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Case study on corporate governance disclosures in the United States of America

Executive summary

The nineteenth session of the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR), which took place in Geneva from 25 to 27 September 2002, requested that field case studies be conducted in the area of transparency and disclosure requirements in corporate governance. Accordingly, five country case studies were conducted focusing on major issues in implementing corporate governance disclosure requirements. The case studies were conducted on Brazil, France, Kenya, the Russian Federation and the United States of America.

This report presents findings of a case study on the implementation of corporate governance disclosure requirements in the United States of America. It provides an overview of the US capital markets. This is followed by a discussion of public and private sector initiatives to promote transparency and disclosure on corporate governance. The report discusses key provisions of the Sarbanes-Oxley Act and rules and regulations issued by the United States Securities and Exchange Commission (SEC). Private sector initiatives covered in the study include those of the Financial Accounting Standards Board (FASB), US stock exchanges, investors and investor groupings, rating agencies and proxy voting service companies, and companies and industry groupings. The study used the transparency and disclosure requirements discussed at the nineteenth session of ISAR (TD/B/COM.2/ISAR/15) as reference points.

The main objectives of the study are to draw lessons from the experiences of the United States in promoting improved transparency and disclosure in the corporate sector and to share the findings with member States that wish to strengthen transparency and disclosure in their respective markets.

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INTRODUCTION

1. The United States has the largest and, arguably, the most developed securities market in the world. The US market includes over 17,000[1] publicly traded companies, with a total market capitalization in the region of approximately US$ 12 trillion.[2] Its long history of regulation began in the Great Depression and resulted in the securities and banking acts of the 1930s that have provided the legal framework for the markets ever since.

2. Corporate governance was catapulted into the public spotlight late in 2001 because of the failure of Enron. Enron, by now a household name, was the largest bankruptcy in US history. It resulted in the loss of over 21,000 jobs, the disappearance of over US$1.2 billion in employee savings, and was an important factor in the closing of one of the world's most prestigious audit firms. Enron's failure was accompanied by failures among every conceivable corporate watchdog ranging from auditors to investment banks, ratings agencies, analysts and regulatory organizations.

3. Although the causes of Enron's downfall are many, much of its demise was blamed upon its accounting and reporting practices. Industry officials and academics surmise that a number of factors may have caused US companies to use questionable accounting and disclosure practices, including a) pressure to meet quarterly earnings projections and maintain stock prices after the expansion of the 1990s; b) executive compensation practices; c) outdated and rules-based accounting standards; d) complex corporate financial arrangements designed to minimize taxes and hide the true state of the enterprise; and e) the compromised independence of public accounting firms.[3]

4. The result has been a tremendous push to improve governance and disclosure practices through legislation, regulation, stock exchange rules and private sector efforts. The outcome is the Sarbanes-Oxley Act of 2002 (SOA), new US Securities and Exchange Commission (SEC) regulations implementing the Sarbanes-Oxley Act and new rules for the major US exchanges.

5. This case study focuses on post-Enron era reforms, and describes efforts to address what went wrong.

I. PUBLIC SECTOR INITIATIVES

6. Full and fair disclosure of information by issuers of securities is a cornerstone of federal securities laws. In enacting mandatory disclosure under the Securities Exchange Act of 1934 (the "Exchange Act"), the US Congress sought to promote disclosure of complete and correct information to facilitate the operation of fair and efficient markets. Since then, a considerable body of law has been developed to enhance the quality of US financial markets.

A. Congressional legislation

7. The most recent of these laws, the Sarbanes-Oxley Act of 2002, signed into law on 30 July 2002, created the most radical redesign of federal securities laws since the Exchange Act in the 1930s. The Sarbanes-Oxley Act contains the blueprint for regulations that would have been inconceivable before Enron. It is worth noting that while the US securities market regulation has traditionally been disclosure-based, the SOA has broken with tradition by introducing more substantive requirements for corporate governance. Progress on the adoption of rules has been rapid by any standard; the act mandates implementation periods ranging from the immediate to no longer than one year.

The key provisions of the Sarbanes-Oxley Act are:[4]

8. *Title I, Public Company Accounting Oversight Board*: Title I establishes the Public Company Accounting Oversight Board (PCAOB), an independent non-governmental body, to regulate accounting firms and to restore the confidence of the investing public in independent audit reports. The SEC retains oversight and enforcement authority over the PCAOB. Foreign public accounting firms are subject to the requirements of the SOA when providing reports on issuers in the United States. The PCAOB is to be operational by 26 April 2003, whereupon public accounting firms have 180 days to register with the Board.

9. *Title II, Auditor Independence*: This Title addresses auditor independence, the scope of services that can be provided to audit clients and audit partner rotation. Certain non-audit services, such as bookkeeping, internal audit, human resources related services, and legal and actuarial services, are specifically prohibited. The same accounting firm is prohibited from providing both audit and non-audit services to a company, subject to exceptions that must be approved by a company's audit committee. Companies must rotate their accounting firms' lead audit partner and the firms' reviewing partner every five years. The auditor reports directly to the board's audit committee, which is responsible for choosing, compensating and overseeing the audit firm. In addition, a study of the concept of mandatory rotation of audit firms is to be completed by 30 July 2003.

10. *Title III, Corporate Responsibility*: This Title requires corporate audit committee and CEO and CFO certifications of quarterly and annual statements, and establishes rules of conduct for attorneys. It establishes tougher penalties for various aspects of corporate fraud, including knowingly shredding records with the intent of obstructing investigations. Penalties and forfeiture of bonuses apply to CEOs and CFOs if the issuer is required to restate owing to non-compliance with financial reporting requirements.

11. *Title IV, Enhanced Financial Disclosure*: The Title seeks to tighten disclosure of off-balance-sheet items and enhance disclosure of conflicts of interest. It requires disclosure of management's assessment of internal controls, and disclosure of a code of ethics for senior financial officers. Public disclosure of material events must be made more quickly and clearly. It requires real-time disclosure of material financial and operational information that could include trend and qualitative information. It also requires disclosure to be in "plain English", that is, fully comprehensible to the reader.

12. *Title V, Analyst Conflicts of Interest*: This Title requires that brokers, dealers and analysts, and others involved in providing recommendations certify in their reports that their recommendations correspond to their own personal views and that they did not receive compensation or recognition that might have influenced their views.

13. *Title VI, Commission Resources and Authority*: Among other things, this Title authorizes additional appropriations for the SEC.

14. *Title VII, Studies and Reports*: Title VII directs federal institutions to conduct studies on (a) the impact of the consolidation of large accounting firms and possible anti-competitive behaviour; (b) impediments to the accurate appraisal of credit rating agencies, and possible conflicts of interest and barriers to entry into the credit rating industry; (c) a study of violators and violations of securities law by securities professionals (defined as accountants, accounting firms, brokers, dealers, attorneys, investment advisers, investment bankers and others); (d) a review of SEC enforcement actions relating to disclosure requirements; and (e) a study of investment banks to see whether they manipulated earnings and concealed the true financial condition in the cases of Enron and Global Crossing.[5]

15. *Title VIII, Corporate and Criminal Fraud Accountability*: Title VIII, or the "Corporate and Criminal Fraud Accountability Act of 2002", provides for tough new fines and imprisonment for altering financial records. The Title also provides, among other things, for the maintenance of audit records for a minimum of five years, protection for employees who signal fraud to authorities ("whistle-blowers") and an extension of existing statutes of limitations for securities fraud.

16. *Title IX, White Collar Crime Penalty*: Title IX, or the "White-collar Crime Penalty Enhancement Act of 2002", increases various penalties for white-collar crime. Penalties for CEOs and CFOs who falsely certify quarterly or annual statements range up to $5 million and 20 years, imprisonment.

17. *Title X, Corporate Tax Returns*: This Title conveys the "sense" (or position of the Senate) with respect to CEO certification of a company's tax returns. A "sense" is not a law. In order for it to have the effect of law, further legislation needs to be passed. The Senate, at present, favours such certification.

18. *Title XI, Corporate Fraud and Accountability*: Title XI, also referred to as the "Corporate Fraud Accountability Act of 2002", provides for further penalties for tampering with records or otherwise impeding an official proceeding. It also provides for penalties for retaliation against informants or "whistle-blowers".

19. The breadth of the SOA is worth noting. Its reach reflects the perception that problems found at Enron were not isolated, but rather of systemic origin. What is striking about the US failures is that all of the elements of the system designed to check corporate abuses failed, simultaneously, to one degree or another: investment intermediaries? caught in conflicts of interest between investment banking clients and investors? provided faulty advice; law firms and audit firms held their clients' interests before the law; boards were unable to stand up to management; the business press and analyst community did not dig deeply enough; accounting standards were no match for the determined wrong doer and their financial advisers; and regulators were unable to detect the extent of manipulation. As a consequence, Congress appears to have attacked the problem on all fronts.

20. One can already discern the focus of future legislative and regulatory attention by looking at the reports and studies that were commissioned by the Sarbanes-Oxley Act. Of the eight studies called for in the act, a number cover governance and disclosure related topics of interest to ISAR. These include: (a) the effects of consolidation in the accounting industry; (b) mandatory rotation of auditors; (c) the effects of rules-based accounting; and (d) the effects of off-balance sheet transactions. Other studies will explore conflicts of interest among credit rating agencies and investment banks, and violations of securities law.

21. Four studies were completed at the time of writing of this report.[6] Some of the major conclusions are:

- Accounting failures have increased significantly in recent years.
- Revenue recognition is the principal accounting problem, followed by questions of expense recognition, accounting for reserves, accruals and contingencies, improper equity accounting, and others.
- Restatements cause significant decreases in stock prices in individual companies and seem to have a ripple effect on investor confidence and market trends.
- Large numbers of restatements seem to shake faith in the financial system and the integrity of markets, and cast doubt upon the system of governance and disclosure.
- Many areas of financial reporting are susceptible to fraud and manipulation.

- Auditor violations arise most often from accepting management representations without verification, improper analytical and substantive procedures, and failure to gain sufficient evidence.
- Recommendations should be made to improve uniform reporting of restatements and improved Management's Discussion and Analysis disclosure among others.

22. While US disclosure rules have long been a model for much of the world, considerable work could be done to make them stronger still. Focus areas will likely be specific accounting standards in the areas of revenue recognition, off-balance sheet transactions, stock option accounting and Special Purpose Entities (SPEs), as well as more general problems arising from a system of rules-based accounting. Further attention will almost certainly be devoted to the question of the independence of auditors.

B. United States Securities and Exchange Commission (SEC) Rules and Regulations

23. The laws and rules that govern the securities industry in the United States derive from the concept that investors should have access to clear and relevant information about an investment before buying. One of the primary functions of the US SEC is therefore to require public companies to disclose financial and non-financial information for investors and to ensure equal access to this information.[7]

24. Crucial to the SEC's effectiveness is its enforcement ability. While small compared with other federal agencies (the SEC has approximately 3,000 employees), it has far more manpower than what is available to market oversight bodies in other countries. With its current resources, the SEC brings between 400 and 500 civil enforcement actions against individuals and companies that break the securities laws each year. The current size and resources of the SEC are, nevertheless, considered inadequate to meet the new demands of oversight and fraud-related enforcement in the wake of Enron.[8]

25. The SEC has not been spared from criticism. It has been suggested that Enron and other cases of corporate misconduct are cause for the SEC to re-examine the way it operates, particularly, its reliance on private sector gatekeepers to ensure the flow of honest and accurate information. Given the failure of some of these gatekeepers to catch numerous cases of misreporting, the SEC may need to find ways to more proactively detect and root out financial fraud.[9]

1. SEC final rules implementing the Sarbanes-Oxley Act

26. Much of the SEC’s efforts in the second half of 2002 and early 2003 was devoted to the development of final rules implementing the Sarbanes-Oxley Act. Some 18 rules were approved in less than one year; these adhere closely to the act and build upon it with further details. A summary of the main disclosure related elements follows.[10]

27. *CEO/CFO certification of financial reports*: The Final Rule issued on 29 August 2002 in response to Section 302 of the SOA, "Corporate Responsibility for Financial Reports", requires that the CEO and CFO certify that: (a) they have reviewed annual and quarterly reports; (b) they contain no misrepresentations; (c) the financial information is fairly represented; (d) they are responsible for disclosure controls and procedures; (e) they have reported any deficiencies in control and fraud to the audit committee; and (f) they have indicated any material changes in internal controls. With respect to Section 403 of the SOA, "Disclosure of Transactions Involving Management and Principal Shareholders", the rule requires accelerated reporting of insider stock transactions; transactions between officers or directors and the issuer must be reported within two business days.

28. *Accelerated filings*: A Final Rule issued on 5 September 2002 further accelerates filings.

29. *Pro-forma statements*: The Final Rule issued on 22 January 2003, responds to Section 401(b) of the SOA on the use of non-General Accepted Accounting Principles pro-forma financial information. The SEC now requires public disclosure of pro-forma information in its closest GAAP form and reconciliation to GAAP.

30. *Codes of ethics*: This Final Rule issued on 23 January 2003 relates to Section 406 of the SOA, which deals with senior management codes of ethics. It requires disclosure in the annual report of whether a company has adopted a code of ethics for the principal executive and financial officers, and, if not, the reasons why. With respect to Section 407 of the SOA on the disclosure of the audit committee financial expert, the rule requires a company to disclose whether it has at least one "financial expert" on its audit committee and, if not, to explain why. The name of the expert must be disclosed, as does whether or not he or she qualifies as an independent director.

31. *Penalties for altering documents*: A Final Rule issued on 24 January 2003 responds to Section 802 of the SOA. It provides for criminal penalties for altering documents, and extends the retention period for auditors specified by the SOA from five years to seven years. Information related to a significant matter that is inconsistent with the auditor's final opinion also needs to be retained.

32. *Off-balance sheet transactions*: The Final Rule issued on 27 January 2003, relates to Section 401(a) of the SOA on off-balance sheet transactions. It requires disclosure in the MD&A of all off-balance sheet arrangements that are reasonably likely to have a material effect on the statements, and requires a summary of other contractual obligations.

33. *Strengthening auditor independence*: This Final Rule issued on 28 January 2003 implements a number of measures to strengthen auditor independence by identifying services that would impair independence. Prohibited services include (a) bookkeeping; (b) financial information system design and implementation; (c) appraisal or valuation services, fairness opinions or contributions-in-kind reports; (d) actuarial services; (e) internal audit outsourcing services; (f) management functions; (g) human resource

services; (h) broker-dealer, investment advisor, or investment banking services; (i) legal services; (j) expert services unrelated to the audit; and (k) any other services that the PCAOB determines impermissible. Tax services would be permissible.

34. With respect to Section 202 of the SOA, audit committees are required to pre-approve all audit and non-audit services, and not delegate this responsibility to management. With respect to section 203, the Final Rule requires lead and concurring partner rotation after five years and a five-year “time out” period. With respect to section 204, the Final Rule requires the auditor to report to the audit committee before filing of the report on (a) critical accounting policies; (b) alternative treatments discussed with the client; (c) any material written communications with management.

35. *Analyst, broker and dealer disclosures*: This Final Rule was issued on 20 February 2003. Called “Regulation Analyst Certification”, it requires brokers, dealers and others to certify their research reports as their own opinions.

36. *Standards relating to audit committees*: The Final Rule issued on 9 April 2003 was the most recent rule at the time of the writing of this report. “Standards Relating to Listed Company Audit Committees” prohibits the listing on US exchanges of companies that do not comply with the audit committee requirements of the SOA.

2. Regulation Fair Disclosure or Regulation “FD”[11]

37. Seemingly forgotten in the race to complete regulations as directed by the Sarbanes-Oxley Act was the SEC’s Regulation Fair Disclosure or Regulation “FD”. At the time it became effective in October 2000, it was hailed as a piece of landmark regulation. Though more recent rule-making surpassed its prominence, it remains an important and interesting element of SEC regulation. In brief, the regulation is designed to eliminate “selective disclosure” by levelling the playing field between investors. It stipulates that material information disclosed to analysts or other members of the investment community be made available simultaneously to the investing public.

38. Federal securities laws prior to Regulation FD did not generally require issuers to make public all material developments as they occurred. As a result, companies could control who received important information that was used in determining stock prices. This allowed issuers, in some cases, to selectively disclose information to favoured analysts or institutional investors prior to making a broad disclosure via a press release or an SEC filing.

39. Regulation FD bars disclosure to selected analysts, funds or individual investors before the information is made available to the public. If a disclosure occurs unintentionally, the violation must be rectified within 24 hours in order to avoid being qualified as selective. The Regulation does not mandate that issuers make public disclosure of all material developments when they occur, but rather requires that when issuers choose to disclose material information, they do so broadly to the investing public.

40. Regulation FD was hotly debated when it was enacted. Representatives of industry and the analyst's profession[12] spoke out strongly against it. The substance of their concern was that less information would be disclosed as a result of fears over potential litigation. They were also concerned about increased "boilerplate" disclosure and reduced transparency that would eventually result in greater market volatility. Individual investors, on the other hand, praised the fairness of the regulation while decrying the analysts' position as trying to maintain their privileged access to information. Ultimately, studies indicated that regulation FD had not reduced the amount or quality of information that companies make available to the public.

41. The first SEC enforcement actions relating to Regulation FD were made public in November 2002. Some of the first four violations appear to result from unintentional oversights while others are attributable to clear lapses in judgement on the part of executives. All of the sanctio ns were imposed as part of settlements with the SEC, and none of the companies involved admitted or denied any of the findings.[13]

42. The legislation, rules and regulations summarized above are a broad-reaching set of reforms that represent a considerable strengthening of governance and governance-related disclosure in the United States. 14 The US approach over the past year, developing regulation on a broad number of fronts, is based upon an understanding of the problem as one of a systemic nature. While broad in the sense that it covers many industries, it is also tightly focused on the information provided to the markets and the certification and independent verification of information.

43. The new regulations also provide for tough penalties and additional resources for regulatory agencies, thus recognizing that failure often occurs at the level of enforcement. It is too early to say what the results will be, although there is some anecdotal evidence that companies and financial service providers are adapting their practices. After the fast-paced legislative response over the past year, the US Government will likely wait to see what happend in the private sector before undertaking further actions.

II. THE PRIVATE SECTOR

A. The Financial Accounting Standards Board (FASB) Accounting Standards

44. The US SEC has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the SEC has relied on the private sector for this function to the extent that the private sector demonstrates ability to fulfil this responsibility in the public interest.

45. The Financial Accounting Standards Board (FASB) was established in 1972. Its mission has been to establish and improve standards of financial accounting and reporting for the guidance of issuers, auditors and users of financial information.

46. Since Enron, there have been increasing calls to make fundamental changes in FASB standard setting and SEC oversight. In congressional testimony, Robert K. Herdman, Chief Accountant of the SEC, advocated revamping certain aspects of FASB's operations. Herdman summarizes the key issues as: (a) a standard-setting process that is too cumbersome and slow; (b) overly complex guidance that reduces transparency; and (c) rules-based accounting that obscures the true position of the enterprise.[15]

47. Publicly, it has not gone unnoticed that FASB standards were easily subverted by Enron and other corporations intent on misleading shareholders. Detailed rules are intended to reduce the use of alternative approaches and, in turn, reduce the potential for errors in judgement and manipulation in reporting. However, rules-based standards can make it more difficult for preparers and auditors to step back and evaluate whether the overall accounting corresponds to the objectives of disclosure– namely, the rendering the company's position accurately, and providing investors with better insight. In practice, compliance with the letter of the standard (as opposed to its spirit) is easily achieved while distorting the big picture.

48. There are also concerns regarding weak public sector oversight and governance at FASB.[16] The Financial Accounting Foundation, the oversight body that appoints the members of FASB, is composed almost entirely of investors, business people and accountants. Critics also point to potential conflicts of interest at the Accounting Standards Executive Committee (AcSEC). AcSEC is FASB's secondary standard setter and a committee of the American Institute of Certified Public Accountants (AICPA), the professional body representing Certified Public Accountants in the United States. FASB delegates the development of specialized standards for industries and other special issues to AcSEC.

49. For FASB to better fulfil its responsibilities, greater efforts may need to be made to shield it from outside political influence. In the mid-990s corporate and congressional pressure forced FASB to back down on its proposal for accounting for stock option compensation. The proposal would have required expensing option grants and would have significantly worsened the income statement of many corporations.

50. On another occasion FASB attempted to improve accounting for Special Purpose Entities (SPEs). Though SPEs may serve legitimate purposes, Tim Lucas, Research Director at FASB, asserts that many companies structure SPEs in order to "escape the financial statements." [17] Amid strong criticism and lobbying, FASB and other financial regulators backed down, possibly missing an opportunity to rein in Enron-style reporting. While suggestions to federalize FASB do not appear to be receiving serious consideration, there appears, nevertheless, to be considerable scope for improving FASB's governance and operations.

51. With respect to International Financial Reporting Standards, the FASB has formal plans for eventual convergence, a process that may be assisted by the fact that the current President, Bob Herz, was a former Board Member of the International Accounting Standards Board. Numerous differences exist between US GAAP and IFRS, some of which can result in significant differences in the financial statements.[18] However, the single most important impediment to convergence is the fact that the United States has a long tradition of standard setting over which it is reticent to relinquish control. Despite shortcomings, the United States is largely satisfied with the quality of its accounting standards and would prefer to improve its own standards rather than cede control over an important element of its market to other standard setters.[19]

B. Stock Exchanges

52. The three major exchanges in the United States are the American Stock Exchange (AMEX), the NASDAQ and the New York Stock Exchange (NYSE). All have proposed changes to their listing rules in order to strengthen the governance and disclosure of listed enterprises.[20] These proposals were filed with the SEC. Recently, the SEC approved some of these proposals. The following points cover the main items pertaining to disclosure.[21]

53. *Disclosure of corporate governance guidelines*: Issuers on the AMEX and the NYSE need to adopt and disclose guidelines on corporate governance. The NYSE requires disclosure of director, qualifications; responsibilities; access to management and independent advisers; compensation; orientation and succession issues; and annual performance evaluations. The NYSE also requires that the CEO certify in the annual report that he or she is not aware of any material violation of NYSE governance standards.

54. *Disclosure of the determination of the independence* of directors and director fitness: The NYSE requires disclosure of the board's determination that directors are independent. The board may determine that a relationship exists between the company and the directors that would not materially affect independence. The basis for determining that a relationship is not material must be disclosed. The company must disclose its determination that directors who sit on more than three audit committees are fit to fulfil their responsibilities.

55. *Codes of ethics*: Each of the three exchanges requires companies to have and disclose codes of ethics for senior officers. The NYSE also requires disclosure of key committee charters. Both the NASDAQ and New York Stock Exchange require disclosure of waivers to the code of ethics.

56. *Stock option plans and stock transactions by executives*: All three exchanges require shareholder approval of equity compensation plans. The NASDAQ requires disclosure of transactions in company stock of up to $100,000 within two business days and within two business days of the following week for smaller transactions.

57. *Internal audit*: The NYSE will require companies to have an internal audit function.

58. *Going concern*: The AMEX requires disclosure of a going concern qualification in the audit report.

59. *Penalties*: Each of the exchanges may issue warnings and may de-list companies for violations.

60. Changes in the United States can be expected to have a significant impact on foreign companies listing on the major exchanges. As the exchanges upgrade corporate governance standards for their members, they will institute "comply-or-explain" procedures for their non-American listings. In the future, foreign issuers on all three exchanges must disclose differences between their national governance practices and those specified by the exchange.

C. Major investors and investor groupings

61. Most major US investors and investor groups support similar positions with respect to corporate governance. They use a variety of techniques to influence government and companies, ranging from lobbying and letter campaigns to the publication of corporate governance ratings and lists of corporate miscreants. Over the past year, investor groups seized the opportunity to press for longstanding wishes by providing congressional testimony and writing comment letters on various pieces of legislation, regulation and listing requirements.

62. Perhaps the best-known investor in the United States, and certainly the largest, is the California Public Employees' Retirement System (CalPERS). CalPERS has long been a leader in the governance movement and is known for its activism. Since CalPERS' investment philosophy is that of an index fund, it must hold shares in all of the companies in the market, and is not able to do the "Wall Street Walk", that is sell shares and walk away from companies it does not like.[22]

63. Its only avenue for improving the performance of its portfolio is to improve the long-term performance of the companies it owns. CalPERS does so by encouraging better governance. In most cases it enters into a dialogue with the companies it owns. It may, however, choose to be quite active in its approach. It has an action plan that includes tough rules that require voting against directors who do not support its positions, and may strike directly at the heart of the matter by lodging lawsuits against companies for violations of shareholder rights. Through careful selection of its battles, it has been able to garner a small number of important victories that have resulted in significant amounts of money being returned to shareholders. CalPERS takes its responsibility for improving company performance beyond lobbying companies to actively lobbying government for financial market reform.[23]

64. The organization that unifies the voice of a large number of retirement funds is the Council of Institutional Investors (CII). It is composed of large public, labour and corporate pension funds, whose combined assets exceed $2 trillion. Some of its members are the AFL-CIO Staff Retirement Plan, CalPERS, federal and state retirement plans, and the Association of World Bank Staff Retirement Plan among many others. CII has a number of programme including tracking shareholder-sponsored resolutions, monitoring responses to majority votes on shareholder resolutions and the publication of a list of underperforming corporations, known as the "Focus List." Its policy on disclosure is that corporations should report all information necessary for determining whether directors qualify as independent, whether or not the disclosure is required by state or federal law.[24]

65. The grouping that represents the mutual fund industry in the United States is the Investment Company Institute (ICI).[25] ICI echoes the major positions of other investors and investor groupings, including requiring the expensing of stock options, requiring that pro forma earnings announcements be reconciled to GAAP, expanding several types of material information disclosure, and requiring shareholder approval of stock option plans.

66. Most of the public sector retirement funds and investor groupings also support positions with respect to transparency on socially relevant issues. CalPERS supports the broad concept of corporate responsibility and, more specifically, the Sullivan Principles in its international proxy voting guidelines. The Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), the second largest public employee retirement fund in the United States, also makes explicit mention of social responsibility issues in its Policy Statement on Corporate Governance.[26] The Council of Institutional Investors, speaking for all of its members, supports the belief that the responsible conduct of business and business relationships is consistent with the fiduciary responsibility of investors and protecting long-term investment interests.

67. Unions are also major investors in the United States. The AFL-CIO uses the considerable weight of workers' pension funds to demand corporate accountability through shareholder actions. It proposes a new, higher corporate governance standard for companies traded on major US stock exchanges that would include accounting for stock options at cost, prohibitions on CEOs selling stock while on the job, and a ban on offshore tax havens.

D. Ratings agencies and proxy voting service companies

68. A number of companies provide services in order to help companies and investors in digesting the already overwhelming amount of information that is provided on corporate governance. Information services such as Standard & Poor's (S&P) and BusinessWeek Online produce rankings, evaluations and research related to how and what companies disclose. These services are intended to assist investors in their work and help companies benchmark and communicate their internal governance practices to the public.

69. Another service provider, Institutional Shareholder Services (ISS), issues research and proxy voting recommendations and will take over an investor's entire proxy voting operation.[27] It also provides companies with a variety of governance advisory services. ISS' maintains a database that assigns a Corporate Governance Quotient (CGQ) to companies. CGQ is a rating tool that assists institutional investors in evaluating the quality of corporate boards and the impact their governance practices may have on performance.

70. The Investor Responsibility Research Centre (IRRC) is an independent research firm that provides information on corporate governance and social responsibility issues affecting investors and corporations. IRRC has a stronger social and environmental focus than other advisers. Its founding can be traced to Viet Nam War era protests that triggered rules changes enabling shareholders to vote for the first time on shareholder proposals with social connotations.

71. S&P, Business Week Online, ISS, IRRC and other service and media organizations all rely on data that are derived primarily from company annual reports and standard regulatory filings. They fulfil an important role in translating raw data into actionable information and also illustrate the fundamental importance of public disclosure to the exercise of influence within the financial market.

E. Companies and industry groupings

72. The first reaction of many companies to the Enron crisis was defensive. Many were slow to recognize the depth of the problem and questioned the need for legislation. While it seems that the business community, over time, has come to support the need for some regulation, if not legislation, it is widely believed that the writing of the SOA should have occurred with greater input from the companies.

73. Some of the most influential US business groupings such as the National Association of Corporate Directors (NACD) and the Business Roundtable (BRT), a grouping of CEOs of large companies, testified before Congress regarding the causes and impact of Enron, Congressional testimony by the BRT traditionally opposed to regulation, and cautious about change, found Enron Corporation to be "a profound and troubling exception" in a system that has "generally worked very well".[28] With the benefit of hindsight, it now appears that businesses underestimated the depth of the problem, the extent of public concern and the will of Congress to act.

74. Both the NACD and the BRT now express strong support for the broad-reaching reforms embodied by the Sarbanes-Oxley Act of 2002 and new exchange listing requirements. Both have underscored in their own recommendations the utmost necessity for improving corporate transparency. The NACD recently joined forces with CII to enhance corporate transparency, and the BRT has developed a body of best practice to assist companies in their efforts to improve governance. The Conference Board, a respected organization that is influential through its research and organization of conferences on themes of topical interest to executives, has conducted research into

the area of governance and disclosure and remains an important voice supporting better governance in the business community.

75. Some companies stand out for the quality of their disclosure. According to a *Business Week* survey of the best and worst boards in the United States, Pfizer was second (while General Electric was ranked first) in overall approval by governance experts. [29] Pfizer is strong in substantive areas of governance such as the ability of independent directors to meet separately from the executive, and fully independent audit, nominating and compensation committees. Pfizer is also transparent. Along with copies of its financial statements and SEC filings, its website posts CEO/CFO certifications of financial statements, information on the board of directors, committee charters, copies of key governance policies and transactions of directors and executives in company stock.[30] Costs of stock option plans in terms of dilution and fair market value are shown in the financial statements.

76. Another company, Computer Associates, was considered until recently to have one of the worst boards because of weak oversight and excessive executive compensation. Sanjay Kumar, its Chairman and CEO, decided to transform the company into the “gold standard” of governance, and in 2002 the company found its way onto the *Business Week* list of most improved companies.

77. Implementing good governance at Computer Associates was not a question of a single dramatic event; it was, rather, a process. The company went through a number of phases. It added staff that were dedicated exclusively to enhancing its governance. The next phase was to develop principles of governance. Implementation of these principles required not only enhanced external communication but also, and more important, better internal communication and education to help employees understand the need for transparency. Computer Associates was, at the time of writing, moving into a final phase of continuous improvement.

78. Experience shows that requirements to disclose in “plain English” may be considerably more difficult to implement than one might anticipate. At Computer Associates, one of the most difficult aspects of bringing about better transparency has been to correctly communicate the company’s view of itself clearly to outsiders. Considerable effort was devoted to developing filings that meet this objective.

79. There are other examples of the company moving to implement best practice. Computer Associates’ website could now be considered a model with detailed and comprehensive information on its governance.[31] Computer Associates will voluntarily expense its stock options beginning in April 2003.

80. A somewhat unusual example of improved disclosure is Fannie Mae. Fannie Mae was created by Congress in 1938 and was originally part of the Federal Housing Administration.[32] In 1968, Fannie Mae became a private company that bought mortgage obligations. Fannie Mae was criticized because of its historical exemption from registering and filing with the SEC. In response to the market's increased focus on governance and disclosure, Fannie Mae decided to voluntarily register its common stock

and seek governance rating from Standard & Poor's. Its first filings are due in early 2003 and will correct the longstanding inconsistency in its disclosure obligations.

81. An increasing number of companies have been improving their disclosure practices by choosing to voluntarily disclose the true costs of their stock option plans in advance of legislative requirements. Before the passage of the SOA, only two companies on the S&P 500 index expensed stock options: Boeing, the aircraft manufacturer, and Winn-Dixie a department store chain.[33]

III. THE MAIN IMPLEMENTATION ISSUES

82. The SOA is a piece of domestic legislation with far-reaching international implications; it does not contain any exemption for foreign issuers. As a result, companies that register securities in the United States, whether directly or indirectly through ADRs, will need to comply with US rules regardless of whether their practices are legal in their country of origin. While the SOA does not apply to issuers exempt from US filing rules (Level 1 ADRs), stock exchanges will institute at least a "comply-or-explain" policy for their non-American listings. Foreign issuers on all three of the major US exchanges will need to disclose differences between their national governance practices and those specified by the exchange.

83. Some provisions of the SOA may not cause enormous problems for foreign companies: requirements for executive certification of financial statements exist in other countries and additional disclosures on board composition and codes of ethics can be developed. However, requirements to establish fully independent audit committees with new powers will inevitably conflict with the company law of many countries. Executives will be limited in their ability to take loans from companies and will own the risk of imprisonment and fines associated with the violation of the new rules.

84. Audit will also change. Foreign public accounting firms are subject to the requirements of the SOA when providing reports on issuers in the United States. Foreign audit firms will need to register with the newly established Public Company Accounting Oversight Board like their US counterparts. They will also need to adhere to the same rules regarding auditor independence and limitations on services that they may provide to audit clients. For all of these reasons, the Sarbanes-Oxley Act of 2002 is being closely scrutinized and, in some cases, harshly criticized in countries with developed and developing securities markets.

85. The US SEC has sought to respond to the concerns expressed in other countries. While it is not willing to budge on the substance of the SOA, the Commission recognizes that US rules may place foreign issuers in a difficult position: violate home country laws or comply with SEC rules. The SEC has made some accommodations where conflicts of law exist, including the following: where bodies similar to audit committees and independent of management exist, they may be accepted as audit committees; expanding the definition of an audit committee "financial expert" to include individuals who have expertise in generally accepted accounting principles in the home country of the issuer;

and excluding foreign attorneys not licensed to practise law in the United States from coverage under SEC attorney conduct rules. [34]

86. Considerable effort has been made to give teeth to the new US governance and disclosure requirements by providing for tough enforcement and penalties, and additional resources have been provided to the SEC. However, resources alone will not make it more effective. Some outstanding questions are how the SEC will organize itself to meet its additional oversight responsibilities and how it can practically assure itself that the enormous amount of filings it receives are credible. Policy makers in other countries, who work with considerably less wherewithal, will be interested in knowing how the US brings its resources to bear.

87. In the accounting area, revenue recognition, accounting for SPEs and stock options seem to be leading concerns. Revenue and expense recognition underlie some of the accounting problems that ISAR sought to address in its past work on transfer pricing. A number of other issues remain on the horizon. One is dealing with the degree of complexity of a reporting system that simultaneously makes obfuscation easy and monitoring difficult. A longer-term issue is a more complete revamping of the accounting system. As KPMG Chairman Steven Butler put it; “Our accounting system doesn’t do a good job of describing any modern company”.[35]

88. The effectiveness and governance of FASB, the US accounting standard setter, will likely receive further attention. The mandatory rotation of audit firms will certainly become an issue once the final studies commissioned by the Sarbanes-Oxley Act of 2002 are completed. The United States has generally led in remuneration disclosure; however, there has been little real impact on the link between pay and financial performance, although a small number of companies are voluntarily disclosing the cost of stock options, which appears to be an important first step.

89. While leadership is clearly visible among some companies, boards remain far less independent (and transparent) than one might think, even when staffed by outsiders.[36] Transforming the good intentions of codes of conduct into corporate reality will require sustained effort, training and changing of entrenched attitudes not only among companies but also among financial service industry professionals. Questions concerning underlying business values seem to suggest that the topic of ethics could play a more prominent role in graduate school curricula.

Notes:

[1] As per Mr. Harvey Pitt, in his response letter to the Senate Committee on Governmental Affairs, dated 4 March 2002.

[2] MSCI Red Book, Month End May 2003.

[3] United States General Accounting Office, "Report to the Chairman, Committee on Banking, Housing and Urban Affairs, U.S. Senate".

[4] The full text of the Sarbanes-Oxley Act of 2002 is available on the website of the United States Government Printing Office: www.accesss.gpo.gov. For a summary that also includes a discussion of SEC Final Rules developed in response to SOA, see "Navigating the Sarbanes-Oxley Act of 2002", PriceWaterhouseCoopers at www.pwcglobal.com

[5] A number of these studies were completed or close to completion at the time of writing of the report.

[6] For full copies of the studies conducted by the Government Accounting Office (GAO), including "Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges", consult the website www.gao.gov. For studies conducted by the US SEC consult www.sec.gov. For "An Analysis of Restatement Matters: Rules, Errors, Ethics" see www.huronconsultinggroup.com

[7] For general information on the US SEC consult www.sec.gov/.

[8] Section 601 of the Sarbanes-Oxley Act of 2002 provides for further appropriations for the SEC.

[9] "Financial Oversight of Enron: The SEC and Private-Sector Watchdogs", Report of the Senate Committee on Governmental Affairs, 8 October 2002.

[10]. For the full text of the Final Rules, consult the US SEC website at www.sec.gov/rules/final.shtml .

[11] For the full text of Regulation FD see the SEC website: www.sec.gov.

[12] The American Institute of Investment Management and Research (AIMR) and the Securities Industry Association (SIA).

[13] For further information on these actions see the SEC website for the following releases: Motorola, Inc., Release No. 46898; Siebel Systems, Inc., Release No. 46896, Lit. Release No. 17860; Secure Computing Corporation, Release No. 46895; Raytheon Company, Release No. 46897.

[14] Individual states also regulate financial markets in the United States. In particular, the state of New York, home of the major US exchanges (American, NASDAQ and the New York Stock Exchange) has regulation in addition to federal regulation. The role of the states in regulating financial markets has not been considered in the preparation of this study. Concerns regarding duplication of efforts and potentially contradictory goals and outcomes of federal and state laws could be the topic of a separate case study.

[15] Testimony of Robert K. Herdman, Chief Accountant, U.S. Securities and Exchange Commission, before the Subcommittee on Commerce, Trade and Consumer Protection, Committee on Energy and Commerce, of the U.S. House of Representatives on 14 February 2002.

[16] Recommendations from The National Association Of Corporate Directors, Concerning Reforms in the Aftermath of the Enron Bankruptcy. Updated Version of 3 May 2002: http://www.nacdonline.org/nacd/enron_recommendations.asp.

[17] "The Holes in GAAP", 01/17/2002, *Financial Times*.

[18] GAAP 2001, A Survey of National Accounting Rules Benchmarked Against IFRS.

[19] GAAP Convergence 2002, A Survey of National Efforts to Promote and Achieve Convergence with International Financial Reporting Standards.

[20] For the full texts of these proposals see the exchange websites: AMEX: www.amex.com; NASDAQ: www.nasdaq.com; NYSE: www.nyse.com.

[21] For a comparison of all of the major elements of the exchange proposals including relevant elements of the Sarbanes-Oxley Act and final SEC rules as of 7 February 2003, see the "Assessment Guide for US Legislative, Regulatory and Listing Requirements", Institute of Internal Auditors Research Foundation.

[22] In an odd twist of fate CalPERS played a role in helping Enron keep debt off of its balance sheet through an SPE called the Joint Energy Development Investors (JEDI). It is also ironic that Enron executives would eventually be accused of manipulating energy markets and causing a severe energy crisis in the state of California.

[23]For more information on CalPERS, including its Principles of Corporate Governance and its plan for corporate and legislative reform, see: www.calpers-governance.org/.
[24] For the full text of CII Core Policies and the General Principles, see: www.cii.org/corp_governance.asp
[25] http://www.ici.org/
[26] http://www.tiaa-cref.org/libra/governance/index.html.
[27] www.issproxy.com
[28] Business Roundtable Corporate Governance Task Force Chairman, Franklin Raines, before House Panel.
[29] *Business Week*, 7 October 2002.
[30] The Pfizer website can be found at: www.pfizer.com/are/mn_investors_corporate.cfm.
[31] The Computer Associates governance website can be found: www.computerassociates.com/governance.
[32] More information on Fannie Mae can be found at: www.fanniemae.com/index.jhtml.
[33] Since then, more and more companies have decided to voluntarily disclose the cost of option compensation plans, Mathew Ingram, "Expensing options is a bandwagon worth joining," *The Globe and Mail*, 16 August 2002.
[34] For a full list of the accommodations cited in a 11 June 2003 speech by Roel C. Campos, SEC Commissioner, see the appendix.
[35] Jeffrey E. Garten, "Corporate Standards: Raise the Bar Around the World", *Newsweek*, 13 May 2002.
[36]One only need look to Enron for what was broadly considered a model board. *Chief Executive Magazine* rated the Enron Board among the top five in the United States in 2000. Enron was also found to be one of the most admired US companies in innovation, employee talent and quality of management by *Fortune* in February 2000.