Governance

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The Ever-Changing Landscape of Corporate Governance

Ethics and Integrity Are the Keys to Stability

By Chris Scherpenseel, CPA

Conventional wisdom dictates that change is the only constant. Perhaps nowhere is that more true than in the arena of corporate governance. A casual glance back over the past several decades reveals that the one thing everyone—from CEOs to CFOs to boards of directors to accountants—can count on is that the ways in which they approach the task of corporate governance are certain to change—and probably sooner rather than later.

Peruse nearly any major business publication, and it will quickly become clear that the landscape is undergoing change today at a pace that would have perhaps been unimaginable in the 1970s or 1980s—or even during the breakneck pace of the 1990s.

The key to being prepared for such change is a firm grasp on what preceded today's culture of corporate governance. I'm offering my perspective as someone who began his career in public accounting and now is a corporate CEO.

A LOOK BACK

In the late 1970s, companies that were being audited focused primarily on the concept of materiality. For instance, when a business underwent its annual audit, the question of materiality related to specific transactions would often come up. If a $100 expense report wasn't posted before the year-end close, it wasn't likely that it would drastically change the financial performance of a $20 million entity—certainly not to the point that it made sense to reopen the books and post the transaction. But an invoice of $50,000 for raw materials was something altogether different and would be a serious material event that should be posted, causing the books to be reopened.

By the mid-1980s, the focus had shifted toward consistently increasing quarterly earnings. There had always been pressure for improved earnings, but around this time it became more intense—and it has increased steadily ever since.

During this era, many colleagues and I saw that, in addition to Securities & Exchange Commission (SEC) reporting requirements, generally accepted accounting principles (GAAP) were often viewed as the standard for corporate governance. The government relied heavily on both SEC requirements and GAAP to instill honesty in financial reporting. In reality, GAAP only specifies methodologies for accounting—it doesn't demand ethics and integrity.

NEW RULES FOR CORPORATE GOVERNANCE

In retrospect, it isn't entirely surprising that the frenzy of the late 1990s and early 2000s is a story that didn't enjoy a particularly happy ending. Enormous incentives were put forth for senior executives. The numbers alone became outrageous. An unprecedented focus on revenue growth and profits put additional pressure on quarterly earnings, and companies were (and still are) condemned for not meeting their short-term targets. Unfortunately, the leadership in place at some businesses veered off course and crossed the line into fraud. Certain events were relegated to transactions that were way off the balance sheet. Put plainly, many executives were acting solely on behalf of their own personal gain.

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And that—again, not surprisingly in retrospect—led to some of the most high-profile scandals of the modern age. It also led to the passage of the Sarbanes-Oxley Act of 2002 (SOX), which is widely considered to be the single most critical piece of legislation in corporate governance, financial disclosure, and public accounting since the U.S. securities laws were enacted in the 1930s.

For publicly held companies, the adoption of Sarbanes-Oxley has ushered forth an era of unprecedented scrutiny—and a significantly higher price tag, including extensive costs and time associated with performing the attest function on internal controls, as well as the cost of meeting other provisions of the Act, including software costs for documentation and additional testing of controls.

Perhaps one of the key changes brought about by SOX is the view of the corporate pyramid. Ten years ago, it appeared to me that the structure was incorrectly influenced by many CEOs who placed their own thoughts and interests ahead of those below them on the pyramid, namely shareholders, the board of directors, and employees. This viewpoint has now evidenced itself by the widely publicized fall of several CEOs accused of lavish spending and corporate fraud. Today you could argue that the company's shareholders are finding themselves taking the right position at the top of the pyramid, where the CEO, the board of directors, and the organization are all working together as they should to increase shareholder value.

Sarbanes-Oxley can be viewed as a new layer that sits alongside GAAP with the purpose of protecting public company shareholders from misleading or downright fraudulent financial reporting. It imposes an enormous number of important changes, many of which are meant to validate that there are strong internal controls being adhered to, spreading the accountability among multiple parties rather than leaving it to the judgment of one individual.

IMPACT OF SARBANES-OXLEY ACT ON THE FUTURE OF CORPORATE GOVERNANCE

Sarbanes-Oxley has already begun to effect a profound change on the way businesses govern themselves. The piece of legislation is sweeping: It places full responsibility on corporate executives and board members and demands accurate and full disclosure of accounting by public companies. Under the legislation, public companies must verify that internal controls are in place and being followed. In addition, SOX requires certification of the financial statements by the CEO and CFO.

Publicly held companies aren't the only ones affected by more rigorous corporate governance, however. Sarbanes-Oxley will have an impact on private companies as well. Private companies that see themselves as acquisition candidates by public companies should also become familiar with and perhaps adopt SOX requirements because their valuation may ultimately depend on their ability to prove that they have stringent accounting, internal control, and financial reporting practices. For good measure, some nonprofits may also want to adhere to SOX procedures, even if it's just to show they are following proper accounting procedures and have good internal controls.

The implications, obviously, are enormous. Here are just a few ways that the Sarbanes-Oxley Act will impact both public and private businesses in the future.

Increased IPO costs. The costs of complying with SOX are high. Companies filing with the SEC to issue an initial public offering (IPO) will experience sharply higher costs, and they will go through a number of additional steps to ensure they're in good shape. As the scope of audits expands, so do the costs of those audits. The pressures associated with Sarbanes-Oxley will be felt not just by the companies that want to go public but by the firms that audit them as well.

A boon for venture capitalists. Because the cost of going public continues to rise as a result of Sarbanes-Oxley compliance, both in terms of IPO filings costs—including the cost of acquiring the needed SEC, legal, and accounting expertise—and the ongoing associated costs of compliance itself, many privately held companies will seek funds through alternative sources. This will create a significant opportunity for venture capital firms to fill this funding need. Although the cost of taking on venture capital money isn't cheap, it may be less expensive than issuing an IPO, which can involve significant costs for compliance with SEC reporting requirements or risks of yielding a percentage of the company's ownership to investors.

Merging rather than IPO. Because the cost of going public continues to skyrocket, chances are good that many small and medium-sized businesses will opt to merge with other organizations—or be acquired by larger ones—rather than file a registration statement with the SEC.

Greater difficulty attracting board members. As the level of scrutiny continues to increase, businesses will find it more challenging to attract quality board members. The level of liability has never been greater for the board of directors, so board candidates will ask themselves if the personal liability outweighs the benefit and will more closely scrutinize organizations whose boards they've been invited to serve on.

These are but a few ways in which corporate governance is likely to change in the future. In the face of change, however, there remains one constant: In the end, although recent corporate governance changes are required, there is never a substitute for the integrity and ethics of management. ■

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