of lectures to bank trust departments in Europe and the U.S. about the tell-tale signs of corporate fraud and how fiduciaries could better insulate themselves from losses due to corporate malfeasance.

In this article, published by *Offshore Investment*, we explain (again) why poor board governance and conflicts of interest are at the heart of today's financial crises. Financial failures will continue at an alarming rate, whether corporate management is skilled and well intentioned or not as long as corporate governance is weak. New legislation that amends Sarbanes Oxley, and that focuses on curing these problems needs to be enacted. Otherwise, company mission statements extolling trust and integrity, and government regulation notwithstanding, we will see and experience more of the same.

The Decline and the Fall in the Wealth of Nations PDF

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The Decline and Fall in the Wealth of Nations

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Attila the Hun slaughtered many with his sword
While he ravaged whole regions at the front of his hoards.
But if you wish to see how whole nations can be gored,
Then look to the companies, it's the boards, it's the boards, it's the boards.

Why are American CEOs so corrupt with their "get rich quick" schemes that ruin good companies?

This question was put to me in Asia last month by the CEO of a well known company with business holdings throughout the Asia Pacific region. This is how American management is currently viewed overseas. Since the signs of today's financial crises were clearly visible in early 2006, why did so many major corporations continue to forge ahead using assumptions and financial models that were highly questionable? Answers vary, but the two themes that are often mentioned are: (1) CEOs and corporate boards were under pressure to generate higher profits; and (2) stock option incentives and bonuses were rewarding management for short-term gains on an unprecedented scale. A closer look at the issue however, reveals a more fundamental root cause. There was nobody on the boards of the failed institutions with both the expertise and the independence to articulate that the "emperor has no clothes" and that it was time to change strategy in order to preserve the company's survival. The boards of large financial institutions chose to shrug off a basic financial law of nature that may hibernate, but will never become extinct. *Higher returns come with higher risks.*

In 2002, Congress passed the Sarbanes Oxley Act (SOX) to ensure that board governance and internal controls were in place to prevent Enron and WorldCom types of disasters. It was clear to many at the time, that SOX rules would not accomplish their objectives. If Congress had given more thought to how corporate boards really function, they would have focused less on imposing costly internal control procedures and more on eliminating conflicts of interest on the board. If the conflicts and problems noted below are not addressed soon, we should be less than optimistic about the time it will take for investors to regain their trust and confidence in how large financial institutions are managed.

Problems with Board Competence and Integrity

1. Management is often challenged to know how the global market will impact the company's well-being when the enterprise's operations straddle several industries, countries and disciplines. The larger and more diverse the company, the bigger the problem. Management turnovers exacerbate the problem and increase the opportunity to steer off course.
2. Non-executive, (outside) board members are typically distanced from the day to day operations of the company. They are almost wholly dependent upon management's input to know how the company is performing. If management overlooks or lacks an understanding of industry risks, there's little chance for other members of the board to be well informed.
3. Board members have significant conflicts of interest due to generous stock options plans that are often geared to rewarding directors for short-term gains in the company's share price. The board is usually a collegial group of seasoned executives where close personal relationships are formed. Outside directors often have misplaced loyalty to management for getting appointed to the board in the first place, so are not in a good position to effectively challenge management's decisions. SOX rules provided very little substantive changes to remedy this problem as a practical matter.

The remaining comments in this article focus on this last point and how to fix it because it is one of the key problems that led to today's financial crises.

Awarding options to board members is generally thought to align their interests with the company and the shareholders. This is usually assumed to be stock appreciation. However, this leads the board to "group think" that anything that creates a higher stock value, or protects the stock value from dropping, is good. This attitude sacrifices long term stability for short term gains. When the stock is on a steady track upwards or even downwards, boards often close ranks and will rubber-stamp managements' game plan. Board members vote and support management in all but extreme cases. A case in point is how AIG's board acted in May 2008:

At AIG's annual meeting, Chairman Robert Willumstad said the giant global insurer's directors stood behind management, including Chief Executive, Martin Sullivan, fending off concerns raised by investors frustrated by two quarters of record losses. Maurice "Hank" Greenberg, the former head of American International Group Inc, said in an interview that he voted against the re-election of the company's board because directors had not met expectations. Asked in the interview if Sullivan should be replaced, Greenberg said the results spoke for themselves. Reuters 26 May 2008.

The SOX rules go into great length about the required qualifications of Audit Committee members. The Audit Committee ultimately has the task of ensuring the integrity of the financial reporting process. However, the SOX rules appear to be off course when the rules set out the requirements for members of the Audit Committee to be independent.

> *In order to be considered to be independent... "a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee accept any consulting, advisory or other compensatory fee from the issuer..." Act Section 301.*

Under the SOX definition, members of the audit committee may own equity or hold options in the company, without restriction. Having served on many boards and having chaired audit committees of public companies, I have no doubt that owning equity or options in the company can create significant conflicts that impair

one's objectivity. If this were not the case, then consider whether options in the hands of the accounting firm performing the audit is a reason for concern. The SOX definition of independence is at odds with reality. For the record, the chairmen and members of the Audit Committees for Enron, WorldCom and most major companies with financial irregularities in the past decade all had substantial option packages.

Would GM be better off today had Ross Perrot remained on the board? Would AIG be better off if Hank Greenberg was still on the board? Absolutely! They knew about how to evaluate risks and were interested in both the short and the long term health of the company. On the other hand, Ken Lay at Enron was a savvy owner but as the company struggled with debt, he gambled the company's future on risky strategies and fraudulent accounting. So merely having a CEO with an owner's attitude at the helm is no guarantee. There is no perfect solution. However, it is clear that boards need a caretaker with independence when stock gains overshadow looming risks. Boards don't like the Ross Perrots and Carl Ichans who are demanding of boards. They are often forced out by other board members. Legislation is needed to ensure that someone is on the board who is competent and will make life uncomfortable when the company is heading towards the abyss.

Solution: Revising Corporate Governance of Audit Committees

When options constitute the bulk of the board's compensation, it is unlikely that highly qualified non-executive board members will invest substantial time and effort enquiring into problems impacting the company, because options are somewhat of a free ride. They are a free ride to the company because there is no cash outlay. They are a free ride to the board members, since the company is doing the real work of increasing share value. Conversely, a hard dollar contract would change the whole psychology and create a working board, or a least a working audit committee, with substance. Members of an audit committee, if compensated for their time, and if limited in their tenure to 48 months, would be accountable to the board for producing meaningful analysis about the company's financial risks and problems. They should have authority to talk to middle management to get input other than that of the senior executives.

If audit committee members were remunerated in cash, boards would be highly selective regarding who they choose and what tasks they would assign. Audit committee members would no longer show up at board meetings with nothing more than the board package that was received only a few days earlier. The governance of the audit committees must be overhauled to achieve objectivity and substance. Another name for the committee would be a good start.

Change will not come easy. It is unlikely that we will see leadership from the accounting profession. The Financial Accounting Standards Board (FASB) moves slowly, and at times, appears to be more concerned with avoiding government oversight than with fixing systemic problems. After SOX passed, the accounting industry generated huge fees due to new compliance rules, but in the end, failed to ensure that critical defects in financial reporting came to light. Better regulatory oversight will help, but resources, talent and expertise are always limited at the regulatory level. As the Madoff scandal recently proved, once again, government watchdogs can be asleep at the switch.

Companies will likely lobby to avoid truly independent board members from serving on their boards. We will hear about Adam Smith and the *Invisible Hand.* In the past, they have argued that capitalism and creative risk taking will be strangled if management know-how is continually challenged by an independent naysayer on the board. For the record, when Adam Smith published his seminal work in 1776, "An Inquiry into the Nature and Causes of the Wealth of Nations", he had for many years been living in his native town of Kircaldy, a mere village in Scotland. When he wrote about the butcher and the baker working for their self interests, and that the impact of others doing the same would be in the public's interest, he didn't contemplate the local baker, motivated to make a quick profit, packaging up a million cakes that would give his neighbours heartburn because he used cheap but toxic ingredients.

Entrepreneurial risk is the core ingredient of capitalism, but when management either chooses to ignore risks or lacks an understanding of risks that could imperil the company's future, they are no longer being entrepreneurial, they are gambling. Today's system of remuneration is flawed where management, atop generous option plans, is rewarded with vast amounts of wealth when the corporate strategy is successful, in the short run, but can often walk away with their wealth in tact, even when they put the enterprise totally at risk and get it wrong.

Investors should still put their trust in capitalism and the free market. However, it is time, out of their own self interest, that they pressure corporations to change how boards are rewarded. Redefining independence for audit committees, and expanding their expertise to include professionals in the risk management areas is a necessary change. Boards have been far too cosy in the past. Andrew Grove of Intel made it clear in his book, "Only the Paranoid Survive," that someone needs to turn up the heat so bad decisions aren't institutionalised and so that management is held accountable. Investors will likely be far more comfortable seeing companies paying six or even seven figure consulting fees to qualified outside board members to serve on the audit committee to oversee financial risks compared to audit committee members remunerated principally with options.

If audit committee members of major financial institutions continue to be compensated with options, thus ensuring their limited involvement and objectivity, and if the members of the committee are not highly qualified professionals with relevant industry know-how in the risk management arena, then shareholders have cause for concern. Congress needs to remedy this problem quickly. There should be no doubt that eliminating options plans for members of the audit committee is a matter of common sense.

Summary

Audit committees of major financial institutions must play the role of gate keeper. To do this effectively, members of the committee must:

(a) serve for limited terms, and be selected and compensated in a manner that ensures independence;

(b) possess expertise in risk areas impacting the company's financial stability so they can advise the board from a position of knowledge and authority; and

(c) produce periodic reports to the board that identify substantial risks to the company. To do this, they must have access to middle management and break their dependence on the executive team as the only source of how the company is performing.

If these changes are made, boards would be compelled to take note of reports produced by the audit committee.

Returning to the question at the beginning of this article, the problem today is not about being an American CEO. We are all the same at the core. However, the US system in particular permitted abuses to occur due to poor regulatory oversight. The system of remuneration currently in place has fostered risk taking that resulted in huge excesses with disastrous consequences. Corporate directors at the major financial institutions were not, and still are not, subject to real accountability. While Congress now ponders vast new regulatory proposals from the Administration, they might do well to focus their attention on the real source of the problem.

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