Private Enterprise, Public Trust:

The State of Corporate America After Sarbanes-Oxley
# Table of Contents

EXECUTIVE SUMMARY ........................................................................................................................................... 1

I. INTRODUCTION ................................................................................................................................................... 7
   The Central Role of the Corporation .................................................................................................................. 8
   What is the Agenda? .......................................................................................................................................... 9

II. HOW SHOULD THE FINANCIAL CONDITION OF THE CORPORATION BE REPORTED TO THE PUBLIC? THE NATURE OF FINANCIAL INFORMATION ........................................ 11
   The Role of Audit Committees ....................................................................................................................... 11
   The Judgmental Nature of Financial Information .......................................................................................... 12
   Recommendations .......................................................................................................................................... 15
   The Issue of Litigation .................................................................................................................................. 16

III. WHAT IS THE PUBLIC COMPANY’S REPRESENTATION TO THE PUBLIC? SECTION 404 AND THE NATURE OF INTERNAL CONTROLS ................................................................. 19
   The Value of Section 404 ............................................................................................................................... 19
   The Costs of Compliance ............................................................................................................................... 20
   CED’s Recommendations .............................................................................................................................. 21

IV. HOW SHOULD MANAGERS BE PAID? THE PROBLEM OF EXECUTIVE COMPENSATION ........................................................................................................................................ 23
   Recommendations .......................................................................................................................................... 24

V. HOW SHOULD CORPORATE BOARDS BE SELECTED? THE ISSUE OF SHAREHOLDER VOTING ........................................................................................................................................ 27
   The Characteristics of a Sound Board of Directors ....................................................................................... 27
   Recent Proposals to Change the Nomination and Election Process ............................................................. 28
   Reform of the Board’s Nomination Process: A Better Way to Construct a Board ..................................... 30

VI. CONCLUSION ...................................................................................................................................................... 33

APPENDIX: PRESENTATION BY PATRICK M. GROSS AT STANFORD GRADUATE SCHOOL OF BUSINESS CORPORATE GOVERNANCE PROGRAM, JUNE 3, 2005 .................. 35

ENDNOTES ................................................................................................................................................................ 43

MEMORANDA OF COMMENT, RESERVATION, OR DISSENT ............................................................................. 45
Responsibility For CED Statements On National Policy

The Committee for Economic Development is an independent research and policy organization of over 200 business leaders and educators. CED is non-profit, non-partisan, and non-political. Its purpose is to propose policies that bring about steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all.

All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This committee is directed under the bylaws, which emphasize that “all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group.” The committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pending specific legislative proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication.

The recommendations presented herein are those of the trustee members of the Research and Policy Committee and the responsible subcommittee. They are not necessarily endorsed by other trustees or by non-trustee subcommittee members, advisors, contributors, staff members, or others associated with CED.
Research and Policy Committee

Co-Chairmen

PATRICK W. GROSS
Chairman, The Lovell Group
Founder, AMS

WILLIAM W. LEWIS
Director Emeritus, McKinsey
Global Institute
McKinsey & Company, Inc.

Chairman

IAN ARNOF
Chairman
Arnof Family Foundation

Vice Chairman

REX D. ADAMS
Professor of Business Administration
The Fuqua School of Business
Duke University

ALAN BELZER
Retired President and
Chief Operating Officer
Allied-Signal Inc.

LEE C. BOLLINGER
President
Columbia University

ROY J. BOSTOCK
Chairman
Sealege Investments

JOHN BRADEMAS
President Emeritus
New York University

DONALD R. CALDWELL
Chairman and Chief Executive Officer
Cross Atlantic Capital Partners

DAVID A. CAPUTO
President
Pace University

MICHAEL CHESSER
Chairman, President and
Chief Executive Officer
Great Plains Energy Services

CAROLYN CHIN
Chairman and Chief Executive Officer
Cebiz

RONALD R. DAVENPORT
Chairman of the Board
Sheridan Broadcasting Corporation

RICHARD H. DAVIS
Partner
Davis Manafort, Inc.

RICHARD J. DAVIS
Senior Partner
Weil, Gotshal & Manges LLP

FRANK P. DOYLE
Retired Executive Vice President
General Electric

W. D. EBERLE
Chairman
Manchester Associates, Ltd.

MATTHEW FINK
President (Retired)
Investment Company Institute

EDMUND B. FITZGERALD
Managing Director
Woodmont Associates

HARRY L. FREEMAN
Chair
The Mark Twain Institute

CONO R. FUSCO
Managing Partner-Strategic Relationships
Grant Thornton

GERALD GREENWALD
Chairman
Greenbriar Equity Group

BARBARA B. GROGAN
President
Western Industrial Contractors

RICHARD W. HANSELMAN
Former Chairman
Health Net Inc.

RODERICK M. HILLS
Chairman
Hills & Stern, LLP

EDWARD A. KANGAS
Chairman and Chief Executive Officer,
Retired
Deloitte Touche Tohmatsu

CHARLES E.M. KOLB
President
Committee for Economic Development

BRUCE K. MACLAURY
President Emeritus
The Brookings Institution

LENNY MENDONCA
Chairman, McKinsey Global Institute
McKinsey & Company, Inc.

NICHOLAS G. MOORE
Director
Bechtel Group, Inc.

DONNA MOREA
President
CGI-AMS, Inc.

STEFFEN E. PALKO
Retired Vice Chairman and President
XTO Energy Inc.

CAROL J. PARRY
President
Corporate Social Responsibility
Associates

PETER G. PETERSON
Senior Chairman
The Blackstone Group

HUGH B. PRICE
Former President and
Chief Executive Officer
National Urban League

NED REGAN
University Professor
The City University of New York

JAMES Q. RIORDAN
Chairman
Quentin Partners Co.

LANDON H. ROWLAND
Chairman
Everglades Financial

GEORGE RUPP
President
International Rescue Committee

ROCCO C. SICILIANO
Beverly Hills, California

SARAH G. SMITH
Chief Accounting Officer
Goldman Sachs Group Inc.

MATTHEW J. STOVER
Chairman
LKM Ventures

JOSH S. WESTON
Honorary Chairman
Automatic Data Processing, Inc.
Chairman
RODERICK M. HILLS
Chairman
Hills & Stern, LLP

Trustees
REX D. ADAMS
Professor of Business Administration
Duke University
HERBERT M. ALLISON, JR.
Chairman, President and CEO
TIAA-CREF
COUNTESS MARIA BEATRICE ARCO
Chair
American Asset Corporation
PETER A. BENOLIEL
Chairman Emeritus
Quaker Chemical Company
ROY J. BOSTOCK
Chairman
Sealedge Investments
JOHN BRADEMAS
President Emeritus
New York University
DAVID A. CAPUTO
President
Pace University
STEPHEN A. CRANE
Chairman, President and CEO
Alpha Star Insurance Group, Ltd.
W. BOWMAN CUTTER
Managing Director
Warburg Pincus LLC
PAUL DANOS
Dean, The Amos Tuck School of Business
Dartmouth College
RICHARD J. DAVIS
Senior Partner
Weil, Gotshal & Manges LLP
SAMUEL A. DIPIAZZA
Global Chief Executive
PricewaterhouseCoopers LLP
HARRY FREEMAN
Chairman
Mark Twain Institute
CONO R. Fusco
Managing Partner – Strategic Relationships
Grant Thornton
CAROL R. GOLDBERG
Trustee
The AvCar Group, Ltd.

GERALD GREENWALD
Chairman
Greenbriar Equity Group
PATRICK W. GROSS
Chairman
The Lovell Group
WILLIAM C. JENNINGS
Chairman
US Interactive, Inc.
ROBERT L. JOSS
Dean, Graduate School of Business
Stanford University
EDWARD A. KANGAS
Chairman and CEO (Retired)
Deloitte Touche Tomatsu
IRA A. LIPMAN
Chairman of the Board & President
Guardsmark, LLC
BRUCE K. MACLAURY
President Emeritus
The Brookings Institution
COLETTE MAHONEY
President Emerita
Marymount Manhattan College
DEBORAH HICKS MIDANEK
President
Solon Group, Inc.
NICHOLAS G. MOORE
Director
Bechtel Group, Inc.
MATTHEW NIMETZ
Partner
General Atlantic Partners
CAROL J. PARRY
President
Corporate Social Responsibility Associates
DONALD K. PETERSON
President and CEO
Avaya Inc.
PETER G. PETERSON
Senior Chairman
The Blackstone Group
HUGH PRICE
Former President and CEO
National Urban League
NED REGAN
University Professor
City University of New York
JAMES Q. RIORDAN
Chairman
Quentin Partners Co.

LANDON H. ROWLAND
Chairman
Everglades Financial
DR. RUTH J. SIMMONS
President
Brown University
FREDERICK W. SMITH
Chairman, President and CEO
FedEx Corporation
SARAH G. SMITH
Chief Accounting Officer
Goldman Sachs Group Inc.
P A U L A S T E R N
Chairwoman
The Stern Group, Inc.
DONALD M. STEWART
Visiting Professor, Harris School of Public Policy
The University of Chicago
RICHARD F. SYRON
Chairman and CEO
Freddie Mac
FRANK VOGL
President
Vogl Communications
JOSH S. WESTON
Honorary Chairman
Automatic Data Processing, Inc.
HAROLD WILLIAMS
President Emeritus
The Getty Trust
LINDA SMITH WILSON
President Emerita
Raddcliffe College
RONALD ZARRELLA
Chairman and CEO
Baush & Lomb Inc.

Guests
CATHERINE BromiLOW
Partner, Corporate Governance Group
PricewaterhouseCoopers LLP
STEVE WAGNER
Partner
Deloitte & Touche LLP

Project Director
ELLIO T SCHWARTZ
Vice President & Director, Economic Studies
Committee for Economic Development

Project Associate
CAROLYN CADEI
Research Associate
Committee for Economic Development
Revelations of misconduct in some of America’s leading corporations in recent years have seriously undermined confidence in U.S. businesses and in business leaders. The Committee for Economic Development (CED), composed largely of business leaders, seeks to improve the system of corporate governance and to restore public confidence in business. Putting businesses on a sound ethical footing and restoring public trust in them are critically important to our economy and society.

As CED was beginning to consider the many issues raised by the corporate scandals, government officials – industry regulators, the Congress, and the administration – were fashioning new rules for public companies and their auditors to live by, mostly embodied in the Sarbanes-Oxley Act of 2002 and related regulations. But the new government-imposed rules, though beneficial on balance and deserving of time to become fully effective, are not sufficient, in our view. In this report, CED recommends additional practical and effective changes – in financial statements, executive compensation, selection of corporate boards, and other matters – that do not require new government mandates. We believe that these changes in institutions and behavior will yield higher corporate ethics and effectiveness, and renewed public trust.

Acknowledgements

This policy statement was developed by the committed and knowledgeable group of business, academic, and policy leaders listed on page vi. We are grateful for the time, efforts, and care that each put into the development of this report.

Special thanks go to the subcommittee chair, Roderick M. Hills, of Hills Stern & Morley, for his guidance and leadership. We are also indebted to Elliot Schwartz, Vice President and Director of Economic Studies at CED, Joe Minarik, CED’s Senior Vice President and Director of Research, and his predecessor, Everett Ehrlich, president of ESC Co. Thanks are also due to Carolyn Cadei for research assistance.

Patrick W. Gross, Co-Chair
Research and Policy Committee
Chairman, The Lovell Group
Founder, AMS, Inc.

William W. Lewis, Co-Chair
Research and Policy Committee
Director Emeritus, McKinsey Global Institute
McKinsey and Company, Inc.
The highly visible accounting scandals that surrounded the collapse of Enron, WorldCom and several other major companies together with the revelation of fraud and other acts of malfeasance by corporate executives have aroused public outrage, called into question the values and ethics of business leaders, and undermined the public’s confidence in public companies.

CED, as a public-policy organization in which current and retired business leaders play a prominent role, is concerned about the reality, as well as the appearance, of corporate impropriety. We are unwavering advocates for the free market system, but we are just as firm in our belief that businesses and their leaders must earn the public’s trust. Perceptions that firms flout rules, behave unethically, and use deceptive business processes weakens confidence in, and support for, the free enterprise system. Executive compensation that is untethered to economic value and violates perceptions of fairness leads to mistrust and the prospect of a stifling regulatory backlash. The ethical failing of a small number of corporate leaders is infectious: it undermines the ethical standards of their own firms and affects the behavior of others and, therefore, must be cured.

This policy statement addresses governmental and corporate policies that affect the behavior of publicly traded companies, as well as the confidence of investors in them. Many of the problems we address, and their solutions, are intangible, though their effects are tangibly felt by investors, employees, and society at large. We acknowledge at the outset that no laws or policies will ever be sufficient to end all corporate misbehavior. We are confident, however, that truly independent and inquisitive boards of directors will provide the best safeguard against corporate wrongdoing.

We observe and conclude the following:

(1) Audit Committees Must be Autonomous and Vigorous

Because shareholders know only what corporate management elects to tell them about the corporation, a substantial body of law, practice and regulation has been created to govern the scope and substance of reporting about a corporation’s financial condition. Some key questions underlie this body of law and regulation: (1) What kinds of information should be provided to investors? (2) How should that information be presented to be clear to a typical investor? (3) What system will most readily produce such information?

Although the primary responsibility to answer these questions is with management, investors depend on corporate boards of directors, who, as agents for shareholders, must oversee the presentation of relevant information. To do so, boards must have access to all pertinent data, and this will occur only if a board’s audit committee is competent, independent, and establishes effective control over both the internal auditors and the independent outside auditors. In CED’s view, the relationship between the audit committee of the board and the outside and internal auditors is crucial. The audit committee should exercise the same tone of control over the internal auditor as it does over the external auditor, extending to decisions of hiring, firing, and compensation.
There is debate over whether the audit process should be governed by specific rules or general principles, but CED believes that this dichotomy is largely a false choice: any rules have principles, and any principles have rules.

Financial statements would be more useful if they were governed by fewer rules and displayed more of the judgment that lies behind estimated numbers. To a significant degree the misdeeds of the 1990s, and their unfortunate consequences, arose from the false belief that financial reports provide a precise measurement of corporate performance. Some corporate managers used unreasonable estimates or assumptions or relied upon unique interpretations of accounting standards to present a fictional financial picture of their companies. But “profits” or “revenues” or “value” are not like “temperature” or “mass” – they cannot be measured with precision. Their estimation requires judgment. The tendency to focus excessively on precise but potentially misleading accounting has been called “the brittle illusion of accounting exactitude.”

CED believes that stock analysts, the investing public, and regulators must recognize the inherently judgmental character of accounting statements and financial information. Ranges of values rather than precise numbers should be explained and understood as such. In addition, financial statements should be supplemented with non-financial indicators of value.

It will take time, and the cooperation of regulators, issuers, and analysts, to develop a modern financial statement. Such an admittedly inexact statement will require managers, directors, and auditors to exercise considerably more judgment than is common today. Audit committees in particular will have to clearly understand the judgments that have been made and take responsibility for assuring investors that the condition of the company is accurately represented by financial statements. CED recognizes that such judgments are not likely unless those making the judgments are protected from unwarranted challenges from private, third-party litigation (as distinguished from regulatory action).

Section 404 of the Sarbanes-Oxley Act of 2002 requires public companies to make an annual assessment of the effectiveness of their internal controls over financial reporting. And, each corporation’s independent auditors are required to audit and report on management’s assessment.

This requirement has become the center of a growing debate. To the detractors, Section 404 is a cost burden with little real return – some call it a “compliance tax” on public companies. However, we believe that Section 404 provides an opportunity to redesign the external audit to make it a far more valuable management tool than it has been. A growing number of companies and auditors report that the new requirement for an examination of internal controls yields benefits both in greater financial information and in improved understanding of a wide range of functions in the firm.

The first-year costs of complying with Section 404 have been significantly higher than initially anticipated. However, we do not believe that Sarbanes-Oxley requires legislative changes; we concur with the predominant view of experts that costs can be substantially reduced in future years. CED sees room to tailor the requirements imposed by Section 404 within the existing statute, and endorses the Public Company Accounting Oversight Board (PCAOB) and Securities and Exchange Commission (SEC) implementation guidance based on their evaluation of the first-year experience. The guidance, issued simultaneously by the two agencies in May 2005, should lower the costs and increase the value of Section 404 compliance.

While CED believes that the implementation of the requirements of Sarbanes-Oxley Section 404 will provide a substantial net benefit for American businesses in general, we also acknowledge that the ongoing costs of compliance and certification will be relatively higher for small and mid-sized companies. CED does not recommend a broad exemption to Sarbanes-Oxley requirements for small-capitalization companies but nevertheless supports the objective of mitigating the costs to smaller companies. That objective is being examined by the PCAOB and SEC, as they reconsider...
the process through which ongoing compliance and certification is achieved.

(4) Excessive Executive Compensation Can be Tamed by the Compensation Committee

Over the past 20 years, the average pay of top corporate managers has risen dramatically, and in our view too often unjustifiably. That is true both in absolute terms and in comparison to the wages of the average corporate employee.

In CED’s view, this disparity of income between top corporate executives and average employees is a cause for serious concern. CED continues to believe that compensation should be determined by the market and must reflect the productivity of the individual in question. We are fundamentally opposed to specific rules, laws, or regulations that place artificial limits on compensation, or that prohibit boards from making compensation decisions based on the performance of the individuals involved, fairly appraised. But we are concerned that the differentials that exist today too often reflect neither market conditions nor individual performance. Our view is that the process for determining executive compensation has been broken at far too many of our larger corporations, and that the solution to excessive executive compensation must be regarded as a matter of process and disclosure. At the center of the process sits the compensation committee.

Our recommendations are as follows:

- **Compensation committees should adopt measurable, specific, and genuinely challenging goals (financial, strategic, operational, and social) for the performance of their businesses, and judge management by them.**

- **The compensation process must be run by compensation committees composed of independent directors. And, compensation consultants, when used, must be entirely independent of management.** In selecting consultants, committees must comprehend how the process of fixing top management compensation has broken down. Whether or not consultants are used, the compensation committee should have direct authority over all terms of any management contract, including all forms of compensation.

- **Management should have a substantial equity interest in their company.** This interest should be over and above equity derived through options or grants. Barring exceptional circumstances, management should act as “buy and hold” investors.

- **Management should make a full, timely, and transparent disclosure of its compensation to shareholders.** The compensation discussion should be presented in one place in the company’s disclosure and should include all forms of compensation. Disclosures should be comprehensive and easily understandable, and they should make clear how top officers would be compensated under plausible retirement or change-of-control situations. As this statement goes to press, the SEC is considering new disclosure rules for executive compensation that appear to carry out CED’s recommendations.

- **Choices of forms of compensation should promote the long-term value of the firm, rather than exploit favorable accounting or tax treatment.** We note that recent changes in accounting for stock options require that options be expensed on the accounting statements of public companies. The expensing of options should neutralize a bias that has favored their use in recent years. The compensation committee must also make clear the effect of its compensation decisions on stockholder dilution.

- **Severance compensation, like all other forms of executive compensation, should be reviewed carefully against criteria set by the compensation committee of the board, and the board should publicly provide full details of awards and explain publicly to shareholders the reasoning behind such awards.**
Companies should have the right to recapture top executive bonuses if financial results by which they were justified turn out not to have been achieved when accounts are restated.

(5) Directors Must be Selected and Appraised by Independent Nominating Committees

A paradox of corporate stewardship is that, despite the principle that directors represent shareholders in the selection and retention of management, historically most directors have been selected by management.

How should boards be assembled? What is the right way to select directors—and, therefore, to represent shareholders in their dealings with management?

CED believes that reform of the nomination process can be effected by board action; that sound practices can convert management selection of directors to a process effectively independent of management control; and that directors, so chosen, will be more reliable representatives of the interests of shareholders.

An additional question is whether an effective board needs leadership independent of the Chief Executive Officer. CED believes that such independent leadership is essential, and that it can come from a non-executive chairman, the chairman of the board’s governance committee, or any other independent director who is designated as the lead director. If a company has a lead director, he or she should not automatically rotate out of the position on a fixed schedule. CED, however, does not believe that one system fits all.

There have been important proposals to change the nomination and election process for directors. Some of these proposals are worth serious consideration. However, CED does not, today, support proposals that would facilitate direct nomination of directors by shareholders. Such proposals would allow leading groups of shareholders—generally, institutional funds that may have agendas inconsistent with the interests of shareholders at large—to exert undue and unequal power over boards, which would lead to conflicts within the board. Also, it is almost impossible to imagine that a board assembled in one or more proxy fights could function constructively.

A better alternative to allow direct shareholder influence over board membership would be to adopt a version of what is often referred to as the “majority vote” condition. In principle, we support the view that an individual who does not have the support of a majority of voted shares should not be a director of a public company. In practice, a majority-vote standard can take many forms. As legal committees, regulators, and legislatures examine the pros and cons, we believe individual companies are in the best position to judge what version of a majority-vote standard is most suitable.

In our view, the best approach to building high-quality boards is to assign to truly independent nominating committees the responsibility for recommending new board candidates and for evaluating the performance of existing board members. The nominating committee should also have the responsibility of recommending committee assignments. We recognize that the task of recruiting well-qualified directors may be difficult. With the passage of the Sarbanes-Oxley Act and other reforms, the workload, time commitment, and responsibilities of independent directors have greatly increased. Notwithstanding the benefits from these reforms, it has become harder for public companies to find well-qualified candidates willing to serve as directors.

Large companies may resort to consultants to recruit for directors. If so, the recruiters must report to the independent nominating committee and maintain independence from management. But whether a company is large or small, and whether or not the board hires an outside recruiter, independent directors should begin the process of board selection by developing, without the participation of the CEO, a list of appropriate candidates. CED believes that this approach provides a broad search pool, reaching talent that may not have been known to the CEO or the board.
Conclusion

Relations between corporations and investors have suffered wrenching change in the last five years, from both corporate misdeeds and the legislative reaction to them. For all of the damage and pain, the potential exists for ultimate benefit to all parties, as better and more transparent information breeds renewed investor confidence and higher standards of behavior and openness.

In this statement, CED has recommended some changes in practice to hasten this beneficial adjustment. However, we would view such proposed change as modest, and within the scope of the recent revisions in corporate governance practices. CED believes that the wisest course now would be patience, to allow these new practices and institutions to be learned and understood, and to demonstrate their merit.
The recent collapse of Enron and WorldCom, and the revelations of accounting misstatements, fraud and other forms of malfeasance at other firms, have focused public attention and outrage on corporate behavior. The conduct of some corporate executives and directors has called into question the values and ethics of business leaders and has undermined the public's confidence in public companies. Continuing investigations and disclosures of unethical business practices have surely further damaged the public reputation of business. According to a 2005 survey, only 2 percent of American investors regard CEOs of Fortune 500 companies as “very trustworthy.” Moreover, 80 percent of individuals surveyed indicated that large companies need to increase their transparency and offer more information on their operations.1

Publicly traded companies are essential to the success of both our free market economy and our democratic society. But the willingness of citizens to invest in them and to continue their legal privileges is undermined by a loss of trust in corporations and the people who run them. Financial scandals, burst bubbles, and the aggressive policies to prevent them have been part of capitalism’s history since the South Seas scandal of 1720. Scandals and other distortions usually have elicited political and regulatory reactions. The 1933 and 1934 Securities Acts were aimed at the corporate excesses of the 1920s. The requirement that publicly traded firms have audit committees comprised only of non-management directors, and the Foreign Corrupt Practices Act of 1977, were directed at commercial bribery. Now, the Sarbanes-Oxley Act has been directed at the accounting and governance outrages of the “Enron and WorldCom Era.” Major aberrations in corporate behavior beget quantum responses, which inevitably have some rough edges. Whatever their merits in the largest sense, there remains controversy over whether the benefits to our economy and to investors justify the inevitable costs of regulatory change.

A debate is taking place over whether it is necessary to modify Sarbanes-Oxley. CED sees the issue of the future of Sarbanes-Oxley in the larger context of the present and future state of corporate America: To what extent has the problem of interlinked weaknesses in accounting and governance been solved by Sarbanes-Oxley? What problems remain? What has Sarbanes-Oxley failed to address, and what has arisen out of the Act’s implementation? And, most fundamentally, what needs to be done in order to give Americans confidence that their business institutions are behaving ethically, responsibly and in ways consistent with sound and sustained long-term economic growth?

This policy statement addresses governmental and corporate policies that affect the behavior of publicly traded companies, as well as the confidence investors have in such companies. Many of the problems we
address, and their solutions, are intangible, though their effects are tangibly felt by investors, employees, and society at large. For the most part, we put our confidence in the board of directors, in particular its independent members. Truly independent and inquisitive boards are the best safeguard against corporate wrongdoing and the best means for promoting the economic interests of the company and its shareholders.

We acknowledge at the outset that no laws or policies will ever be sufficient to end all corporate misbehavior. Unfortunately, some detrimental activities will always be a part of every human system governed by laws and regulations. But the recommendations of this report, if implemented, will go a long way towards curbing the excesses uncovered by recent scandals, and allowing the free-enterprise system to return to the task of producing valued goods and services for American and global customers on the one hand, while generating incomes for workers and shareholders on the other.*

The Central Role of the Corporation

The links between corporate behavior and economic growth and performance have helped to determine the ground rules of American capitalism. Anglo-American capitalism is distinct among capitalism’s global variants in its reliance on “public” sources of funding – stock – as opposed to “private” funding, such as direct holdings by banks or financial families, as is generally the case in Japan, continental Europe, and in emerging market economies.

This more open financial system conveys important advantages. By making the control of public corporations – and therefore most of society’s productive wealth – a contestable proposition, the system creates important checks and balances, as well as incentives, in the economy. Corporate directors and managers must respond to changes around them quickly and adeptly or, in theory, be vulnerable to displacement.

This openness has at times been criticized. In the 1980s, for example, critics claimed that the U.S. economy was myopic, and that the churning that is characteristic of the U.S. stock market, and the resulting rapid turnover of shareholders, had shortened management’s time horizons to a dangerous degree. By way of comparison, they pointed to the closely held financing of the Japanese economy and argued that this gave the Japanese more room to plan and innovate. A decade later, however, the two economies’ circumstances were reversed, and the open U.S. economy had proved more able to respond to the transformational imperatives of information technology. And both systems – Japan in the 1980s and the United States in the 1990s – fell prey to equities bubbles, although the more open U.S. system was much better able to right itself, avoiding the decade-plus of stagnation that beset Japan. To be sure, the U.S. system is not foolproof, but it does have the compelling advantage of putting pressure on directors and managers to adapt and innovate.

But the extent to which this model enjoys those advantages depends greatly on the extent to which the system solves the paradox of “the agency problem.” Economists long ago identified the separation of ownership and control in U.S. corporations.² But at the heart of this separation lies a conundrum: shareholders invest in corporations and hire managers to run them, but shareholders cannot know as much about the condition of those corporations as the corporation’s management knows. How, then, can shareholders assess the performance of their managers? A workable and efficient corporate sector requires that the managers of corporations be led – by culture, incentive, and regulation – to act ethically and in the interest of shareholders, without self-dealing, and to provide the market with an adequate base of accurate, timely, and meaningful information.

This cannot be deemed an automatic, certain, or natural result. Neither shareholders nor the public can rely on all corporate managers to provide accurate self-appraisal of their performance. Instead, the nation has developed various rules and procedures to provide such appraisals. The most prominent of these is the corporate board of directors. The debate over the behavior and structure of boards – over corporate governance in general – goes to this “agency” question.

Shareholders, theoretically, created boards of directors to act as their agents – to provide the assurance that corporations are being run by managers in the interests of their shareholders. The directors, supposedly chosen by shareholders, were to retain

* See Memorandum by Colette Mahoney (p.45).
management, and replace management if necessary, in order to provide such assurance. In fact, the reality is that in all companies of size, the management chooses the directors, subject to the formal approval of shareholders. Whenever corporate scandals occur, serious questions are raised about the reliability of boards of directors.

The concern over corporate behavior and many of the other issues that have arisen alongside it (e.g., executive compensation, shareholder rights, or accounting misstatements) in the past several years should be considered in this frame – these issues all share the problem of defining a role for boards of directors that leads them to align the incentives of managers and (current and prospective) shareholders. Boards must have directors who are truly independent, but independent directors need not be adversarial. A board needs to work with management towards common goals. In sum, getting agency capitalism “right” means devising a system – one that includes ethical standards; government law, regulation and oversight; corporate governance practices; business processes and management culture – that makes boards effective agents for shareholders, which in turn leads managers to work in shareholders’ interests.

Without the changes instituted in the 1970s, the abuses of the past decade could have been far greater. Nonetheless, the breakdown that we have seen since the bursting of the technology bubble is egregious, because it represents a regression from widely shared standards of integrity and accountability, and because it has real economic consequences.

CED, as a public-policy organization in which current and retired business leaders play a prominent role, is concerned about the reality, as well as the appearance, of corporate impropriety. We are unwavering advocates for the free market system, but we are just as firm in our belief that businesses and their leaders must earn the public’s trust. Perceptions that firms flout rules, behave unethically, and use deceptive business processes weakens confidence in, and support for, the free enterprise system. Daily reports on the front pages of newspapers detailing malfeasance at large companies continue to sap public trust. Instances of executive compensation that is untethered to economic value and violates perceptions of fairness lead to mistrust and the prospect of a stifling regulatory backlash. The ethical failing of a small number of corporate leaders is infectious: it undermines the ethical standards of their own firms and affects the behavior of others and, therefore, must be cured. By their actions, the board of directors and the most senior corporate managers set the ethical tone of a corporation and develop and sustain its ethical culture. Establishment of a culture of integrity is imperative if shareholder trust and, more broadly, public confidence in the free market system are to be secured.

These were the concerns that gave rise to Sarbanes-Oxley. But how well has that new law functioned in these regards? In this policy statement, CED addresses the state of corporate America after this landmark legislation. Specifically, we have chosen to focus on the following four vital questions:

- **First,** how should the financial condition of the corporation be reported to the public? What kinds of financial information, and other, non-financial indicators of value, should be developed and made public, and what is the right process for doing so?
- **Second,** how should publicly traded companies assure markets that the audit process is
independent and fair? Has the controversial Section 404 of Sarbanes-Oxley, relating to the effectiveness of internal controls, gone too far, and if so, how should it be changed?

• Third, how should the managers of corporations be compensated? What is society’s interest in executive compensation, and what, if any, rules should govern it?

• Fourth, and finally, how should corporate boards be selected and led? What are the characteristics of a “good” board? What is the role of the lead member? Should shareholders have more direct access to the nomination and selection process? And, how should boards be constructed?

These questions are addressed in the chapters that follow.
Because shareholders know only what corporate management elects to tell them about the corporation, a substantial body of law, practice and regulation has been created to govern the scope and substance of the financial information corporations produce to describe their performance – to help shareholders to see the corporation “through the eyes of management.” But the questions that underlie this body of law and regulation raise larger issues: How should the public corporation represent its condition to the world? How should investors comprehend a company’s financial condition and its drivers of value? The focus of this chapter is on the kinds of information that should be provided to investors, and what systems might best produce it.

Solutions begin with the role of corporate boards of directors. As agents of the shareholders, they must oversee the presentation of information that describes the corporation’s financial condition. Ideally, boards would see to it that effective systems provide appropriate, accurate information about the performance, conditions, risks, and prospects of the corporation in a clear and comprehensible form. Doing so raises two problems. The first is whether boards and management have the process, structure and incentive to provide this information. The second is that characterizing the state of the corporation requires various judgments. Reasonable people may differ, leaving boards and management with the difficult task of ensuring that the representation is fair.

The Role of Audit Committees

Investors depend on corporate boards of directors to be responsible for the oversight and presentation of relevant information about the company. To do so, boards must have access to all pertinent data. This requires an effective, competent, and independent audit committee. In practice, the audit committee must establish effective control over both the internal auditors and the independent outside auditors.* The roles of outside auditors are to verify the financial statements and disclosures, to evaluate the process that produces them, and to highlight relevant risks and weaknesses. Auditors must be independent of management and able to challenge management's information.

In 1976, the Securities and Exchange Commission persuaded the New York Stock Exchange to mandate that every company listed on the NYSE have an audit committee consisting solely of independent directors. (It also required that auditors report to the audit committee conditions discovered in their audit that struck them as suspicious, and required companies to have independent controllers.) These requirements produced substantial improvement in corporate governance, but in most instances the audit committee did not take control of the audit. The external auditors selected to provide an independent view to the audit committee were usually hired by management, had their compensations determined by management, and solicited other consulting revenues from management.

In addition, some audit firms lacked a process – or the will – to make sure that the audit partner for a particular client had no special ties or conflicts of interest. The instance of Enron was an extreme example – the Arthur Andersen partner in charge

* This chapter emphasizes the role of the audit committee in corporate governance. The final chapter discusses the importance of the board as a whole, and its independent members and other committees.
apparently allowed management to publish a manifestly unfair financial statement.* (This failure was abetted by a procedure, unique to Arthur Andersen, under which engagement partners were allowed to ignore opinions from their headquarters.)

Sarbanes-Oxley directly addressed these concerns. It required that every audit committee member must be independent, and that the board must report whether at least one member is expert in financial matters. Both of these criteria – independence and expertise – are hard to define, and regulators continue to struggle to find the right definitions to put into practice. But between the statutory requirement that these criteria be used, and pressure from the marketplace that they be used, we see ample evidence in our professional experiences that audit committees are becoming more effective.

In CED’s view, *the definition of who is a “financial expert” is less important than the relationship between the audit committee of the board and the external and internal auditors.* The misrepresentations, abuses, and frauds revealed in the past several years did not occur primarily because of a lack of financial expertise – Enron’s audit committee and its external auditors appeared to be well-qualified, but the audit committee did not take control of the process. Every audit committee must take charge.

The relationship of the audit committee with the internal auditors, though not dictated by law, is also crucial. The audit committee should exercise the same tone of control over the internal auditor as it does over the external auditor, extending to decisions of hiring, firing, and the setting of compensation. We believe the internal auditor must maintain a posture of operational independence. This standard of objectivity should be such that both the Public Company Accounting Oversight Board (PCAOB, which was created by the Sarbanes-Oxley law to regulate auditors of public companies) and the external auditor should be prepared to accept the work of the internal audit process if they are satisfied that it was independent and competent.

(Sarbanes-Oxley also required, in section 404, that companies’ public annual reports assess the effectiveness of their internal controls over financial reporting. This requirement has had important effects on corporate processes and has led many companies to incur significant costs. Some market participants have questioned whether the benefits of this process justify its costs. A separate chapter later in this report discusses that issue.)

---

**The Judgmental Nature of Financial Information†**

CED believes that the goal of financial statements must be to provide a truly fair and clear presentation of the firm. And for this to occur, markets must understand and accept that financial information is to a large extent based on judgments.

Even if the relationship between a board and its outside auditor is properly structured, a second problem in representing a company’s circumstances is that the representation is inherently judgmental and a result of many assumptions. This has always been so, among other reasons because the true value of assets held at any time depends upon future income, which is inherently unknowable. But it is especially true today. The present form of a financial statement, formulated in the bricks-and-mortar society of yesteryear when most assets were tangible, is obsolete. A large proportion of assets in today’s information- and knowledge-based economy are intangible, a fact that raises a host of new questions in the preparation of financial statements.

* On April 9, 2002, the Arthur Andersen partner in charge of auditing Enron, pled guilty to a single felony count of obstruction of justice. Federal prosecutors had charged him with orchestrating a large-scale effort to destroy Enron-related documents in order to hinder a federal investigation. Two months later, Arthur Andersen itself was found guilty of a single count of obstruction of justice for its role in the destruction of documents. In late 2005, however, the U.S. Supreme Court invalidated Arthur Andersen’s felony conviction on the grounds that the jury instructions in the case were too broad. Based on this court decision, the Andersen partner moved to withdraw his guilty plea, and as this paper goes to press, the motion is still pending.

† This section draws substantially from a report of the American Assembly, a national, non-partisan public affairs forum affiliated with Columbia University, titled “The Future of the Accounting Profession.” The report was co-chaired by Roderick M. Hills, who also chaired CED’s subcommittee on corporate governance. The American Assembly report is available at http://www.americanassembly.org.
Tangible assets can be depreciated – that is, their costs can be deferred and allocated against future revenues – relatively easily by amortization of historic costs based on a fixed schedule. The fixing of intangible values, however, although similar in theory, is more difficult in practice. Depreciation of either tangible or intangible assets requires that management employ various estimates and assumptions. Because reasonable people will often make different judgments on such matters, especially with respect to the value of intangibles, the inescapable conclusion is that it is not feasible to have “hard and fast” numbers in financial statements. Rather, there is a range of numbers available depending on which estimates and assumptions are chosen.

Consider, for example, the following questions.

What techniques yield the best valuations for such intangible assets as knowledge or brand value?

Over what period of time should expenditures for research and development be written off?

What approach should govern the ability of management to create reserves for contingencies and, by so doing, defer current income?

Although accounting rules for such issues exist, the answers to these questions are all debatable, with no universally “right” answer in reality. Together, these examples illustrate the larger point that “profits” or “revenues” are not like “temperature” or “mass” – they cannot be measured with precision. If they could, we could simply require that they be measured according to scientific standards. Instead, the standards by which profits are measured, no matter how well thought-out, inherently require judgment. The Economist magazine aptly described this problem as “the brittle illusion of accounting exactitude.”

This leads to a variety of tensions within the corporate reporting and governance system. The reality is that any depiction of revenue, cost, or net income in a large public corporation depends critically on the assumptions made by the depicter. This problem has been exacerbated by recent trends in business. For example:

- In the past 25 years, balance sheets have acquired a far higher proportion of intangible assets, as “knowledge” (often in the form of expertise or embodied in software) rises in importance in the economy. Valuation of an old-fashioned bricks-and-mortar firm was comparatively, though deceptively, simple, with the original cost of each tangible asset a known datum and estimated annual depreciation rates widely accepted. But some analysts have demonstrated that the values of many companies’ intangible assets today are as large as, or larger than, their physical assets. These intangible assets are generally situation-specific and not traded in markets. Their valuation, therefore, is inherently more difficult to determine.

- The use of historic costs in financial statements is being steadily replaced by current or “fair” values. This has the potential to make statements more useful. Historic costs for real estate, for example, may not capture substantial asset appreciation, and historic costs for equipment may underestimate the effective rate of depreciation in the face of accelerating technological change. But, again, such a change requires judgment. Current or fair values require either active markets in which particular assets are traded, or a strong element of judgment in determining their value. It should be noted that the use of fair values introduces more volatility into financial statements. Although such volatility makes period-to-period comparisons more difficult, it attempts to reflect actual (fluctuating) values of assets and liabilities.

- Sophisticated financial engineering has created new financial derivative products and risk-management techniques that sometimes make it unclear what belongs on a balance sheet. These may create risks or rewards in the face of parameters such as interest rates that are not under the firm’s control, but might nonetheless be material. A related problem concerns other special purpose entities that might be controlled by the firm, the consolidation of which must be determined as part of the audit.

These trends all exacerbate the problems associated with identifying a fair and clear depiction of the firm by requiring that judgment be exercised. In times of heightened market awareness, such as the technology
bubble of the late 1990s, and for shareholders who trade rapidly based on earnings projections sharpened to the penny per share, the pressure on the firm to generate and report attractive but falsely precise earnings numbers becomes intense. That pressure can lead to techniques of “earnings management” to ensure that over-precise forecasts are met.

This broad problem is exacerbated by the desire for comparability across firms in the same industry, so that investors can compare companies. The idea behind uniform standards is to lower the costs of investor decision-making by increasing comparability. But, a quest for too much comparability sacrifices both detail and accuracy. Analysts have been on an endless, and ultimately fruitless, quest for perfect comparability of results among firms. But most situations are unique, and each instance of judgment will differ from every other. This is the “brittle illusion of accounting exactitude” in stark relief.

In practice, this conundrum is addressed through the required use of financial accounting standards, so-called “generally accepted accounting principles” (GAAP). In the extreme, these standards – often referred to as accounting “rules” – have been described as a second tax code that governs the decisions auditors and management make on a daily basis.

CED believes that the distinction between an accounting system based on narrow rules and an accounting system based on broad principles should not be overstressed. In its extreme, such a distinction is a false choice – the line between the two is not hard and fast. Rules have principles, and principles have rules. Furthermore, as noted above, the integrity, ethics, and competence of management, plus rigorous oversight of the financial reporting process, are as important as rules and guidelines for developing financial information – an autonomous and vigorous audit committee will produce a better result than any particular set of rules. Still, the point on which thoughtful commentators can agree is that in the United States we should have fewer rules and rely far more on judgment and integrity in their application.

Over the years, GAAP has been transformed from a set of underlying concepts or principles to a veritable maze of rules that has so dominated the system that, for all practical purposes, what the rules do not expressly forbid has been deemed to be allowed.

In recent years, therefore, accounting has become far too much an exercise in rule checking, rather than an attempt to achieve a truly fair and clear presentation of a company’s financial position. The language accompanying auditing opinions states that the audited financial results “…fairly represent…the financial position of the company, in accordance with generally accepted accounting principles.” That simple statement has been tortured by lawyers and auditors alike to mean that any financial statement that is in accordance with GAAP is necessarily “fair.”

The race for ever more rules has been exacerbated by auditors who, fearful of litigation, have sought the precision of rules to avoid judgment that might be questioned in court. But the existence of such an abundant and complex set of static rules invites a search for loopholes and may encourage circumvention. In the recent past, the ability to circumvent the spirit of the rules while still being in compliance with them (and therefore being able to represent the same) has meant that rules give a false sense of security. At times, as a result, having rules can be more misleading than having no rules at all.

Regulators have added to the problem, for example, when they insist on narrow interpretations of the rules and require companies to restate when they have not been followed in minute detail. Auditors and companies cannot be expected to risk being reprimanded by regulators and forced to restate their financials because they attempted to implement rules “fairly” instead of as required in the letter of current regulations.

The inability of any set of “rules” to anticipate all of the situations that a firm’s financial accounts must confront, and the potential for circumventing unduly rigid or narrow rules, should make it clear that we have gone much too far down the path of rules. Instead of providing accountants only with prescriptive rules, accounting standards should begin with a broad, over-arching set of principles. Of course having too few rules can also be a problem. Thus, the current thrust of U.S. regulators – FASB, PCAOB, and SEC – who have relied more heavily on rules, and European and Asian regulators – under the
banner of the International Accounting Standards Board—has been towards convergence of accounting standards. Convergence would be especially helpful to multinational companies, which today have to meet differing standards.

The agenda for improving financial reporting, therefore, concerns how to redesign the financial reporting process to reach appropriate judgments. Part of this is a matter of the audit committees of boards living up to their responsibilities. For too long, the choice among alternative assumptions, accounting treatments, questions of materiality, and the like was considered the province of management, leaving auditors and audit committees to ratify management’s judgment. But this sometimes excessive delegation of responsibility is inconsistent with the responsibility of audit committees to provide a fair and clear presentation of the company’s financial condition.

Sarbanes-Oxley has changed this practice. Now auditors must provide audit committees with all alternative treatments of financial information that have been discussed with the corporation’s management, including the ramifications of those alternatives. Having that information means that audit committees now must determine whether management has chosen fairly from those alternatives. Auditors have the same responsibility.

**Recommendations**

In light of these realities, the presentation of information in financial reports must change, and the interested public’s understanding of that information must change as well. CED makes the following recommendations regarding the provision of financial information.

**First, stock analysts, the investing public, and regulators must recognize the inherently judgmental character of accounting statements and financial information.** Businesspeople, regulators, investment managers, and other market participants must ensure that this reality is made clear, in particular through full disclosure, whenever possible.

**Second, it must be widely understood that judgments have an enormous impact on the numbers used in financial statements.** Because financial statements rely on judgments, accounting cannot continue to rely on the brittle illusion of accounting exactitude. Ranges of values rather than precise numbers must be explained and understood as such.

This could be accomplished in any of several ways. Financial statements could present a “preferred” set of results (as approved by the board and its audit committee) and “alternative” results alongside them. Key results could be presented as estimates surrounded by ranges suggested by important assumptions.* Supplemental discussion of financial results, akin to Management’s Discussion and Analysis or in the form of expanded notes accompanying financial statements, could be required as part of standard quarterly and annual reporting. Most important, whatever the form in which judgments and alternative treatments play a role in financial reporting, regulators should encourage a format that ensures that management’s presentation is fair, clear and best understood by investors.

**Third, financial statements should be supplemented with important non-financial indicators of value in order to understand better the firm’s situation.** Some detailed examples of this type of reporting have been developed by the Enhanced Business Reporting Consortium.5 These examples illustrate, among other things, how a company might display in matrix form a sensitivity analysis of the impact of changes in such variables as currency exchange rates, interest rates, GDP growth, and sales price on the company’s revenue, net operating cash flow, and economic value added.6 Especially in the knowledge-based economy, a given set of financial results can arise from a wide range of underlying operating conditions. As a prime example, a bricks-and-mortar firm might show a given level of net income and a substantial value of as-yet-undepreciated physical assets on its balance sheet. Alternatively, an information-based firm might have the same current net income but far less in apparent assets, because its earnings were generated by employee knowledge and

---

*Some analysts have noted that “ranges” for estimates are usually construed as being statements of the range over which the value of a statistical variable has a certain percentage probability of occurring given an underlying inherent distribution. They express the concern that ranges in financial statements might be construed in the same manner—that, for example, the “true” value of net earnings has a 95 percent probability of being within the range. Presentations would have to be explicit regarding the implications of the ranges they present in order to avoid this confusion.
skills, the costs of which were expensed. Analysts might look at the information-based firm and incorrectly assume either a much higher rate of return on investment, or a depleted asset base. But even a comparison with a similar firm in the same industry could be problematic, with no meaningful asset values to measure and compare. How might financial reports fairly depict the condition of such a firm or for that matter any firm that relies significantly on intangible assets?

Pursuit of this end – the goal of financial reporting, providing investors with a fair depiction of the firm – may involve presentation of some non-financial indicators of value (subject to protecting confidential information that is truly essential to the competitiveness of the firm, and protecting the firm from exposure to lawsuits for good-faith efforts to provide more information), as is now undertaken by many firms.* Financial analysts and economists are the sources for numerous examples of indicators, such as vacancy rates for hotel chains. Recognizing that any possible indicator could be manipulated and distorted, much as could any projection of future dollar income, auditors and corporate boards will need to exercise judgment in their presentations, and investors will need to exercise no less diligence in interpreting these reports. Much of this information is already available in scattered sources, in particular from financial analysts who track individual companies – the goal of reporting would be to integrate it within the financial results to create a fuller depiction of the firm. Properly executed, such presentations could reduce somewhat the reflex reliance on pennies-per-share estimates, and the impulse toward earnings management that follows from it. Although such a system may take time to develop fully, CED believes that we must get started on this road.

Fourth, auditors should not be required, or assumed, to “attest” to specific numbers, such as earnings per share.

Auditors’ attestations should be seen as an opinion on whether the financial statements taken as a whole are fairly stated, not whether each number is precisely correct. If their “attestations” are properly qualified, investors will be on notice of the unavoidable ambiguity in the numbers.

Fifth, financial disclosures should be as clear and concise as possible, so as not to confuse the reader or bury unfavorable information. Proxy statements and annual reports now frequently run to 100 pages or more, and the use of obscure language makes it relatively easy for a company to hide bad news. Financial disclosures should be written in plain English. They should aim towards the spirit of transparency, not just the letter of the law. It has been noted, for example, that Enron “disclosed” in its 2000 annual report some $2 billion of complex financial transactions with entities run and partly owned by its chief financial officer. But those disclosures were incomprehensible and “buried at page 48, footnote 16 of Enron’s annual report.”

The Issue of Litigation

“Rules-based” accounting arose in part because of the desire by accountants and auditors for a “clear, bright line” between legal and fraudulent practices. In contrast, when judgment is needed to supplement or replace adherence to rules or other guidelines, a variety of questions are raised regarding the legal recourse of the investor and the exposure of auditors and boards. CED recognizes that such judgments are not likely to be made unless some protection can be developed to shield those making the judgments from unwarranted challenges from private, third-party litigation (as distinguished from regulatory action, which may also inhibit the use of judgment).

The risk is that, without such protection, the judgment used by the company and its auditors might or might not be found deficient, depending on the court and the moment. As is noted repeatedly in this statement, accounting assumptions and treatments are an area within which “reasonable people may differ.” The responsibility of management, auditors and boards is to guide investors through this thicket of uncertainty. Audit committees in particular will have to understand clearly the judgments that have been made and take responsibility for assuring investors that the
condition of the company is accurately represented by financial statements. But the system cannot function if individuals incur legal exposure in the process of providing additional information through reasonable judgments.

CED has frequently commented on its support for legal liability reform, and shares with many Americans the concern that litigiousness has negatively affected many corners of the economy and society. But our goal is neither to address the problem of whether our society has too many plaintiffs, nor somehow to “move the line” regarding litigation. Rather, our goal is to keep the “line” where it is – to stop it from moving, as an unintended result of necessary changes in accounting practices, and further inhibiting the necessary application of judgment. Our view is that the reasonable exercise of judgment in preparing financial statements should not be subject to excessive litigation so long as the judgment is made in a transparent and informed manner, free of fraud.

This is a reasonable standard, but its implementation is difficult in practice. However, such a standard could be widely accepted once the SEC, supported by the new Public Company Accounting Oversight Board, demonstrates its capacity to monitor firms and their reporting on financial statements for misrepresentation or other high-risk behavior.

Audit failures have invariably been by companies on the “watch list” of their external auditor, a list which is already shared with the PCAOB.* PCAOB’s maintenance of such a watch list, plus the SEC’s massive electronic “Edgar” database of all filings, could help to set inspection priorities to protect the public. The PCAOB, by assigning an inspector to review the audit of each firm on the watch list, perhaps annually, in the manner that the Comptroller of the Currency uses bank examiners, would provide significantly improved investor protection.

The system should be redesigned starting with the premise that any misbehavior uncovered by these inspections will be dealt with either by the PCAOB, the SEC, or the Justice Department, depending on the severity of the offense. With that assurance to the public, the SEC, strengthened by the inspection capacity of the PCAOB, could use its existing authority to provide a limited “safe harbor” that would prevent third-party litigation from challenging good-faith judgments made by auditors. Any such safe harbor would need to be constructed carefully and would not be politically feasible until the PCAOB has demonstrated its capacity to examine the high-risk audits. At the same time, any malfeasance by auditors would continue to be subject to challenge by the SEC and, in criminal cases, by the Justice Department. The PCAOB’s far greater access to both the auditing firms and to the high-risk audits enhances the government’s ability to go after the most egregious cases of accounting manipulation.

An alternative to the “safe harbor” approach could be the creation of a special federal court for adjudicating such disputes, as now exists for such functions as bankruptcy or family law.

The relief provided to good-faith auditors by such a system of safe harbors or expert courts would further encourage the prudent use of judgment, leading to more transparent and informative financial statements. The long-term interests of investors would be better served than they would be by extending the cycle of litigation, which in turn would only encourage more “defensive accounting.”

The approaches advocated here would encourage audit committees to pursue their assignments with vigor, would enhance transparency, and could provide significant improvements in the quality of the information provided to investors.

---

* Audit firms maintain internal rankings of the risk in the audit process, such as from the risk of failure of the firm, past errors in the audit, management’s tone, etc. These rankings may take any number of forms, such as numerical rankings or grades, but inevitably designate those firms in the greatest danger of failure. Following a convention often found in the audit industry, we refer to these firms as the “watch list.”
Since the SEC acted in 1997, bolstered by the Foreign Corrupt Practices Act, publicly traded corporations have been required to maintain adequate internal controls on their financial reporting. Section 404 of the Sarbanes-Oxley Act of 2002 further bolsters that obligation by requiring these companies to make an annual assessment of the effectiveness of their internal controls. Additionally, each corporation’s independent auditors are now required to audit and report on management’s assessment process.

This requirement has become the center of a growing debate. To the detractors, Section 404 is a cost burden with little real return – some call it a “compliance tax” on public companies. They see the compliance costs created by Section 404 as discouraging private companies from going public, and perhaps driving some public companies private. There may well be cases in which this has occurred, and there are undoubtedly steps that could be taken by the SEC and the PCAOB to reduce unnecessary costs; the situation of smaller firms requires particular attention. But on balance, CED believes that Section 404 is a positive element of the American corporate governance system. It forces management to do formally what they had too often not done even informally: to review their internal control systems and discover ways to improve them.

The greater problem is that the basic audit has become a commodity that is seen by management as having little intrinsic value. Section 404 provides an opportunity to integrate the external audit with the 404 process and make the unified effort a far more valuable management tool. Those long-term benefits of Section 404 should not be forgotten in the context of its short-term, and in some measure one-time, costs.

The Value of Section 404

Section 404’s detractors see it as a tax. The danger is that some companies will treat it that way. Just as too many companies treated their audits as check-off exercises, Section 404 compliance can become an expensive appendage to management processes for those companies that ignore its positive aspects.

However, a growing number of companies are coming to see their investments in the Section 404 process as having created a valuable management tool. By forcing their attention to the control process, Section 404 allows management to identify weaknesses and to understand their businesses better.

Many firms report that the compliance process has allowed them to identify control-design improvements and to consider the underlying business processes. Potential improvements include the ability to standardize processes, to share best practices across business units, to leverage technology in improving processes, and to focus better on strategic issues revealed by the Section 404 process.

And if the process yields improved investor confidence, as intended, benefits would extend to more efficient capital markets and better allocation of capital in the economy as a whole. A May 2004 survey by the Institute of Internal Auditors concluded that almost a third of respondent firms approach Sarbanes-Oxley with long-term plans for achieving compliance beyond the attestation required by law. Forty percent see the law as an opportunity to create value for the company. Investors have the same perception. A study by McKinsey & Company found that investors are willing to pay a 14 percent premium for better governance.
Then-SEC Chairman William H. Donaldson recently summarized this calculus in a letter to the Wall Street Journal:

...Public companies have been working overtime to document and assess the effectiveness of their internal controls over financial reporting, and their accounting firms have been diligently testing and preparing reports regarding those controls. This effort will, of course, help to protect against fraud and the misuse of corporate assets. But it should also improve the quality of information companies report to their shareholders, along with the quality of information management relies on to make decisions. So while investors will benefit from enhanced protection against misconduct, they may also find that the companies they have invested in are better managed.

We are already seeing the results. A number of companies have uncovered lurking weaknesses in their controls and disclosed what they have found, and are working to strengthen them. Armed with information about these weaknesses and the remediation plans, investors appear to be making reasoned judgments about whether those disclosures affect the mix of information they use to make investment decisions.11

In a 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley compliance, 74 percent of financial executives said that their companies had received benefits from Sarbanes-Oxley compliance, and 57 percent said that they believed the costs incurred were a good investment for shareholders.12 Reflecting this sense, General Electric Chairman and CEO Jeffery R. Immelt wrote in his 2004 Letter to Shareholders:

None of us likes more regulation, but I actually think SOX 404 is helpful. It takes the process control discipline we use in our factories and applies it to our financial statements. Implementing SOX 404 cost GE $33 million in 2004. But we think it is a good investment ... Investors should demand high standards of governance and great performance. Some managers failed investors in the late 90s. Companies were destroyed, value was lost, and billions are being paid because of fraud. This happened. SOX 404 is by no means perfect, but it is a price we are willing to pay to restore investor trust.13

The Costs of Compliance

The costs of complying with Sarbanes-Oxley, driven by implementation of Section 404, are sizable. Foley & Lardner, a law firm, noted in its survey of 2004 compliance costs that “the average cost of being public has increased 223 percent for public companies with under $1 billion in annual revenue since the enactment of Sarbanes-Oxley.”14 The survey also noted that the average cost of being public for these same companies rose by 33 percent between 2003 and 2004 alone.15 In 2004, General Electric reported spending $33 million on Sarbanes-Oxley compliance. Similarly, Boeing and Kraft Foods reported 90 percent increases in audit fees from 2003 to 2004, which can largely be attributed to efforts to comply with the new regulations set forth by Sarbanes-Oxley.16 A survey conducted by Financial Executives International of 217 companies found that they spent, on average, $4.36 million complying. Companies with over $5 billion in revenue averaged costs of over $10 million; firms with under $5 billion in revenue spent an average of $2.7 million. Compliance costs likely vary significantly according to many firm characteristics as well as mere size.17

The true costs are not yet known, and these estimates, however accurate, are typically made for only the first year of implementation, in which one-time fixed costs of setting up compliance systems were assumed. Substantial costs have been incurred developing new control systems, documenting existing ones, and training employees in the proper use of both. Some costs were incurred because the regulations were still being written as companies and auditors were already trying to meet new standards. Uncertainty and caution on the part of many auditors caused them to refuse to offer advice to clients out of concern that doing so would compromise their independence. There were costs incurred in repairing the pre-existing control deficiencies that were found.18 Once what amounts to “deferred maintenance” of compliance systems is out of the way, steady-state costs should be lower; a survey of 90 of the Fortune 1000 companies yielded an estimate
of 46 percent lower costs for 2005 relative to 2004.\(^{19}\) Moreover, any reviews of financial and accounting controls that were undertaken before Sarbanes-Oxley are probably built into estimates of current costs. Again, these figures do not tell us whether the effort has produced results; implementation costs are evident immediately, but benefits may emerge only over time.

The most consistent complaints regarding Section 404 relate to timing and to firm size. Many companies were slow to understand the effort required by Section 404. In many cases, they struggled to catch up and had to devote extra effort to rectify control deficiencies resulting from years of “deferred maintenance.” The supply of accountants is relatively fixed in the short term, and there are now not enough to go around. The Big Four accounting firms are shedding clients and turning away new ones. The small number of major accounting firms and their market power is a matter of concern, and has, in some ways, tipped the balance between management and external auditors back to the auditors.\(^{20}\)

Some companies complain that their external auditors refused to accept the work done by the internal audit process and, thus, have incurred unnecessary expense by repeating that work. These complaints appear to be legitimate, and the PCAOB has taken steps to alleviate this issue.

This overall 404 problem is particularly pressing for smaller companies. Many of these companies have had only informal controls in place. For them, the 404 process has proven to be difficult and expensive. The Foley & Lardner study cited above estimated that audit fees for companies in the S&P Small-Cap 600 index rose an average of 84 percent in FY2004, to over $1 million.\(^{21}\) Based on reports from small businesses, the SEC in September 2005 voted to extend to July 2007 the deadline for small business compliance with Section 404. That extension, however, was accompanied by an admonition from SEC Chairman Christopher Cox that the decision to delay implementation “in no way reflects a desire to back away from the letter or spirit of Sarbanes-Oxley requirements.”\(^{22}\)

CED does not recommend a broad exemption to Sarbanes-Oxley requirements for small-capitalization companies, but nevertheless believes that the process through which ongoing compliance and certification is achieved should be re-visited, and ways to mitigate the cost to smaller companies should be explored.

CED’s Recommendations

We do not believe that Sarbanes-Oxley requires legislative changes. \textbf{CED sees room to tailor the requirements imposed by Section 404 within the existing statute, and endorses the implementation guidance released by the PCAOB and SEC based on their evaluation of the first-year experience with section 404. The guidance, issued simultaneously by the two agencies in May 2005, should lower the costs and increase the value of section 404 compliance.}

The guidance emphasizes integrating audits of internal control with audits of financial statements; exercising judgment to tailor work to high-risk areas rather than using standardized checklists; using a top-down approach to distinguish between areas that require further testing and areas that may safely be disregarded; using the work of internal auditors

\footnote{COSO refers to The Committee of Sponsoring Organizations (“COSO”) of the Treadway Commission’s publication, \textit{Internal Control – Integrated Framework} (the “COSO Report”). An exposure draft, released by COSO in October 2005, proposes new guidelines to reduce the section 404 compliance costs for smaller companies. As CED’s report is being prepared for publication, the COSO draft can be accessed at \texttt{http://www.ic.coso.org/}.}
and others whose work can be trusted; and engaging in direct communication between management and external auditors on various issues before decisions are made or controls put into place.

Two aspects of the agencies’ guidance are particularly important. First is the agencies’ call for an integrated audit. We believe the entire audit process should be redesigned, in light of the productive and beneficial aspects of Section 404 compliance, to make the external audit of financial statements and the Section 404 audit of internal controls over financial reporting a single process. An integrated audit would be far more of a management tool than is today’s external financial audit, which has become too much of a commodity.

Second is the emphasis placed on the use of judgment. Both the PCAOB and the SEC placed strong emphasis on “reasoned good faith exercise of professional judgment focused on reasonable, as opposed to absolute assurance.”

There is evidence, as indicated above, that the accounting firms and the corporate community at large are becoming aware of the potential for such positive developments, which would benefit firms and shareholders alike.

Substantial financial and ethical abuses by corporations imposed significant costs on shareholders, workers, and society at large. A large-scale legislative remedy imposed its own costs of transition, and involved its own inevitable uncertainty and inexactitude. Over time, after implementation problems are encountered and solved, and start-up costs are absorbed, the greater information and security for shareholders, and the improved internal control for firms, should yield substantial net benefits for all parties.
IV. How Should Managers Be Paid?
The Problem of Executive Compensation

Over the past 20 years, the average pay of top corporate managers has become dramatically, and in our view too often unjustifiably, higher. That is true both in absolute terms and in comparison to the wages of the average corporate employee. Three researchers from U.S. business and law schools report that the average CEO of a company included in the Standard and Poor's 500 stock index made 400 times what the average worker of such a company earned in 2000, in contrast to 82 times that pay only eight years before.23 Other researchers using a different methodology found a multiple of 300 times in 2000, compared with only 24 times in 1965.24 Pay differentials have apparently declined somewhat since the end of the Internet boom but remain at vast multiples of the differences of earlier years. These burgeoning differentials have made executive pay a matter of public scrutiny, and the issue has gained added prominence because of the extraordinary compensation obtained by CEOs in numerous recent high-profile cases of corporate fraud.

In CED’s view, the disparity of income between top corporate executives and average employees is a cause for serious concern, because it is socially divisive and casts doubt on the fairness of the market system. In addition, such pay disparity is contagious, spilling over to other parts of the economy. CED continues to believe that compensation should be determined by the market, and that it must reflect the productivity of the individual in question. We are fundamentally opposed to specific rules, laws, or regulations that place artificial limits on compensation, or that prohibit boards from making compensation decisions based on the performance of the individuals involved, fairly appraised. But we are concerned that the differentials that exist today too often reflect neither market conditions nor individual performance.25 Our view is that the process for determining executive compensation has been broken at far too many of our larger corporations. This is borne out in studies demonstrating no statistically significant relationship between compensation and performance measures.26 Thus, the presence of these sizable pay differentials is a troubling indicator that something is wrong in the process by which executive pay is determined.

* The solution to excessive executive compensation must be regarded as a matter of process and disclosure.* At the center of this process sits the compensation committee of the corporate board. Compensation committees propose executive pay packages, which are approved by the full board. This requires that the compensation committee has an informed and objective view of management’s performance, a sense of a market-determined value of management’s services, and the ability to negotiate with the CEO at arm’s length. It must also have comprehensive information about the total compensation package including special retirement benefits, other deferred compensation, and awards in the event of early termination of a top executive or change of control of the company, and what that package could be under different possible circumstances.

At present, the process of information gathering, especially in larger companies, often involves compensation consultants who provide the board with a distribution of executive compensation packages at a range of chosen “comparable” companies. At this point, the system too often breaks down. Consultants present the board with a distribution of comparables, which can be chosen to predispose the process toward higher pay. The board is left to determine where their

---

23 We note that as this paper goes to press, the SEC has published for comment proposed rules to enhance disclosure requirements for executive compensation.
CEO should be placed within the distribution. But boards too often lack performance goals to make this judgment, too readily accept the “comparables” as being correct, and lack a holistic view of the entire compensation package. They may be extremely hesitant to depict their CEO’s performance as being “below average” for fear of not only offending the CEO, but also depicting themselves as being incapable of finding a better CEO, and sending a public signal that firm performance has been sub-par. Thus, the inclination is to categorize the CEO as superior to his or her peers, with a salary in the higher part of the population of “comparables,” in a fashion reminiscent of the mythical Lake Wobegone, where “all the children are above average.” The result is that the distribution of “comparables” keeps rising, creating a spiral of total executive compensation.

Recommendations

CED supports a set of seven recommendations, the first five of which were put forward by its Trustee, Peter G. Peterson, Chairman of the Blackstone Group and co-chair of the Conference Board Commission on Public Trust and Private Enterprise, and echoed in the recommendations endorsed by that group.

**First, compensation committees should adopt measurable, specific, and genuinely challenging goals for the performance of their businesses, and judge management on their ability to achieve them.** These goals should be financial (such as returns on assets, investment, or equity), strategic (market share, quality improvement), operational (margins, revenues or profits), and social (such as adherence to the corporate code of conduct, communication of ethical standards to employees, environmental compliance, worker retention). These standards should be challenging to management; the board must not in effect lower the bar to ground level, such that management cannot possibly fall short. Once agreed upon by the board, these standards should be the yardstick by which management is measured.

**Second, the compensation process must be run by independent compensation committees.** Compensation consultants, if any, should have no business or other relationships with management (neither should the firms for which they work). They should be hired by and report to a compensation committee of the board that is autonomous from management, and that controls the terms of the consultant’s engagement. Compensation committees should consider engaging new entrants and others beyond the usual consultants. If the firm is too small to hire a consultant, or if in any event a consultant of sufficient independence cannot be engaged, then the compensation committee must meet the strict standards of unbiased judgment. The compensation committee should have direct authority over all terms of management’s contracts, including all forms of compensation (pay packages, retention, retirement, major perquisites, and so on), and they should thoroughly scrutinize those terms and understand their potential interactions.

**Third, management should have a substantial equity interest in their company.** This interest should be over and above equity derived through options or grants. Barring exceptional circumstances, management should act as “buy and hold” investors.

**Fourth, management should make a full, timely, and transparent disclosure of its compensation to stockholders.** The compensation discussion should be presented in one place in the company’s disclosure, including all forms of compensation. Disclosures should be comprehensive and easily understandable. They should make clear how “comparables” were chosen and how top officers would be compensated under plausible retirement or change-of-control situations. They should not be written to obfuscate or hide information by overwhelming the reader with unrelated, useless information. As this report is being prepared for publication, the SEC has voted to propose new disclosure rules for executive compensation. At first glance, these rules appear to carry out CED’s recommendation for improved disclosure. (See Box.)

Disclosures can be a powerful tool to curb excess compensation that has long remained hidden, and the SEC should consider better ways of showing the relative size of executive compensation and its trend. For example, it could require companies in their annual proxy statements to calculate and disclose the ratio of the present value of their CEO's compensation compared to the company’s average full-time employee
Proposed SEC Changes to Disclosure of Executive Compensation

On January 17, 2006, the Securities and Exchange Commission published for comment proposed rules to enhance disclosure requirements for executive compensation and related matters (notably related party transactions and director independence). The following is a summary of the proposed changes. Companies would be required to prepare most of this information using plain English principles in organization, language and design.

The centerpiece of the proposal is to change the currently required tabular presentation of executive pay and to improve the narrative discussion. The objective is to provide a complete disclosure of compensation of the principal executive officer, principal financial officer, and the three other highest paid executive officers. Disclosure rules would also apply to the company's directors and to employees other than the named executive officers who are paid more than those executives.

Disclosure of executive compensation would be organized into three broad categories and reported for the last three years: cash compensation; equity-related compensation that is a source of future gains; and perquisites, retirement plans and other post-employment payments and benefits. A summary column would add all forms of compensation into a single, comprehensive number. (Rules may allow small businesses to avoid high compliance costs by publishing a single compensation figure for executives.)

Equity-based awards, including stock and stock options, would be reported as a present-value dollar number measured as the fair value on the grant date, as computed according to newly applicable accounting standards (FAS 123R). Two supplemental tables would report grants of performance-based awards and grants of all other equity awards. These tables would indicate amounts realized on equity compensation during the last year and amounts that may be received in the future.

An “all other compensation” column would include the aggregate increase in actuarial value of pension plans accrued during the year and all earnings on deferred compensation that is not tax-qualified. Also included would be disclosure of amounts payable on termination or change in control. Other compensation would include any perquisites valued at the new lower threshold of $10,000.

A new narrative section called Compensation Discussion and Analysis is modeled after the Management Discussion and Analysis section required in current financial reports. The new compensation discussion would address the objectives and implementation of executive compensation programs. It would focus on key factors underlying compensation policies and decisions.

Source: Securities and Exchange Commission Fact Sheet, January 17, 2006

over several years.* The display of such a figure would allow boards, investors and others to evaluate its appropriateness and its comparability to similar calculations in other companies.†

Fifth, choices of forms of compensation should promote the long-term value of the firm, rather than exploit *The basic concept, which should include auditor verification, is subject to various permutations based on the definition of compensation, the person or group subject to disclosure, and so on. One simple variation would be for companies to report the ratio of the CEO's compensation, as reported to the IRS on the W-2 form, to a similarly calculated amount for the average full-time employee.

favorable accounting or tax treatment. We note that recent changes in accounting for stock options require that options be expensed on the accounting statements of public companies. The expensing of options should neutralize a bias that has favored their use in recent years. The compensation committee must make clear the effect of its compensation decisions on stockholder dilution.

Sixth, severance compensation, like all other forms of executive compensation, should be reviewed carefully against criteria set by the compensation committee of the board, and the board should publicly provide full

† See Memorandum by Josh Weston (p.45).
details of awards and explain publicly to shareholders the full reasoning behind the granting of such awards. Public confidence in corporations has been impaired not only because of the mounting gap between top pay and average employee pay, and the relative rates of increases of pay awards at those levels, but also on account of rewards of extraordinary levels to CEOs as severance compensation. Such compensation arises, in particular, when CEOs have been prevailed upon by boards of directors to resign, or as a result of mergers in which the CEO has played a central role. In some cases, it has appeared that the level of compensation has been arbitrary, unrelated to any standard of executive performance pre-determined by the board of directors. Companies would be well-advised both to rein in the amount of severance pay and to tighten conditions by which executives are compensated in change-of-control situations, for example, by stipulating that executives will only be compensated if they actually lose their jobs as a result of a merger or acquisition.

High-profile top-executive severance cases, such as those in recent times at the New York Stock Exchange and the Walt Disney Company, underscore the importance for corporate reputations and for shareholder confidence of boards of directors fully and comprehensively familiarizing themselves with all aspects of complex executive contracts prior to voting for them, rather than relying too greatly on the views of management.

Seventh, companies should have the right to recapture bonuses awarded to top executives in error, because financial results justifying those awards later are restated adversely. Executives should not reap rewards based on false information from inaccurate accounting. In 2004, amended filings for financial restatements rose to a record 414. When accounts are restated and previously achieved targets no longer provide a basis for bonus awards, executives should be required to return those awards. At present, Sarbanes-Oxley allows the SEC to require that bonuses be paid back only if there is evidence of misconduct. In some cases, however, companies have also sought to recover bonuses even where fraud is not present. International Paper, for example, has added provisions to its long-term incentive compensation plan to allow the company to recover compensation paid when there is a restatement of the company’s financials. Some companies, such as Nortel Networks, have sought and obtained voluntary repayment of bonuses from senior executives and have filed lawsuits where voluntary compliance could not be achieved. In conclusion, corporate boards must fully appreciate that media attention to exceptionally large executive compensation packages, often in connection with disturbing revelations about a corporation’s practices, have contributed to an erosion of public confidence in the leadership of major enterprises. Thus, disclosure, as noted above, is especially important. Corporations must make fully transparent to shareholders the criteria, methods and reasoning used in determining total compensation. As we write this report, the SEC has indicated its intention to address the issue of companies’ reporting on executive compensation. Only with transparency can trust in the system be restored.
Effective stewardship by boards of directors requires a commitment to shareholder interests in the corporation, as opposed to the distinct and often different interests of management. But to meet this commitment, how should boards be assembled? What is the right way to select directors—and therefore to represent shareholders in their dealings with management?

Although Sarbanes-Oxley calls attention to the role of the board’s audit committee, the board of directors as a whole is responsible for having systems in place to enable the corporation to comply fully with all laws and regulations, and to provide comprehensive and clear information to shareholders and the public. The board assigns specific areas of governance to its committees that typically include a compensation and nominating/governance committee in addition to the audit committee. These committees are increasingly important in enabling the board as a whole to meet its responsibilities and to build public trust. But the ability of these committees to do so depends to a very large degree on the manner in which the independent directors are selected.

A paradox of corporate stewardship is that despite the principle that directors represent shareholders in the selection and retention of management, historically most directors have been selected by management. Where CEOs control the selection of directors, as they do in most companies, there will be a suspicion, often justified, that directors are not as independent as they are expected to be.

The Characteristics of a Sound Board of Directors

Effective oversight by truly independent directors can prevent many of the kinds of abuses that have occurred in recent years. (See Appendix on the role of independent directors.) Many of the conspicuous corporate governance breakdowns of the last ten years have been blamed on the failure of independent directors to monitor corporate managers properly. The earlier sections of this paper, and the press, have focused on the role of the audit committee, but the need for reform extends to the entire board. Independent directors play a key role. Stock exchange listing standards require companies to have boards with a majority of independent directors and to have nominating and compensation decisions made by directors who are fully independent. Listed companies are expected to have an executive session of independent directors at least once a year, and many boards now have executive sessions of independent directors at virtually every board meeting.

Board Chemistry and Skill

What are the characteristics of a high-quality board of directors? One is a blend of compelling and complementary talents, backgrounds, and perspectives. Another is cohesion, the ability to work together built around a shared commitment to the long-term well-being of the corporation. A third is candor and openness to dissent and adherence to ethical standards, such that potential problems will be investigated fully. A fourth is a finely constructed, balanced relationship with management. We have repeated throughout this statement the importance of a board’s independence.
been found to be an “imperial” CEO. And some companies have chosen to split the roles of CEO and chair with positive results. But having a non-executive chair is not a panacea. There is no way to be certain in advance whether the non-executive chair will be more interested in protecting the CEO from aggressive committee chairs than in conveying views of the board to the CEO.

CED believes that should the chief executive officer hold the position of chairman of the board of directors, it is crucial that there be a clearly designated, and diligent, lead independent director. That individual might logically be the chair of the nominating/governance committee, because he or she has a base within the board from which to work, and is already charged with the responsibility of holding the board to the highest ethical standards.

The function of a non-executive chair or a lead independent director, whether or not he or she is designated as the board chair, is among other things to organize the participation of all board members, participate in setting the agenda of the board, and be a conduit of communication to the CEO. That person also has a role in ensuring appropriate follow-through on items requested by the board. (The Appendix provides a broader list of suggested responsibilities for the lead independent director.) A non-executive chair or a lead independent director is not empowered to run the corporation on a day-to-day basis, or to interfere with the work of the chief executive officer – or, for that matter, to protect the CEO from a diligent board, or to interfere in the work of such a board. His or her role is to head off the potential for inside dealing that has followed from an excessive concentration of power and control.

If a company has a lead director, he or she should not automatically rotate out of the position on a fixed schedule. It is important to have continuity of leadership and responsibility in the lead director position.

Recent Proposals to Change the Nomination and Election Process

In the wake of the reconsideration of the role of boards following Enron and WorldCom, institutional shareholders have sought to exert greater influence
investors are rarely in a position to hold even one percent, much less five percent, of a company’s stock, or to take on the search and transaction costs associated with board nominations, let alone a proxy election. In reality, the “minority” investors who stand to benefit the most from such a proposal are institutional investors such as mutual and pension funds. If any 5-percent shareholder can start a proxy fight with the corporation’s money, the interests of the other shareholders can too easily be sacrificed. During the second quarter of 2005, U.S. institutions held over 60 percent of domestic corporate equities, according to the Federal Reserve, generally in larger blocks than individual investors hold. To be sure, many institutions (“funds”) may have the longer time horizons associated with investment rather than speculation, and many have tried to use their holdings to have a positive influence on the companies they hold. But this is not universally the case. Some pension funds are administered either by elected government officials (in the instance of some public pension funds) or unions with interests that may be at odds with the long-term economic objectives of the companies in which they invest. Other large holders are private fund managers who may be hesitant to act against management for fear of losing fund management business, such as the management of some part of the corporation’s savings trust or pension plan. Other large “minority” holders may have other business interests that raise potential conflicts; they may have board positions on firms that they buy and sell, or that they seek to combine, to the detriment of other shareholders.

There is no a priori way of knowing the extent to which these conflicts may occur. But they will probably occur over the selection of directors. Their initial proposal, since rebuffed, asked for the right under some limited circumstances to put forward their own candidates for board membership through access to a company’s proxy – a change that would significantly reduce the cost of seeking a board seat.

A second proposal, discussed later in this section, would change the standard for director elections.

**Direct Nomination by Shareholders**

The issue of who will select the independent directors takes on added significance in light of proposals considered by the Securities and Exchange Commission to allow shareholders, under certain circumstances, to nominate directly candidates for board membership. One variant would allow a shareholder, or group of shareholders, owning at least one percent of voting shares outstanding for at least a year, access to the company’s proxy solicitation to nominate directors for election if they submitted a governance resolution that subsequently received more than 50 percent of the votes cast on it. Another trigger would allow a shareholder, or group of shareholders, owning five percent of voting shares for one year, access to the company’s proxy solicitation to nominate directors if 35 percent or more of votes cast for one or more director nominees were “withhold” votes.

At present, the SEC has shelved consideration of these proposals. Nevertheless, many institutional shareholders and other commentators continue to press for such changes.

CED has serious concerns about these proposals, and others like them, to facilitate direct nomination of directors by shareholders. **CED does not, today, support proposals that would facilitate direct nomination of directors by shareholders.** Although the development and protection of “shareholder rights” is of indisputable importance, we believe that proposals to allow direct shareholder nominations may not be entirely consistent with that ideal. Investors already have the right to propose nominations to a company’s nominating committee.

These proposals summon up images of “independent stockholders” — alternatively, widows and orphans, or, to the fears of many, advocates of political or social causes that might not be consonant with the best interests of all shareholders. But these individual

---

* Foreign investors held approximately 15 percent of U.S. equities. The remainder was comprised of U.S. households, non-profits, and other entities.

† Some investment funds do the opposite. They delegate voting of portfolio securities to “independent” organizations such as Institutional Investor Services (ISS). In doing so, they shift voting power from shareholders who have an economic interest to an organization with no direct economic stake in the corporation. CED is concerned about such practices and intends to address this and other issues in a follow-on report. Our current view, however, is that funds should be transparent about how they vote proxies and they should not side automatically with either management or those who challenge management.
with enough regularity to challenge the assumption that institutional investors and fund managers have interests identical to those of “all shareholders,” particularly small investors.

Also, it is almost impossible to imagine that a board assembled with one or more proxy fights could function constructively. The ugliness of the fight is not conducive to creating the cohesion that is essential to a well functioning board of directors. Although most boards would be unlikely to yield to such pressure, the notion that proxy fights could be started so easily would discourage a very large number of competent people from accepting a board position.

For these reasons, CED has serious concerns about proposals to give large minority shareholders more power over the board selection process.

The Majority Vote Approach
A better first step in using the annual meeting to reshape a board would be to adopt a version of what is often referred to as the “majority vote” condition. This proposal is that corporations should agree that any director who has more than half the votes present at an annual meeting withheld from his election will not be allowed to take a seat on the board.

Generally, state laws dictate that corporate directors are elected by the votes of a plurality of shareholders, unless otherwise provided in the corporation’s by-laws or charter. Under a plurality standard, the candidates garnering the most votes are elected; they need not achieve a majority. This might seem on the surface to be a robust process, and in contested elections it works well. If there are 12 candidates seeking nine seats, the nine with the highest vote totals win. However, contested board elections are rare in the United States. In the typical uncontested election, where, say, a slate of nine candidates is nominated for nine board seats, a plurality for any individual is guaranteed by just a single vote.*

Changing the standard for electing directors, from a plurality of votes cast to a majority of votes cast, is seen by proponents – mostly institutional investors – as enhancing the accountability and legitimacy of corporate boards, without incurring the drawbacks of entitling shareholder nominations.

We note that several companies, initially led by Pfizer, have announced their intention to adopt a majority vote standard voluntarily. In several cases, companies have revised their governance principles (although not their charter or by-laws) to require any director who received more “withheld” votes than “for” votes to submit his or her resignation to the board. The board would then nominate a successor.

In principle, we support the view that an individual who does not have the support of a majority of voted shares should not be a director of a public company. In practice, a majority-vote standard can take many forms. As legal committees, regulators, and legislatures examine the pros and cons of these forms, we believe individual companies are in the best position to judge what version of a majority-vote standard is most suitable.

Reform of the Board’s Nomination Process: A Better Way to Construct a Board
The manner of selection and renomination of independent board members is of central importance in corporate governance. But sound governance practices can build high-quality boards without adding new regulations on top of the substantial restructuring of Sarbanes-Oxley that is still being digested by the corporate community. Companies can act on their own

* Current regulations allow shareholders only the choice of voting for a board candidate, or withholding their votes; and elections are decided by a plurality of votes. Votes to withhold, under current regulations, have no effect. Accordingly, and in theory, a board candidate can be elected with a single affirmative vote. Following from this, there are actually three procedural considerations behind the apparently simple concept of “majority voting,” which requires, in the first instance, considering votes to withhold support as negative votes, rather than merely ignoring them. The first procedural consideration is whether a voting result is judged relative to the number of shares outstanding, or the smaller number of shares voted. Virtually all discussion of this issue is in reference to the number of shares voted, because a large number of shareholders, including probably some of those most satisfied with the state of the corporation, simply do not bother to vote their shares. A second consideration is how to handle abstentions. The third consideration under majority voting is whether, with both of the above questions settled, a board candidate must have a majority of votes cast “for” to be elected; or whether opponents must have a majority of votes cast “withhold” to defeat the candidate, in the event that some shares are abstained or the vote is measured relative to shares outstanding.
to bolster nominating committees and the committees’ processes for choosing new board candidates, evaluating the performance of existing board members eligible for re-nomination, and recommending committee assignments and chairmanships.

The best approach to building high-quality boards is to assign to truly independent nominating committees the responsibility for recommending new board candidates and evaluating the performance of existing board members. The nominating committee should also have the responsibility of recommending committee assignments.

If the nominating committee is truly independent, it can build the kind of balanced and qualified board that would guard against the kind of governance abuses that have rocked the financial markets and, through them, the economy. A process that weighs the characteristics of a high-quality board described above – how the board “fits together,” how it will work with management – requires an independent nominating committee, much as effective auditing requires an independent audit committee. In fact, the independence and integrity of the nominating committee – in form and in practice – may be more important, because the nominating committee determines the membership from which all other committees are drawn.

Whether a company is large or small, independent directors should begin the process of board selection by developing, without the participation of the CEO, a list of appropriate candidates. The committee should independently exercise its best judgment about possible candidates, including candidates who are incumbent directors eligible for renomination.

For larger companies that can afford to hire recruiters, CED favors an approach along the following lines. First, the nominating committee hires a recruiting consultant – one that has no association with management – and discusses with the consultant the desired qualities of new directors. Just as it is imperative that the auditor’s engagement be determined by the audit committee and not by management, the recruiter must report to, and be wholly obliged to, the nominating committee. The recruiter then produces a list of prospective directors, of whom the nominating committee interviews several candidates that provide acceptable options from which to choose. For example, a large-sized corporation might interview between 9 and 12 such candidates. The nominating committee, with input from the CEO, selects a small number from that list, perhaps 3 in this example. The board and CEO then interview the most promising candidates, of whom one is selected. CED is aware of several corporations, for example Chevron, Chiquita Brands, and Time-Warner, that have established nominating processes substantially in this form.

In CED’s view, this type of process offers investors the best chance of effective representation. It provides a broad search pool, reaching to talent that may not have been known to the CEO or the board. It allows boards to be built with a balanced range of skills and a cohesive culture. It prevents any one group of shareholders from having an inordinate role in determining the board’s composition. And it leads to an effective and independent board that nonetheless has the ability to work with management towards the corporation’s long-term ends.

This approach is based on best emerging practice, being put to the test by companies responding to their own needs and market conditions. It does not require legislation or regulation that dictates a single approach for all companies, regardless of circumstances. It can be copied and spread by emulation.

Although we do not, at this time, support new legislation or a new regulatory effort, we recommend that SEC Commissioners, and particularly the Chairman, publicly call on the corporate community to make the selection of directors independent of management control.

CED’s approach has the advantage of allowing existing reforms to be digested, before another layer of restructuring of board processes is added on top of the previous ones. Since the passage of Sarbanes-Oxley, boards have been laboring diligently to meet all the various new requirements. A period of acclimation, in which market forces and emerging practices are allowed some interplay, could be helpful. Current voluntary reforms should be given a chance to prove themselves, before we launch upon another round of regulation. If, as we expect, a stronger nominating process produces better-quality and more cohesive boards, further actions may not be necessary.
VI. Conclusion

Relations between corporations and investors have suffered wrenching change in the last five years, from both corporate misdeeds and the legislative reaction to them. For all of the damage and pain, there is the potential for ultimate benefit to all parties, as better and more transparent information breeds renewed investor confidence and higher standards of behavior and openness.

In this statement, CED has recommended some changes in practice to hasten this beneficial adjustment. However, we would view such proposed change as modest, and within the scope of the recent revisions in corporate governance practices.* CED believes that the wisest course now would be patience, to allow these new practices and institutions to be learned and understood, and to demonstrate their merit. It is also imperative, however, that these new practices show discernable progress towards meeting the goal of restoring public confidence in America’s public companies and their leaders.

* This report is largely confined to specific areas of corporate finance and compensation. However, CED is fully aware that public trust in corporate leadership also relates to perceived corporate ethics. CED believes that corporate executives must demonstrate commitment to the highest ethical standards, to the full application of codes of corporate conduct, and to building sound ethical cultures within their organizations. Each corporation must find its own best approach to demonstrating that commitment. Notably, special annual reports of several corporations have focused exclusively on corporate social responsibilities, including adherence to high ethical standards. Such reports, which include candid disclosures of shortcomings and plans for improvement, can be valuable tools to encourage employee integrity and loyalty, convey valuable information to shareholders, and build public trust.
Presentation by Patrick M. Gross
Chairman, The Lovell Group
Founder, AMS
At Stanford Graduate School of Business
Executive Education
Corporate Governance Program
June 3, 2005
Independent Directors Roles and Leadership

Stanford Graduate School of Business
Executive Education
Corporate Governance Program
June 3, 2005
# Degree of Board Engagement

<table>
<thead>
<tr>
<th>Least Involved</th>
<th>Most Involved</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The Passive Board</strong></td>
<td><strong>The Certifying Board</strong></td>
</tr>
<tr>
<td>- Functions at the discretion of the CEO</td>
<td>- Certifies to the shareholders that the CEO is doing what the board expects and that management will take corrective action when necessary</td>
</tr>
<tr>
<td>- Limits its activities and participation</td>
<td>- Emphasizes the need for independent directors and meets without the CEO</td>
</tr>
<tr>
<td>- Limits its accountability</td>
<td>- Stays informed about current performance and designates external board members to evaluate the CEO</td>
</tr>
<tr>
<td>- Ratifies management preferences</td>
<td>- Establishes an orderly succession process</td>
</tr>
<tr>
<td></td>
<td>- Is willing to change management to be credible to shareholders</td>
</tr>
<tr>
<td><strong>The Engaged Board</strong></td>
<td><strong>The Interviewing Board</strong></td>
</tr>
<tr>
<td>- Provides insight, advice and support to the CEO and management team</td>
<td>- Becomes intensely involved in decision-making around key issues</td>
</tr>
<tr>
<td>- Recognizes its ultimate responsibility to oversee CEO and company performance guides and judges the CEO</td>
<td>- Convenes frequent, intense meetings, often on short notice</td>
</tr>
<tr>
<td>- Conducts useful, two-way discussions about key decisions facing the company</td>
<td></td>
</tr>
<tr>
<td>- Seeks out sufficient industry and financial expertise to add value to decisions</td>
<td></td>
</tr>
<tr>
<td>- Takes the time to define the roles and behaviors required by the board and boundaries of the CEO and board responsibilities</td>
<td></td>
</tr>
<tr>
<td><strong>The Operating Board</strong></td>
<td></td>
</tr>
<tr>
<td>- Makes key decisions that management then implements</td>
<td></td>
</tr>
<tr>
<td>- Fills gaps in management experience</td>
<td></td>
</tr>
</tbody>
</table>

Key Areas of Independent Director Focus for BOTH “Certifying” and “Engaged” Boards

- Board agenda setting to assure adequate and complete information (much more extensive for “engaged” boards)
- CEO compensation (Compensation Committee)
- CEO assessment and goal setting
- CEO and executive succession planning
- CEO selection
- Board Assessment and improvement recommendations

To be effective...
Independent directors need a leadership process to carry out these responsibilities
There are a Number of Means by Which Independent Directors Leadership can be Exercised:

- Non-executive chair
- “Lead” director combined with CEO/chair
  - Lead independent director
  - Presiding director
  - Chairman of Governance Committee
  - Chairman of Independent Directors (General Motors)
Roles for Leader of Independent Directors

- **PERIODIC EXECUTIVE SESSIONS**
  - Serve as focus for identifying items for executive session consideration
  - Lead setting of agenda for executive sessions
  - Chair/preside at executive sessions
  - Assure appropriate engagement with CEO before and after executive sessions
  - Take responsibility for feedback to/engagement with CEO on executive sessions

- **BOARD AGENDA SETTING**
  - Serve as a focal point for input from other independent directors on agenda items
  - Engage with CEO on setting agenda and establishing information to go to the Board
    NOTE: The Governance Committee of the Board should recommend overall Board agenda and calendar for the full year ahead. Each Board meeting will have "routine every meeting," "scheduled for that meeting," and perhaps "special topics" on each meeting agenda.

- **COORDINATION/FACILITATION OF INDEPENDENT DIRECTORS**
  - Be available to facilitate discussions among independent directions on any key issues and concerns
  - Serve as a non-exclusive conduit to the CEO of views, concerns, and issues of the independent directors
Roles for Leader of Independent Directors (continued)

- **SPECIAL SITUATIONS AND CRISES**
  - Take proactive steps to establish the role and process for the Board, and independent directors, to take around special situations [e.g., major acquisition, merger] including calling together the independent directors with regard to independent counsel and advisors to be retained.
  - In a crisis, call together the independent directors to establish appropriate Board leadership responsibility.
    
    NOTE: In both these type situations, the CEO should be a key party to these and the independent directors should actively collaborate with the CEO.
  - In the event there is a “critical” performance issues with the CEO, the independent Board leader should bring together the independent directors to establish the course of actions. It might well be appropriate for a different independent director to take a leadership position in such a situation since the necessary skills may be different.
Roles for Leader of Independent Directors (continued)

- **INDIVIDUAL DIRECTOR PERFORMANCE ISSUE**
  - Take responsibility for “dealing” with an “disruptive” or “problem” director on behalf of the Board

- **SPECIFIC AREAS TO BE “LED” BY INDEPENDENT DIRECTORS**
  - Take proactive actions to assure that the independent directors carry out the key areas needing independent director leadership:
    - CEO performance assessment and goal setting
    - CEO and executive succession planning [including a “hit by a bus” plan for CEO]
    - Board assessment and recommendations for improvement
    - Individual director assessments [if done; pros and cons]


18 Letter from PricewaterhouseCoopers LLP to Jonathan G. Katz, Secretary, SEC, April 1, 2005, pp. 5-6.

19 Letter from Deloitte & Touche USA LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP to Jonathan G. Katz, Secretary, SEC, April 11, 2005.


21 Foley & Lardner LLP, “Foley & Lardner Sarbanes-Oxley Study Finds Cost of Being Public Rose 33 Percent for Small and Mid-Sized Companies in 2004.”


26 Daines, Nair, and Kornhauser, “The Good, the Bad and the Lucky: CEO Pay and Skill.”


30 Jeffrey A. Sonnenfeld, “Why it’s so Hard to Blow the Whistle,” *Yale Alumni Magazine*, March/April 2005. Sonnenfeld argues that several of the noteworthy recent corporate governance failures could have been averted if not for an environment of “groupthink” among the boards and management. He cites expressions of concern on the part of one or a small number of board members or outsiders that were dismissed by the majorities of the boards because they were unshakably convinced of the rectitude of the corporation, all evidence aside.

Submitted by COLETTE MAHONEY, with which LINDA SMITH WILSON has asked to be associated.
p. 8.

This well done presentation will, I hope, be the foundation for continued studies, analyses, and critiques of the state of Corporate America.

Submitted by JOSH WESTON, with which PETER BENOLIEL and LINDA SMITH WILSON have asked to be associated.
p. 25.

I think the CED recommendation on transparent disclosure of CEO compensation is unnecessarily general, as is the proposal that the SEC merely consider better ways of showing the relative size of a CEO’s compensation. Seemingly full disclosures about compensation often result in voluminous, verbose, disaggregated information that is further complicated by footnotes and appendices that an average reader cannot readily or fully grasp in a modest amount of time.

Instead, I applaud the recent SEC full disclosure proposal and propose the following simple, new SEC mandate for all publicly owned companies in their annual proxy statement: The Compensation Committee shall clearly report the ratio of its CEO’s W-2 compensation (line 1) to the average W-2 compensation of all of the company’s full-time employees, for each of the past three calendar years. By using the W-2 definition of compensation, there need not be any additional recordkeeping or data ambiguity. By displaying the ratio for the past three years, unusual one-year blips could be seen in perspective, and explained in the text.

Furthermore, if each company displays this same, single, non-judgmental ratio, then boards, investors, and others could readily make their own determinations and draw their own conclusions.

If the Compensation Committee believes that the suggested simple W-2-based display does not appropriately or fairly present matters, it has the opportunity and obligation to add its comments in the same proxy statement.

I do note that when there is an intra-year or inter-year change of CEO within a company, some explanatory footnote would be necessary, perhaps accompanied by some kind of annualization of the rump-year W-2. I further recognize that the W-2 simplicity will not fully deal with options, parachutes, deferred pay, and special pension perks. Nonetheless, there would be tremendous progress in clarity, comprehension, and comparability, compared to today’s often obscure disclosures.

Submitted by PETER BENOLIEL, with which W. BOWMAN CUTTER, JOSH WESTON, and HAROLD WILLIAMS have asked to be associated.
p. 28.

The offices of the Chief Executive Officer (CEO) and Chair of the Board should be separate and distinct. Not having sharp delineation between the two offices carries with it too many risks as evidenced in any of number of instances over the past 10 years. While “one size does not fit all” the designation of “Lead Director” really begs the question. The Chair should be designated as such thus underlining the crucial distinction between the two positions. Preferably, the Chair should serve from 2 – 5 years, so as to build and maintain a productive working relationship with the CEO as well as providing a critical face to shareholders and the public.
CED Board of Trustees

Co-Chairmen

W. BOWMAN CUTTER, Managing Director
Warburg Pines LLC
RODERICK M. HILLS, Chairman
Hills & Stern, LLP

Vice Chairmen

GEORGE H. CONRADES, Chairman and Chief Executive Officer
Akamai Technologies, Inc.
JAMES A. JOHNSON, Vice Chairman
Perseus, LLC
ARTHUR F. RYAN, President, Chairman, and Chief Executive Officer
The Prudential Insurance Company of America
FREDERICK W. TELLING, Vice President, Corporate Strategic Planning and Policy Division
Pfizer Inc.

KENT M. ADAMS, President
Catepillar Financial Services Corporation
REX D. ADAMS, Professor of Business Administration
The Fuqua School of Business
Duke University
PAUL A. ALLAIRE, Retired Chairman
Xerox Corporation
HERBERT M. ALLISON, JR., Chairman, President and CEO
TIAA-CREF
COUNTESS MARIA BEATRICE ARCO, Chair
American Asset Corporation
IAN ARNOF, Chairman
Arnoff Family Foundation
EDWARD N. BASHA, JR., Chairman and Chief Executive Officer
Bashas' Inc.
NADINE MATHIS BASHA, Chair
Arizona State School Readiness Board

THOMAS D. BELL, JR., Vice Chairman, President and Chief Executive Officer
Cousins Properties Inc.
ALAN BELZER, Retired President and Chief Operating Officer
Allied-Signal Inc.
PETER A. BENOLIEL, Chairman Emeritus
Quaker Chemical Corporation
MELVYN E. BERGSTEIN, Chairman and Chief Executive Officer
Diamond Cluster International, Inc.
DEREK BOK, Professor
Harvard University
National Chair, Common Cause
LEE C. BOLLINGER, President
Columbia University
ROY J. BOSTOCK, Chairman
Sealedge Investments
STEPHEN W. BOSWORTH, Dean
Fletcher School of Law and Diplomacy
Tufts University
JACK O. BOVENDER, JR., Chairman and Chief Executive Officer
HCA Inc.
JOHN BRADEMAS, President Emeritus
New York University
WILLIAM E. BROCK, Chairman
Bridges Learning Systems, Inc.
ROBERT H. BRUININKS, President
University of Minnesota
FLETCHER L. BYROM, President and Chief Executive Officer
MICASU Corporation
DONALD R. CALDWELL, Chairman and Chief Executive Officer
Cross Atlantic Capital Partners
DAVID A. CAPUTO, President
Pace University
RAYMOND G. CHAMBERS, Retired Chairman of the Board
Amelior Foundation
ROBERT CHESS, Chairman
Nektar Therapeutics
MICHAEL CHESSER, President, Chairman and Chief Executive Officer
Great Plains Energy Services
CAROLYN CHIN, Chairman and Chief Executive Officer
Cebiz
JOHN L. CLENDENIN, Retired Chairman
BellSouth Corporation
FERDINAND COLLOREDO-MANSFELD, Partner
Caboat Properties, Inc.
DAVID M. COTE, Chairman, President and Chief Executive Officer
Honeywell International Inc.
DAVID CRANE, President and Chief Executive Officer
NRG Energy, Inc.
STEPHEN A. CRANE, Chairman
Alpha Star Insurance Group Ltd.
DENNIS C. CUNEO, Senior Vice President
Toyota North America, Inc
PAUL DANOS, Dean
The Amos Tuck School of Business
Dartmouth College
RONALD R. DAVENPORT, Chairman of the Board
Sheridan Broadcasting Corporation
RICHARD H. DAVIS, Partner
Davis Manafort, Inc.
RICHARD J. DAVIS, Senior Partner
Weil, Gotshal & Manges LLP
JOHN J. DEGIOIA, President
Georgetown University
CLARA DEL VILLAR, Vice President
Nortel Networks Corporation
JOHN DIEBOLD, Chairman
The Diebold Institute

*Life Trustee
SAMUEL A. DIPIAZZA, Global Chief Executive
PricewaterhouseCoopers LLP

LINDA M. DISTLERATH, Vice President, Global Health Policy
Merck & Co., Inc.

PATRICK DOLBERG, President and Chief Executive Officer
Holcim (US) Inc.

IRWIN DORROS, President
Dorros Associates

FRANK P. DOYLE, Retired Executive Vice President
General Electric Company

ROBERT H. DUGGER, Managing Director
Tudor Investment Corporation

T. J. DERMOT DUNPHY, Chairman
Kildare Enterprises, LLC

CHRISTOPHER D. EARL, Managing Director
Perseus, LLC

W. D. EBERLE, Chairman
Manchester Associates, Ltd.

STUART E. EIZENSTAT, Partner & Head, International Practice
Corington & Burling

ROBERT A. ESSNER, Chairman, President and Chief Executive Officer
Wyeth

DIANA FARRELL, Director
McKinsey Global Institute

KATHLEEN FELDSTEIN, President Economics Studies, Inc.

TREVOR FETTER, President and Chief Executive Officer
Temet Healthcare Corporation

MATTHEW FINK, Retired President
The Investment Company Institute

* EDMUND B. FITZGERALD, Managing Director
Woodmont Associates

HARRY L. FREEMAN, Chairman
The Mark Twain Institute

MITCHELL S. FROMSTEIN, Chairman Emeritus
Manpower Inc.

CONO R. FUSCO, Managing Partner-Strategic Relations
Grant Thornton

PAMELA B. GANN, President Claremont McKenna College

JOSEPH GANTZ, Partner
GG Capital, LLC

E. GORDON GEE, Chancellor Vanderbilt University
THOMAS P. GERRITY, Dean Emeritus
The Wharton School
University of Pennsylvania

ALAN B. GILMAN, Chairman
The Steak n Shake Company

CAROL R. GOLDBERG, Trustee
The Goldberg Family Foundation

ALFRED G. GOLDSTEIN, President and Chief Executive Officer
AG Associates

JOSEPH T. GORMAN, Retired Chairman and Chief Executive Officer
TRW Inc.

EARL G. GRAVES, SR., Publisher and Chief Executive Officer
Earl G. Graves Publishing Co., Inc.

GERALD GREENWALD, Chairman Greenbrier Equity Group

BARBARA B. GROGAN, President
Western Industrial Contractors

PATRICK W. GROSS, Chairman, The Lovell Group
Founder, AMS

JEROME H. GROSSMAN, M.D., Senior Fellow
John F. Kennedy School of Government
Harvard University

RONALD GRZYWINSKI, Chairman
ShoreBank Corporation

STEVEN GUNBY, Chairman, The Americas & Senior Vice President
The Boston Consulting Group, Inc.

JUDITH H. HAMILTON, Former President and Chief Executive Officer
Classroom Connect

WILLIAM A. HASELTINE, President Haseltine Associates

RICHARD H. HERSHEY, Former President
Trinity College

HEATHER R. HIGGINS, President
Randolph Foundation

HAYNE HIPP, Chairman and Chief Executive Officer
The Liberty Corporation

JOHN HOFMEISTER, President Shell Oil Company

PAUL M. HORN, Senior Vice President, Research
IBM Corporation

PHILIP K. HOWARD, Vice Chairman
Covington & Burling

SHIRLEY ANN JACKSON, President
Rensselaer Polytechnic Institute

CHARLENE DREW JARVIS, President
Southeastern University

WILLIAM C. JENNINGS, Chairman
US Interactive, Inc.

JEFFREY A. JOERRES, Chairman, President and Chief Executive Officer
Manpower Inc.

L. OAKLEY JOHNSON, Senior Vice President, Corporate Affairs
American International Group, Inc.

VAN E. JOLISSAINT, Corporate Economist
DaimlerChrysler Corporation

ROBERT L. JOSS, Dean
Graduate School of Business
Stanford University

PRES KABACOFF, Chief Executive Officer
HRI Properties

*Life Trustee
ROBERT KAHN, Director, Country Risk Management Citigroup Inc.

EDWARD A. KANGAS, Retired Chairman and Chief Executive Officer Deloitte Touche Tohmatsu

JOSEPH E. KASPUTYS, Chairman, President and Chief Executive Officer Global Insight, Inc.

WILLIAM E. KIRWAN, Chancellor University System of Maryland

THOMAS J. KLUTZNICK, President Thomas J. Klutznick Company

CHARLES E.M. KOLB, President Committee for Economic Development

EDWARD M. KOPKO, Chairman, President, and Chief Executive Officer Butler International, Inc.

THOMAS F. LAMB, JR., Senior Vice President, Government Affairs PNC Financial Services Group, Inc.

KURT M. LANDGRAF, President and Chief Executive Officer Educational Testing Service

W. MARK LANIER, Partner The Lanier Law Firm, P.C.

PAUL LAUDICINA, Vice President and Managing Director, A.T. Kearney Inc.

ENRICO A. LAZIO, Executive Vice President, Global Government Relations and Public Policy JPMorgan Chase & Co


ROBERT G. LIBERATORE, Group Senior Vice President, Global External Affairs DaimlerChrysler Corporation

IRA A. LIPMAN, Chairman of the Board and President Guardsmark, LLC

JOHN LOOMIS, Vice President, Human Resources General Electric Company

LI LU, President Himalaya Management

BRUCE K. MACLAURY, President Emeritus The Brookings Institution

COLETTE MAHONEY, President Emeritus Marymount Manhattan College

T. ALLAN MCARTOR, Chairman Airbus of North America, Inc.

ALONZO L. MCDONALD, Chairman and Chief Executive Officer Avenir Group, Inc.

DAVID E. MCKINNEY, Vice Chair Thomas J. Watson Foundation


ALAN G. MERTEN, President George Mason University

DEBORAH HICKS MIDANEK, President Solon Group, Inc.

HARVEY R. MILLER, Vice Chairman Greenhill & Co., LLC

ALFRED T. MOCKETT, Chairman and Chief Executive Officer Corinthian Capital LLC

NICHOLAS G. MOORE, Director Bechtel Group, Inc.

DONNA MOREA, President CGI-AMS, Inc.

IKUO MORI, Chairman and Chief Executive Officer Daiwa Securities America, Inc.

JAMES C. MULLEN, Chief Executive Officer Biogen Inc.

DIANA S. NATALICIO, President The University of Texas at El Paso

MATTHEW NIMETZ, Partner General Atlantic Partners

DEAN R. O’HARE, Retired Chairman and Chief Executive Officer Chubb Corporation

RONALD L. OLSON, Partner Munger, Tolles & Olson LLP

NOBUHARU ONO, President and Chief Executive Officer NTT DoCoMo USA

M. MICHEL ORBAN, Partner RRE Ventures

HIDEAKI OTAKA, President and Chief Executive Officer Toyota Motor North America, Inc.

STEFFEN E. PALKO, Retired Vice Chairman and President XTO Energy, Inc.

JERRY PARROTT, Vice President, Corporate Communications & Public Policy

Human Genome Sciences, Inc.

CAROL J. PARRY, President Corporate Social Responsibility Associates

VICTOR A. PELSON, Senior Advisor UBS Securities LLC

DONALD K. PETERSON, Chairman and Chief Executive Officer Avaya Inc.

PETER G. PETERSON, Senior Chairman The Blackstone Group

RALPH R. PETERSON, President, Chairman, and Chief Executive Officer CH2M Hill Companies Ltd.

TODD E. PETZEL, President Azimuth Alternative Asset Management LLP

HUGH B. PRICE, Former President and Chief Executive Officer National Urban League

*Life Trustee
HAROLD WILLIAMS, President Emeritus
The J. Paul Getty Trust

LINDA SMITH WILSON, President Emerita
Radcliffe College

MARGARET S. WILSON, Chairman
and Chief Executive Officer
Scarborough

H. LAKE WISE, Executive Vice President and Chief Legal Officer
Daiwa Securities America, Inc.

JACOB J. WORENKLEIN, President and Chief Executive Officer
US Power Generating Co., LLC

NANCY WYSENSKI, President and Chief Executive Officer
EMD Pharmaceuticals

KURT E. YEAGER, Former President and Chief Executive Officer
Electric Power Research Institute

RONALD L. ZARRELLA, Chairman and Chief Executive Officer
Bausch & Lomb, Inc.

STEVE V. ZATKIN, Senior Vice President, Government Relations
Kaiser Foundation Health Plan, Inc.

EDWARD ZORE, President and Chief Executive Officer
Northwestern Mutual

*Life Trustee
RAY C. ADAM, Retired Chairman  
NL Industries  

ROBERT O. ANDERSON, Retired Chairman  
Hondo Oil & Gas Company  

ROY L. ASH  
Los Angeles, California  

ROBERT H. B. BALDWIN, Retired Chairman  
Morgan Stanley Group Inc.  

GEORGE F. BENNETT, Chairman Emeritus  
State Street Investment Trust  

HAROLD H. BENNETT  
Salt Lake City, Utah  

JACK F. BENNETT, Retired Senior Vice President  
Exxon Corporation  

HOWARD W. BLAUVELT  
Keswick, Virginia  

ALAN S. BOYD  
Lady Lake, Florida  

ANDREW F. BRIMMER, President  
Brimmer & Company, Inc.  

PHILIP CALDWEll, Retired Chairman  
Ford Motor Company  

HUGH M. CHAPMAN, Retired Chairman  
NationsBank South  

E. H. CLARK, JR., Chairman and Chief Executive Officer  
The Friendship Group  

A.W. CLAUSEN, Retired Chairman and Chief Executive Officer  
BankAmerica Corporation  

DOUGLAS D. DANFORTH  
Executive Associates  

JOHN H. DANIELS, Retired Chairman and Chief Executive Officer  
Archer-Daniels Midland Co.  

RALPH P. DAVIDSON  
Washington, D.C.  

ALFRED C. DECRANE, JR., Retired Chairman and Chief Executive Officer  
Texaco, Inc.  

ROBERT R. DOCKSON, Chairman Emeritus  
CalFed, Inc.  

LYLE EVERINGHAM, Retired Chairman  
The Kroger Co.  

THOMAS J. EYERMAN, Retired  
Partner  
Skidmore, Owings & Merrill  

DON C. FRISBEE, Chairman Emeritus  
PacifiCorp  

RICHARD L. GELB, Chairman Emeritus  
Bristol-Myers Squibb Company  

W. H. KROME GEORGE, Retired Chairman  
ALCOA  

WALTER B. GERKEN, Retired Chairman and Chief Executive Officer  
Pacific Life Insurance Company  

LINCOLN GORDON, Guest Scholar  
The Brookings Institution  

JOHN D. GRAY, Chairman Emeritus  
Hartmarx Corporation  

JOHN R. HALL, Former Chairman  
Ashland Inc.  

RICHARD W. HANSELMAN, Former Chairman  
Health Net Inc.  

ROBERT S. HATFIELD, Retired Chairman  
The Continental Group, Inc.  

PHILIP M. HAWLEY, Retired Chairman of the Board  
Carter Hawley Hale Stores, Inc.  

ROBERT C. HOLLAND, Senior Fellow  
The Wharton School  
University of Pennsylvania  

LEON C. HOLT, JR., Retired Vice Chairman  
Air Products and Chemicals, Inc.  

SOL HURWITZ, Retired President  
Committee for Economic Development  

GEORGE F. JAMES  
Ponte Vedra Beach, Florida  

DAVID KEARNS, Chairman Emeritus  
New American Schools  

GEORGE M. KELLER, Retired Chairman of the Board  
Chevron Corporation  

FRANKLIN A. LINDSAY, Retired Chairman  
Itek Corporation  

ROBERT W. LUNDEEN, Retired Chairman  
The Dow Chemical Company  

RICHARD B. MADDEN, Retired Chairman and Chief Executive Officer  
Potlatch Corporation  

AUGUSTINE R. MARUSI  
Lake Wales, Florida  

WILLIAM F. MAY, Chairman and Chief Executive Officer  
Statue of Liberty-Ellis Island Foundation, Inc.  

OSCAR G. MAYER, Retired Chairman  
Oscar Mayer & Co.  

GEORGE C. MCGHEE, Former U.S. Ambassador and Under Secretary of State  

JOHN F. MCGILLICUDDY, Retired Chairman and Chief Executive Officer  
Chemical Banking Corporation  

JAMES W. MCKEE, JR., Retired Chairman  
CPC International, Inc.  

CHAMPNEY A. MCNAIR, Retired Vice Chairman  
Trust Company of Georgia  

J. W. MCSWINEY, Retired Chairman of the Board  
The Mead Corporation  

ROBERT E. MERCER, Retired Chairman  
The Goodyear Tire & Rubber Co.
RUBEN F. METTLER, Retired Chairman and Chief Executive Officer TRW Inc.
LEE L. MORGAN, Former Chairman of the Board Caterpillar, Inc.
ROBERT R. NATHAN, Chairman Nathan Associates, Inc.
JAMES J. O’CONNOR, Former Chairman and Chief Executive Officer Unicom Corporation
LEIF H. OLSEN, President LHO GROUP
NORMA PACE, President Paper Analytics Associates
CHARLES W. PARRY, Retired Chairman ALCOA
WILLIAM R. PEARCE, Director American Express Mutual Funds
JOHN H. PERKINS, Former President Continental Illinois National Bank and Trust Company
DEAN P. PHYPERS New Canaan, Connecticut
ROBERT M. PRICE, Former Chairman and Chief Executive Officer Control Data Corporation
JAMES J. RENIER Renier & Associates
IAN M. ROLLAND, Former Chairman and Chief Executive Officer Lincoln National Corporation
AXEL G. ROSIN, Retired Chairman Book-of-the-Month Club, Inc.
WILLIAM M. ROTH Princeton, New Jersey
WILLIAM RUDER William Ruder Incorporated
RALPH S. SAUL, Former Chairman of the Board CIGNA Companies
GEORGE A. SCHAEFER, Retired Chairman of the Board Caterpillar, Inc.
ROBERT G. SCHWARTZ New York, New York
MARK SHEPHERD, JR., Retired Chairman Texas Instruments, Inc.
ROCCO C. SICILIANO Beverly Hills, California
ELMER B. STAATS, Former Controller General of the United States
FRANK STANTON, Former President CBS, Inc.
EDGAR B. STERN, JR., Chairman of the Board Royal Street Corporation
ALEXANDER L. STOTT Fairfield, Connecticut
WAYNE E. THOMPSON, Past Chairman Merritt Peralta Medical Center
THOMAS A. VANDERSLICE TAV Associates
SIDNEY J. WEINBERG, JR., Senior Director The Goldman Sachs Group, Inc.
CLIFTON R. WHARTON, JR., Former Chairman and Chief Executive Officer TIAA-CREF
DOLORES D. WHARTON, Former Chairman and Chief Executive Officer The Fund for Corporate Initiatives, Inc.
ROBERT C. WINTERS, Chairman Emeritus Prudential Insurance Company of America
RICHARD D. WOOD, Director Eli Lilly and Company
CHARLES J. ZWICK Coral Gables, Florida
CED Research Advisory Board

Chairman

JOHN PALMER
University Professor
Maxwell School of Citizenship and Public Affairs
Syracuse University

RALPH D. CHRISTY
J. Thomas Clark Professor
Department of Applied Economics and Management
Cornell University

ALAIN C. ENTHOVEN
Marriner S. Eccles Professor of Public and Private Management
Stanford University
Graduate School of Business

BENJAMIN M. FRIEDMAN
William Joseph Maier Professor of Political Economy
Harvard University

ROBERT W. HAHN
Resident Scholar
American Enterprise Institute

HELEN F. LADD
Professor of Public Policy Studies and Economics
Sanford Institute of Public Policy
Duke University

ZANNY MINTON-BEDDOES
Washington Economics Correspondent
The Economist

WILLIAM D. NORDHAUS
Sterling Professor of Economics
Cowles Foundation
Yale University

RUDOLPH G. PENNER
Senior Fellow
The Urban Institute

HAL VARIAN
Class of 1944 Professor of Information and Management Systems
Haas School of Business
University of California, Berkeley

JOHN P. WHITE
Lecturer in Public Policy
John F. Kennedy School of Government
Harvard University
CED Professional and Administrative Staff

CHARLES E.M. KOLB
President

Research

JOSEPH J. MINARIK
Senior Vice President and Director of
Research

DONNA M. DESROCHERS
Vice President and Director of Education Studies

ELLIOT SCHWARTZ
Vice President and Director of Economic Studies

VAN DOORN OOMS
Senior Fellow

CAROLYN CADEI
Research Associate

RACHEL DUNSMOOR
Research Associate

JULIE KALISHMAN
Research Associate

Advisor on International Economic Policy

ISAIAH FRANK
William L. Clayton Professor of International Economics
The Johns Hopkins University

Communications/Government Relations

MICHAEL J. PETRO
Vice President and Director of Business and Government Relations and Chief of Staff

MORGAN BROMAN
Director of Communications

CHRIS DREIBELBIS
Business and Government Policy Associate

CHRISTINE RYAN
Program Director

ROBIN SAMERS
Director of Trustee Relations

JENNIFER SEGAL
Development Associate/Grants Administrator

RACHEL PILLIOD
Communications and Outreach Associate

Development

MARTHA E. HOULE
Vice President for Development and Secretary of the Board of Trustees

RICHARD M. RODERO
Director of Development

KATIE McCALLUM
Development Associate/Corporate Relations

Finance and Administration

LAURIE LEE
Chief Financial Officer and Vice President of Finance and Administration

ANDRINE COLEMAN
Senior Accountant

JERI McLAUGHLIN
Executive Assistant to the President

JEFFREY SKINNER
Senior Accountant/Grants Administrator

AMANDA TURNER
Office Manager

JANVIER RICHARDS
Membership and Administrative Assistant
Selected Recent Publications:

The Emerging Budget Crisis: Urgent Fiscal Choices (2005)
How Economies Grow: The CED Perspective on Raising the Long-Term Standard of Living (2003)
Learning for the Future: Changing the Culture of Math and Science Education to Ensure a Competitive Workforce (2003)
A New Vision for Health Care: A Leadership Role for Business (2002)
Preschool For All: Investing In a Productive and Just Society (2002)
From Protest to Progress: Addressing Labor and Environmental Conditions Through Freer Trade (2001)
The Digital Economy: Promoting Competition, Innovation, and Opportunity (2001)
Reforming Immigration: Helping Meet America's Need for a Skilled Workforce (2001)
Measuring What Matters: Using Assessment and Accountability to Improve Student Learning (2001)
The Case for Permanent Normal Trade Relations with China (2000)
Breaking the Litigation Habit: Economic Incentives for Legal Reform (2000)
New Opportunities for Older Workers (1999)
The Employer's Role in Linking School and Work (1998)
America's Basic Research: Prosperity Through Discovery (1998)
Modernizing Government Regulation: The Need For Action (1998)
U.S. Economic Policy Toward The Asia-Pacific Region (1997)
Connecting Inner-City Youth To The World of Work (1997)
Fixing Social Security (1997)
Growth With Opportunity (1997)
Close relations exist between the Committee for Economic Development and independent, nonpolitical research organizations in other countries. Such counterpart groups are composed of business executives and scholars and have objectives similar to those of CED, which they pursue by similarly objective methods. CED cooperates with these organizations on research and study projects of common interest to the various countries concerned. This program has resulted in a number of joint policy statements involving such international matters as energy, assistance to developing countries, and the reduction of nontariff barriers to trade.

<table>
<thead>
<tr>
<th>Code</th>
<th>Name</th>
<th>Location</th>
</tr>
</thead>
<tbody>
<tr>
<td>CE</td>
<td>Circulo de Empresarios</td>
<td>Madrid, Spain</td>
</tr>
<tr>
<td>CEAL</td>
<td>Consejo Empresario de America Latina</td>
<td>Buenos Aires, Argentina</td>
</tr>
<tr>
<td>CEDA</td>
<td>Committee for Economic Development of Australia</td>
<td>Sydney, Australia</td>
</tr>
<tr>
<td>CIRD</td>
<td>China Institute for Reform and Development</td>
<td>Hainan, People’s Republic of China</td>
</tr>
<tr>
<td>EVA</td>
<td>Centre for Finnish Business and Policy Studies</td>
<td>Helsinki, Finland</td>
</tr>
<tr>
<td>FAE</td>
<td>Forum de Administradores de Empresas</td>
<td>Lisbon, Portugal</td>
</tr>
<tr>
<td>IDEP</td>
<td>Institut de l’Entreprise</td>
<td>Paris, France</td>
</tr>
<tr>
<td>IW</td>
<td>Institut der deutschen Wirtschaft Koeln</td>
<td>Cologne, Germany</td>
</tr>
<tr>
<td>経済同友会</td>
<td>Keizai Doyukai</td>
<td>Tokyo, Japan</td>
</tr>
<tr>
<td>SMO</td>
<td>Stichting Maatschappij en Onderneming</td>
<td>The Netherlands</td>
</tr>
<tr>
<td>SNS</td>
<td>Studieförbundet Naringsliv och Samhälle</td>
<td>Stockholm, Sweden</td>
</tr>
</tbody>
</table>