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Clueless Corporate Boards are Invisible Culprits in Company Failures

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CEOs Sweet-talk their Boards; Federal Sarbanes-Oxley rules too weak to help, and Accounting Industry too timid to intervene.

In the swirl of failures that have swamped giants like AIG, Lehman Brothers, and General Motors, corporate boards of directors are too often overlooked as the major culprit in such financial debacles. Board governance is the problem. Today, boards of major financial institutions are putting companies at risk because they are lacking in competence in risk analysis. In addition, conflicts of interest keep most - if not all - boards from being the objective advisors they are supposed to be.

Today, Congressional negotiators hammered out final changes to HR 4173, the Wall Street Reform and Consumer Protection Act, passed the U.S. Senate on May 20. This 2,000-page bill, is being hailed as the way to rein in Wall Street excesses and protect the consumer. However, this bill does absolutely nothing to deal with the problem of board governance and audit committees too beholden to corporate executives. Once again, Congress goes for getting more regulation on the books instead of getting it right. What we're seeing today is Enron déjà vu that got us the Sarbanes-Oxley Act which did nothing to prevent the financial crises we're currently facing throughout the country. Congress will continue to muddle along, more interested in being perceived as taking action rather than doing something to get to the heart of the problem.

The issue of board governance is again, becoming a hot topic. It is discussed in the attached April issue of [Reuter's Venture Capital Journal](#), authored by [Brian Rowbotham](#).

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GUEST ARTICLE SOX NEEDS TO BE REVISED TO STRENGTHEN CORPORATE BOARDS



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"Having served on venture-backed boards and also 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."

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

This question was recently put to me 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. Why did so many major corporations continue to forge ahead using assumptions and financial models that were highly questionable? Why would so many boards seemingly ignore that higher returns come with higher risks.

Two themes that are often mentioned are: (1) CEOs and their 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.

However, a closer look reveals that most of the boards of the failed institutions didn't have the expertise or the independence to challenge the CEOs with the notion that it was time to change strategy to preserve the company's survival. The source of the problem can be traced in part to defective rules contained in the Sarbanes-Oxley (SOX) Act.

In 2002, the U.S. Congress passed SOX to insure that board governance and internal controls were in place to prevent corporate disasters, such as **Enron** and **WorldCom**, from happening again. 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 about eliminating conflicts of interest on the board noted below.

The SOX rules perpetuate two problems with today's corporate boards:

- Non-executive board members' lack of expertise.
- Lack of independence of the audit committee.

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. Non-executive board members are typically distanced from the day-to-day operations of the company and are almost wholly dependent upon management's input to know how the company is performing.

If management overlooks major risk factors, there is little chance for other members of the board to be well informed.

Boards are often formed through past associations and business relationships that often make the board overly supportive of management even in the face of mounting problems.

Would **General Motors** be better off today had **Ross Perot** remained on the board? Would **AIG** be better off if **Hank Greenberg** was still on the board? Absolutely! They knew how to evaluate risks and were interested in both the short-and long-term health of the companies.

Boards don't like the Ross Perots and Carl Ichans, since they are demanding of management. Boards have been far too cozy 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 that bad decisions aren't institutionalized. Even, with venture-backed companies, when the CEO or CFO influences the choice of who will, serve on the audit committee, the board loses a major source of checks and balances.

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

- Serve for limited terms.
- Be selected in a manner that insures independence from executive members of the board.
- Posses expertise in risk areas impacting the company's financial stability.
- And produce periodic reports to the board that identify substantial risks to the company.

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To do this, they must have access to middle management and break their dependence from relying on the executive team as the only source as to how the company is performing.

Lack of independence

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.

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 upward or even downward, boards often close ranks and will rubber-stamp management's game plan.

A case in point is how AIG's board acted in May 2008. In the face of mounting losses, the board chose to stand behind management, fending off concerns raised by investors frustrated by two quarters of record losses.

The SOX rules for independence of audit committee members are at odds with reality. To be considered 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..." according to 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 venture-backed boards and also 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

"The SOX rules perpetuate two problems with today's corporate boards: non-executive board members' lack of expertise and lack of independence of the audit committee."

consider whether options in the hands of the accounting firm performing the audit is a reason for concern.

Furthermore, when options constitute the bulk of the board's compensation, it's unlikely that highly qualified non-executive board members will invest substantial time and effort inquiring into problems impacting the company because options are somewhat of a free ride. They're a free ride to the company because there's no cash outlay. They're 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 at least a working audit committee, with substance. Members of an audit committee, if well compensated for their time, and if limited in their tenure, would be accountable to the board for producing meaningful analyses about the company's financial risks and problems.

If audit committee members were remunerated in cash, boards would be highly selective regarding who they choose and what tasks would be assigned. 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.

While generous compensation packages for venture-backed companies that are not yet public may be difficult to implement, it should

be recognized even by private companies that the audit committee should spend substantive time and that compensation reflecting time, qualifications and written reports merit higher levels of pay than other non-executive board members.

With respect to major financial institutions, Congress needs to revise the SOX rules for independence. Options for the pre-IPO, venture-backed companies are less of a concern, but even in these situations, limiting the compensation of audit committee members to mostly options is an invitation to getting less than dependable results.

Corporate lobbies will pressure against new laws that require truly independent board members from serving on their boards. We'll hear about **Adam Smith** and the "invisible hand" of capitalism being compromised. Entrepreneurial risk is the core ingredient of capitalism, but when a company's managers either choose to ignore risks or lack an understanding of risks that could imperil the company's future, they are no longer being entrepreneurial—they are gambling.

Returning to the question at the beginning of this article, the problem today is not about being an American CEO. We're all the same at the core.

However, the U.S. system in particular permitted abuses to occur due to poor regulatory oversight and remuneration packages that are not in sync with the company's long-term financial success.

While some of the disasters came from risk taking, many boards, as well as management teams had no idea that their companies were on the edge of the cliff. Congress is now considering vast new regulatory proposals from the Obama Administration. Before passing legislation that may cripple much of the financial industry, it might do better to focus on revising SOX governance rules where the real source of the problem exists.

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