Your Voice

Viewpoint:

The Hidden Danger Of Sarbanes-Oxley

By Hal Shear

On July 30, 2002, U.S. boards set sail in uncharted waters. With the passage of the Sarbanes-Oxley Act of 2002 (SOX), it's clear that a sea change took place in all elements of board service, particularly in the relationship between the board and management. Boards and directors were told "You've been bad," and "We're going to make sure you don't sin anymore." While it is certainly true that there were far too many bad apples in the executive ranks of corporate America, no one has shown that more than a small handful of directors were crooks, and there have been very few cases where an entire board committed a fraud. Certainly, there was mismanagement by boards, but little in the reforms addresses that.

There is evidence that many boards had begun to adopt many "best corporate governance practices" in the uncertain boom and bust times of our most recent past. Membership in NACD increased dramatically in the 36 months before SOX was passed. Pensions for directors were eliminated in most *Fortune* 500 boardrooms. Director compensation plans moved toward less cash and more equity. Lead directors and corporate governance committees began to appear. Independent audit and compensation committees became more prevalent. More attention was paid to aligning strategy with shareholder return. The progress was slow, but it was progress.

Then came SOX. Clearly, the new law has many positive elements, and its implementation through SEC regulations and proposed exchange listing requirements has accelerated adoption of some governance best practices. But there is a more ominous side to the new regulations and requirements. With the implementation of SOX, we have the real possibility that we have moved the central tenet of effective corporate governance—making the company successful, in the eyes of stockholders and stakeholders—to making it "honest."

The "reformed" oversight role has the potential for disaster—for the CEO, management, the stockholders, and for the very change sought by the reforms. Rather than balancing oversight with attention to the other two central elements of effective directorship—CEO selection/succession, and strategic advice and counsel—the newly empowered board is likely to err on the side of looking for predictable surprises; in time, this focus on detail may lead to a false sense of security.

An understanding of the human condition suggests greed will always be with us. It is my belief that boards and directors are unlikely to detect every fraud perpetrated by skilled conspirators no matter what control systems are in place. And few auditors will, either. At best, such systems may protect directors from being liable for fraudulent actions—not exactly what the writers of the new law had in mind. It is much more likely that the attention and time devoted to oversight will divert directors from giving enough attention to the wisdom and perspective that they need to provide to make companies successful.

As more control systems are put in place, at enormous cost, surprises will surely be reduced, but in time more and more false positives will appear. Gradually, the creative tension that is the bedrock of effective oversight will diminish in intensity. Wait long enough, and corporate America's misdeeds will again be front-page news. Boards can and need to overcome this scenario by planning for the institutionalization of oversight.

The following steps can help you as a director achieve this goal.

- Recognize the need to regularly *refresh people, process, and procedures.*
- Reevaluate not only the *audit partner or firm* every five to seven years, but also the *internal audit function*, and the designers and operators of internal control systems.
- Determine whether a change in *risk management advisors*, or a competition for an outsourced whistleblower system vendor should take place. Do this at the board level—not in committee.
- Consider *career development and rotation* for senior financial staff to ensure fresh eyes on the controls.
- Within the boardroom, develop a process to *rotate committee assignments*, including the audit committee, to accomplish the same thing.
- Maintain *board currency*, i.e., the skills and education to serve, by mandating regular director education.

In addition, boards need to:

- Be principled in oversight approach, rather than on "letter of the law" compliance.
- Watch a few key performers and performance metrics.
- Take prompt, responsible action.
- Manage oversight professionals.
- Guard against overconfidence, especially overconfidence in senior executives' ability.
- Question everything.
- Apply the "smell" test, if it doesn't smell right, "inspect."

Boards must recognize that by 2005-06, companies that have implemented SOX and the new rules will enter the "realization" phase, and remember that supreme confidence often leads to colossal failure.

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