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CORPORATE ACCOUNTABILITY -- A LOOK AT STRATEGY

An Address by

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You have heard what you may think of as a bit of semanticism a minute ago when you heard at the conference that I am here as part of corporate governance in the '80s, but that I was going to talk about corporate accountability. To most people, those two concepts are one in the same. I, however, distinguish them and have a very strong preference for the concept of corporate accountability. To me, governance connotes a political process which is linked with concepts such as corporate democracy. I think it is clear, and should be made clear, that running a corporation is not a democratic process, nor is it intended to be. Corporate boards of directors are not political bodies, nor were they intended to be, nor should they become. Using terms that suggest the political scene, I think, inadvertently give some comfort and nourishment to thoughts that, in some fashion, the corporation ought to be more directly interwoven with the political scene, with the public-at-large and with concepts such as constituency directors.

If we talk then about accountability, let me preface it in this fashion. This Country, both politically and otherwise, has been built on the concept of accountability, and if we are to preserve the private enterprise system, it needs to account for itself to the larger society. Indeed, every institution in this society has a franchise -- a franchise from the society -- and every institution needs to account to that society for its relationship and its contribution. If it does not, or if it fails to satisfy the society in its accounting, the franchise will be changed. The concern that I want to present to you is that corporate franchise, in many ways, is being changed -- perhaps, to a great degree inadvertently or without the benefit of conscious decision of where it takes us.

Now, if I were to talk to you about corporate accountability in the '80s, I could address it in two ways. There are at least two issues that are of concern to the corporate community today that relate particularly to the relationship with the government and the larger society. First, we can characterize regulation and the increasing oppressiveness of regulation, and we could talk about the extent to which it dampens innovation and creativity, creates uncertainty, diverts scarce resources, capital and energy to frequently nonproductive purposes. We should be concerned about the extent to which the increasing burden of regulation creates a downward spiral that takes with it the economy and the responsibility of the corporate community to provide the goods, services and the jobs which it has provided in the past which most people would view as the basic responsibility of business. As we live with inflation and with an economy that is not productive, and as we become increasingly concerned about how we divide up a pie that is not growing rapidly enough, we have to be very concerned about the effect that our responses will have on the future of the system as we know it, and on the ability of private enterprise to flourish and to continue to do that which society primarily looks to it to do.

In the same context, a second concern that business has relates to tax policy, and how we can change a tax policy that encourages consumption, penalizes investment, and generally makes it difficult for business to attract and retain the capital it needs in order to replenish its resources, to replace plant and equipment, to build new facilities, to create the jobs, to be competitive internationally, and to be able to continue to deliver the standard of living that we expect.

One of the problems that we face in our society, and in government and business, as well as other places, is that everyone points to the other guy. Let us look at these same issues more from the standpoint of what it is that business can do to improve the likelihood that these conditions will change.

I would like to talk to you about two aspects of accountability in the '80s. The first is the process by which the corporation and the corporate community holds itself accountable, particularly the role of the boards of directors. The second is corporate profits as a measure of corporate accountability, which I think inevitably must be a very key concern for directors in the '80s.

With respect to the first issue on the accountability process -- the process by which the corporate community holds itself accountable -- there are, at various places in our society, and, indeed, throughout the political scene, pockets of opinion that are much too large to be ignored that express concerns about corporate power and corporate responsibility. They express these concerns in different ways and with a variety of motivations, but the theme remains the same. It is that management is all powerful and that, indeed, the corporate community has an enormous amount of power. Now, as I relate this to you, just listen to the music, whether you like it or not or agree with it or not is really rather irrelevant -- listen to the music.

The corporate community has enormous power. Management is all powerful. That power is largely used in ways that are in the interest and to the benefit of the corporation and not to the larger society. Corporate management is not accountable to anyone. Directors do not hold management accountable. Shareholders are merely speculators in the income stream and do not behave as owners as they might have done at one time in the history of the corporate structure. Over the years, the Congress, which supposedly expresses the public view or what it perceives to be the public view, has found it necessary to impose specific types of legislation on the corporate community in order to address, or redress if you will, certain specific abuses or failures of performance on the part of the corporate community. We could spend the next half-hour listing them -- OSHA, ERISA, auto safety, environmental quality, truth in packaging, truth in lending -- and probably 50 or 60 others.

Now, the reasoning says there has to be a better way to deal with the problems than by continuing to plug these holes only when they occur, or after the egregious failures of the corporate community have become so manifest that legislation is passed. The real problem underlying all this is the fact that the corporate community is neither responsible nor responsive. Therefore, the way to deal with the problems is to deal directly with the manner in which corporations are run. What we need is legislation which establishes the rules by which corporations are run that will determine for us who can serve on boards, how boards should be composed, etc.

The ground is fertile for that kind of reasoning. Business is not popular. Business, according to many of the polls, is perceived as not striking a fair balance between its own interests and those of the public. We can cite to you all the public opinion polls that point to that perception. So, whether the accusations against business are valid or not, there is a strong level of public support -- and very fertile soil -- for that kind of concern.

There are now two bills in Congress designed to deal with that kind of concern; one by Senator Metzenbaum of Ohio that would establish standards for boards of directors; and a second one by the Nader group that is much more comprehensive and called, innocently, the Corporate Democracy Act.

Is either of these bills likely to pass this session of Congress? No. I would say that there is no chance at all. But, I would urge that you do not take comfort from that. We can go back in the history of most pieces of legislation that have eventually been passed of the type that I have described to you, and you can track that history where in the early days a bill is introduced and nothing happens to it. But then along comes a thalidomide case -- and there will be one in the corporate community, whether it is another Penn Central, W. T. Grant, or Chrysler -- and then that kind of legislation may be passed. I would say at some time it could well be passed.

How do we avoid it? You are not going to avoid it by changing political parties. Do not count on that making a difference. When you look at the history of this kind of legislation, you find that it does not particularly respond to political parties. Can you hope or expect that the regulatory reform trend will make a difference? Not likely. That is a talk unto itself. The nature of the regulatory reform efforts in Congress at this point are patchwork, and although they may be cosmetically attractive, they are not likely to be very effective.

I think there is, at least at this point throughout the Country, a degree of justifiable disenchantment with the effectiveness of government regulation. I think, therefore, that there is a degree of opportunity here to shift the momentum. Now, how do we shift the momentum? Again, another talk unto itself. We have got to tell the story better of how the corporate community works. This is not a zero-defect society. It cannot be, nor will it be. Despite all of our best efforts, there are still going to be some bad apples and some risks taken that did not turn out right, as well as some losses, human risks and human failures. But, if we want the system to remain as it is and not be changed by the prospect of regulation or legislation, I think the key lies in making the system, as it is, work as effectively as it can. I think that points, in my mind at least, directly to the board of directors. I do not think we can expect the shareholder community, which is, I think, by and large, speculating in the income stream and looking short-term, to provide the kind of discipline and accountability that will be satisfying. I think boards of directors can be very effective. Some of them are. Others can be more effective than they have been.

I do not, however, think the main reason for boards of directors to be effective is to ward off legislation. I think the main reason for boards of directors to be effective is that they are a tremendous corporate asset when they are effective. These are very difficult and changing times where it is increasingly difficult for a corporation to be profitable. While management is increasingly focused on today's and tommorrow's performance by the very nature of things, and the struggle to survive and prosper, a corporate board, which is independent, effective, concerned about the future of the corporation and working with management, can provide a very valuable resource to management.

The second, less purposeful and maybe a more tactical reason why you want a good, independent, effective board of directors is that they are a very good defense when you are sued by shareholders. Having had an effective board of directors while at the same time being a defendant in 11 derivative shareholder suits, I can tell you that it is an asset. If you read the cases, you will find that, particularly in tender offer situations, it is good to have an independent board that <u>appears</u> to be independent and <u>is</u> independent. An independent board and an effective board is not an anti-management concept. There is no substitute for effective management. You can have the best board in the world, but if you do not have good management, the company is in trouble. I would rather have good management than a good board, but I do not think we have to make that choice.

In terms of the value served by the board, management cannot assess itself with objectivity -- that is the primary role of a board of directors -- to oversee and assess management. Management can be no more objective in evaluating itself than you or I can be in many other situations where we are personally involved. A board dominated by management cannot do that either. Dominated means either in terms of being dominated specifically by members of management, or directly by board members whose economic interests in the corporation are substantial and are subject to the will of management -- whether it is outside counsel, investment bankers, suppliers or others.

A board dominated by management raises two problems. First is the problem of the potentiality of conflicts. Can such persons function effectively as directors? That is the most important dimension substantively. A second problem we tend to ignore and underestimate the importance of is appearance. Mike Blumenthal, in his Fortune article a year and a half ago, published when he left the Treasury Department, observed that, in Washington, appearance is more important than substance. That is a rather tragic statement, but, unfortunately, it is quite true. It is true largely because of our society. We have to be concerned then not only about substantively how these institutions work, but whether they have the appearance of working well, whether they instill credibility and confidence, and whether they are resistive enough to criticism in order to survive as institutions.

What should such a board look like? For today's purposes, what is the trend? I would say that first the trend clearly is towards at least a majority of independent outside directors and, second, a committee structure that includes an audit committee, a compensation committee, and a nominating committee -- all staffed with independent directors.

But what do these committees do? I am not going to go through the whole litany, but audit committees not only meet with the auditors and look at the financial statements, but are increasingly concerned with the flow of financial information to the board. Compensation committees not only approve the CEO's compensation, but increasingly concern themselves with whether the compensation pattern and philosophy of the company is consistent with its other objectives. We put too much emphasis on short-term incentive compensation and we should not be too surprised if executives cut corners and give you long-term problems. The nominating committee ought to concern itself not only with nominating prestigious individuals to join the board, but should also be concerned with the effectiveness of existing directors in discharging their responsibilities, and how well the board, as a body, functions. To the extent that there ought to be additional members of management, such as outside counsel, it ought to be the independent nominating committee that looks to the question of whether the need for such members on the board outweighs the appearance and potential conflict problems.

I think the momentum is strong enough towards this type of board structure and composition that we are virtually at a point where a corporation that does not at least meet that kind of standard bears the burden of justifying why not. I think today, in the most extreme example, if you do not have an audit committee, you had better be prepared to explain why not.

Now, if you have an audit committee, the real substance is, you have got to make it work. There is no piece of legislation in the world that is going to make an audit committee work well -- only the board can make it do so. It has to be the commitment of the board members. It has to be the environment in the board room. Ultimately, those will be the determinants of how well boards work.

In the interest of time, let me move on to the second point. Corporate profits. The most misunderstood term in this Country is profits. I must say it is even misunderstood, at times, in the corporate community. But when it goes beyond the corporate community, it is totally misunderstood, both in terms of what profits are for and in terms of how adequate they are.

In terms of what they are for, this is where it is often misunderstood, even in the corporate community.

I read an interesting definition just the other day in Peter Drucker's new volume. I want to read it to you. "A business that does not earn the accrued cost of staying in business impoverishes the economy and is untrue to its first social responsibility: to maintain the wealth-producing and the employment-producing capacities of the resources entrusted to the enterprise and its management." */ This really says that when you end up the year and you have used up part of your manufacturing resources in order to produce products, you had better be sure that you put aside enough profit -- that really is not profit yet -- to replace what you have used up. Neither the public community nor the Congress as a whole know what profit is for. They do not understand the relationship between profit and jobs, the perpetuation of existing jobs, existing productive capacity or the need for new capacity.

Then the question is how do we measure profits even apart from the definitional problems? The historic accounting model does not measure profit. Now we are struggling with how to measure them. In the context of an inflationary

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*/ Peter Drucker, <u>Managing in Turbulent Times</u>, (1st Ed. 1980) 28.

environment, how we measure these profits becomes increasingly important. Financial Accounting Standard 33 makes the most recent and, I think, the most constructive step towards finding a way to measure profits.

Price Waterhouse recently did a survey of some 200 of the top Fortune 500 largest industrials and 200 of the others (banks, etc.) comparing reporting under FAS 33 with historic cost reporting. FAS 33, for those of you who are not familiar with it, endeavors to adjust traditional profit or income statements for the impact of inflation. That is an oversimplified summary of FAS 33, but generally that is what it tries to do. In the process of doing that, what the numbers told them was that income for these 200 companies was 60 percent of reported income. It was 40 percent less than nominal income as reported by these companies. The return on assets instead of being 17 percent was 8 percent. The effective tax rate rather than being 39 percent was 53 percent. The dividend payout ratio rather than being 33 percent was 60 percent. Now, if you adjust for before and after-tax the fact that dividends are post-tax and that the tax rate is pre-tax, what it tells us is that 86 percent of what we call profit goes out in inflation, dividends and taxes. It leaves us then with some 14 percent, on the average, for these 200 companies. When you boil it down further, it makes it very clear that many industries in our society, particularly those that are capital intensive, do not have the capital necessary to replace plant and equipment, to expand, to invest in productivity, to be competitive in world markets, to create more and better jobs and to assure our standard of living. What it tells us is that profits, rather than being obscene, are not adequate, and in many industries we are, to use Reg Jones' expression, eating our seed corn, and that in many instances we have companies, consciously or unconsciously, in the process of partial liquidation. And, in many instances, we are rewarding management with incentive compensation for liquidating the company.

But you cannot have it both ways. You cannot report record earnings and then go up to Congress and urge a change of tax policy so we can begin to get enough incentive to encourage, stimulate and reward investment. That is the dilemma we face. We have got to begin to reconcile these inconsistencies. Look at the earnings forecasts of projections for 1980 by major industry, and with the exception of one industry (and I will let you all guess which one it is) there is not one major industry in this Country whose expected rate of earnings growth in 1980 will equal the expected rate of inflation. So, as a practical matter, right now there is only one industry in this Country that expects earnings to increase to keep up with inflation.

We have got to be credible. We have got to tell the story -- and sophisticates understand the story. If you look at a stock in a heavy industry and it is selling at four times earnings, it is not undervalued. If you adjust those earnings for the impact of inflation, or if you look at the Dow in relation, not to reported earnings, but to inflation-adjusted earnings, the pattern fits the market much more closely. Sophisticated investors understand -- but the public does not understand, Congress does not understand and maybe some people in the corporate community do not understand.

These are the problems that are very much within the control of the corporate community. It is not easy to tell the story that profits are not what they appear to be, but the story is known. If we are going to change the picture, if we are going to change tax policy, if we are going to change the public perception of the corporation, the extent to which the public recognizes the importance of profits, the role of the corporations in the economy and the importance of the corporation to our society, and if we are to establish and re-establish and preserve the system as we know it and the importance of the corporation as we know it, then there is much that is within our control in the private sector which can be done. And that is where the buck has to start, if not stop.

Thank you.