

Scandals Prompted Changes, But Critics Say More Are Needed To Prevent Another Enron

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A YEAR HAS PASSED since regulators told U.S. businesses the old style of corporate governance couldn't continue in the face of scandals at Enron, Tyco, WorldCom and elsewhere. Directors of these companies had missed or ignored the problems, some of which involved fraudulent accounting schemes.

The Sarbanes-Oxley Act, signed into law last July 30, along with rules proposed by two stock exchanges, have spawned dozens of overhauls for publicly traded companies. They include more separation of the jobs of chief executive and chairman, and the appointment of more independent directors who don't have business ties to the company. Board audit committees, which are supposed to monitor a company's books, must now have at least one financial expert or explain why they don't. The full audit committee must review financial statements every quarter after the company's CEO and chief financial officer certify them.

CORPORATE REFORM: THE FIRST YEAR

It is far from certain, however, how much better public companies govern themselves than they did before the reforms.

Certainly, the reforms have raised awareness of honest procedures and the criminal liabilities of not following them. The changes may finally put an end to the country-club atmosphere of boards, where members care more about their resumes and networking than about guarding against corruption. And they have shifted some power from CEOs to boards by requiring outside—or nonmanagement—directors to hold frank discussions privately.

Still, critics say the new regulations have buried directors in extra paperwork while failing to address the issues close to the heart of the average investor: overgenerous executive pay, little evaluation of directors' own performance on the board and a feeling among shareholders that they are left out of the director-selection process. And there still isn't an easy way for corporate whistleblowers to communicate directly with board members.

Some also worry that if boards and management focus primarily on compliance, companies will become risk averse. It will result in fewer strategic questions being asked, such as, "What makes your company distinct and why do you think you can achieve your strategy?" says Steven Reinemund, chairman and CEO of PepsiCo Inc.

Here are five critical areas where overhauls have been sought.

Audit Committees

Sarbanes-Oxley has prompted greater vigilance by the audit committees that oversee a company's accounting practices. Many audit committees are spending far more time than they used to reviewing financial statements and overseeing auditors, meeting 10 or 11 times a year, up from three or four times. As a result, "they are better equipped to

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head off trouble," says Barbara Hackman Franklin, who heads the audit committees at Dow Chemical Co. and Aetna Inc., and also serves on audit committees at two other companies.

Before convening an audit-committee meeting at Dow Chemical earlier this month, she sent other members nearly 100 pages of reading material. "Does this [extra work] mean we will never have another Enron scandal? I think not," concedes Ms. Franklin, who is an international business consultant and former U.S. Commerce Secretary. "If management is being dishonest, it still will be hard to get to the bottom."

Other audit-committee heads are trying to avoid accounting problems by supervising outside audit firms more scrupulously. Sarbanes-Oxley says audit committees must change their auditors' lead audit partner every five years.

Roderick M. Hills decided to make that switch even sooner. The former Security and Exchange Commission chairman took charge of Chiquita Brands International Inc.'s audit committee when the Cincinnati food producer and distributor emerged from bankruptcy protection in March 2002.

He and committee colleagues chose Jim Havel, managing partner of Ernst & Young's St. Louis office, to be chief auditor. Mr. Havel says it was the first time in his 27-year career an audit committee—instead of management—decided whether he would lead a client's audit work.

Mr. Hills got Mr. Havel to take a fresh look at how Chiquita accounts for buying boxes of bananas. The company was using a weighted-average price per box that didn't reflect the actual cost, which var-

WSJ 7/22/03

ies by season. "It was a way to smooth earnings," Mr. Hills says.

In May, Chiquita said it was embracing "an actual costing method, which recognizes costs as incurred" for some expenses during interim periods.

Yet numerous audit-committee members lack sufficient knowledge to review financial statements, says Roman Weil, an accounting professor at the University of Chicago's Graduate School of Business. At recent governance seminars jointly sponsored by Chicago and two other universities, 70% of about 500 participants who took Mr. Weil's test of basic accounting principles got a failing score.

Many were top executives serving on audit committees. Most didn't understand how to question auditors. "The only thing certain on a balance sheet is the date. Everything else is a judgment," says Mr. Weil.

"Directors need enough business acumen to understand and smell the difference between right and wrong, so they perform their chief duty to be a check and balance to management," says Mr. Reinemund.

Shifting Power to Boards

Not surprisingly, many corporate boards are hiring lawyers and consultants to advise them on their expanded duties and liabilities under current and pending reforms. But they sometimes find themselves spending too much time listening to advisers, rather than attending to the company's business.

At one recent board meeting he attended as an outside director, Jeffrey Rodek, CEO of **Hyperion Solutions Corp.**, realized soon after a consultant began speaking he had heard an almost identical presentation from another consultant

at a different company's board meeting.

Nevertheless, the pending stock-exchange requirements that outside directors meet separately from management is prompting more assertiveness.

Richard Koppes, an outside director at **Peregrine Systems Inc.**, saw this change at his first board meeting in April at the San Diego software company that is in bankruptcy-court proceedings. CEO Gary Greenfield, who had joined Peregrine after it uncovered accounting fraud last year, told Mr. Koppes and three other new outside directors that he also wanted to be board chairman. Mr. Koppes, counsel to **Jones, Day, Reavis & Pogue** in Sacramento, Calif., disliked the idea—and worried he would be the only dissenter.

But when Mr. Greenfield left the room so directors could discuss the issue privately, Mr. Koppes learned he wasn't alone. "Everyone said we needed an independent chairman," he recalls. "It was an acknowledgment about the environment we're in and what was needed to avoid future problems at the company."

Mr. Greenfield was turned down.

To gather more information, separate from what they are told at board meetings, more directors are visiting company locations. Among the corporate governance changes **General Electric Co.** initiated this past November is the requirement that directors visit two GE businesses each year without the presence of corporate management.

That is a start, but likely won't yield enough information, says Paul Lapidès, head of the Corporate Governance Center at Kennesaw State University in Marietta, Ga., and a director at **Sun Communities Inc.**, Farmington Hills, Mich. He says he

