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ADEQUATE INFORMATION: PREREQUISITE TO AN EFFECTIVE BOARD

An Address By

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I am pleased that this session is devoted to the important subject of information and the effective director. I am confident that the many perspectives which you will hear today will share a common theme -- that adequate and timely information is a prerequisite to an effective board. As with any other individual or group, the quality of the deliberation and decision process of a board of directors can be no better than the quality of the information considered by it. Yet, notwithstanding the import of an adequate information flow to the performance of the board and ultimately the corporate enterprise, remarkably little attention has been devoted to the subject in the literature, in the academy, or -- most significantly -- in the board room itself.

Among the differing perspectives with which you will be presented, my present position as Chairman -- particularly given my background in both the practice and theory of management and boards of directors and having personally served, at one time or another, on 16 boards -- seems closest akin to a corporate pathologist, i.e., because, in the context of determining whether all disclosures required by the federal securities laws were made, the Commission oftentimes becomes involved in analyzing the causes of a corporation's financial difficulties, illegal or questionable activities, or potentially material liabilities. And, this perspective has enhanced my appreciation that adequate information assumes a pivotol significance both to the effective operations of the board and, if subsequently challenged, to justifying its actions.

As a general matter, an effective board is marked by a number of characteristics -- such as independence from management -- which contribute to its objectivity and credibility. But, regardless of the other safeguards that may apply, a board which functions without adequate information assumes an unacceptable and unjustifiable risk of failure. Thus, the quality and adequacy of the information available to the board, in usable form, is a threshhold issue in assessing whether the board has the ability to responsibly perform the obligations of its office.

As a corollary to this principle, the adequacy of its information has become a necessary element in justifying a board's decision in the face of a challenge. A board which does not receive adequate information is in a position which should be as uncomfortable to its members as it is detrimental to the corporation's welfare. As public institutions -- such as government and the courts -- have reconsidered and rearticulated their expectations of directorial performance, a subtle -- but significant -- modification has occurred in the evidentiary burden that applies to legal proceedings in which board decisions are challenged. A vulnerable principle of corporate law -- the business judgment rule -- has long instructed courts to avoid intervening in a corporation's internal affairs or imposing liability on its directors for good faith judgments dutifully made. More and more, however, when the protections afforded by this precept are claimed, the burden is, in fact if not in law, shifting to the directors who claim their applicability to affirmatively show that the board was, in fact, not impaired by conflicts of interest or loyalty, or by lack of adequate information or deliberation in the discharge of its duties.

In sum -- both for the corporation's welfare and their own -- it is incumbent on directors to regularly examine the adequacy of the information flow available to them. And, particularly instructive in this examination would be an understanding of the problem areas most likely to frustrate the informational process. Accordingly, I would like to devote this presentation to highlighting three particular areas in which directors' informational systems appear most susceptible to failure. The first area involves establishing the parameters of the board's informational requirements. As I will discuss, these parameters are defined according to what I call the "vital issues" of the corporation. The second critical point involves the means by which such information flows to the board. It is my view that the final authority and responsibility for the adequacy of the information flow rests with the board itself. The third potential area for a systems failure arises when the board places undue reliance on certain performance measures which need to be considered in the context of other measures. And, in this context, I will discuss my concerns with some of the most frequently utilized performance measures.

I. Defining Adequate Information

At the outset, directors must determine the parameters of the information which they need to consider. They should begin by discussing and agreeing on the responsibilities of the particular board and the information needed to discharge those responsibilities. No corporate board, of course, is expected to be intimately familiar with all aspects of the corporation's operations. But, each corporation will face a number of issues -- I call them "vital issues" -- which will, individually or in aggregate, largely determine its success or failure. These vital issues represent the critical areas and policy questions which a board, to be effective, must monitor and consider on an on-going and intimate basis.

But most vital issues are not uniform among corporations. Rather, they will differ according to such variables as the corporation's financial condition, product or service mix, marketing and distribution techniques and particular operations. The competitive position of some companies, as an illustration, may be heavily dependent on their research and development capabilities -- which, therefore, must be considered a vital issue to them. For others, maintaining adequate material and resource supplies may be very crucial and warrant continuing board attention. For others their extensive operations in foreign countries will raise special problems. And, a corporation's vital issues may not always be identified by their immediate bottomline impact. In recent years, for example, questions of legal compliance and environmental impact have become increasingly significant to a corporation's future. While it would often be difficult to put a dollar value on their immediate impact, their eventual effect on the corporation may be sufficiently vital that they should be included among the issues to be regularly considered by the board.

Because these vital issues vary among corporations -- and even may change, over time, for a particular corporation -- it is the responsibility of each board to define and regularly identify the vital issues which it should consider. But, having done that, the board has, for all practical purposes, also substantially defined its informational needs. For, in my opinion, an adequate information flow -- both for purposes of directing the corporation and for justifying board actions -- is that information which will allow directors to deal intelligently with the issues which are vital to the corporation's welfare as a continuing enterprise -- and to evaluate management's performance against them.

II. The Information Flow

True, serious questions are often raised as to whether directors can ever gather all the information necessary to make and justify intelligent decisions -- or even to hold intelligent discussions. I recognize that, as businesses grow larger and corporations are divided into an increasing number of segments with unrelated markets, distribution systems and technologies, it is an increasing challenge to assure that even the most conscientious directors can be adequately briefed on important corporate developments without drowning in an incomprehensible flood of reports, charts and printouts. But, my belief is that if a corporation is not too complex to be managed, then there is no reason why it cannot also be effectively directed -- at least, if there is a disciplined control maintained over the information flow.

It is, therefore, critical that the information flow provided to the board be concise and relevant. It should not needlessly impose on the directors' limited time. Already, to be effective and absent special problems, board members must devote generally a day a month to meetings plus additional time for preparation. Thus, directors should not be weighted down with comprehensive reports which serve a managerial purpose, but which relate to matters that are not within the board's responsibilities or whose degree of detail would not contribute meaningfully to the board's deliberations.

However, neither should a concern for the directors' time be used to rationalize not providing the board with all of the data necessary for directors to fully consider vital corporate issues. And, this means analysis as well as numbers. While raw information is valuable, it is essential that it be supplemented by an explanation -- on an exception basis -- of particularly significant results and trends.

This information flow is the responsibility of the board itself. The board should periodically and comprehensively consider the adequacy of the information it receives. While the originating source of such information must be the corporation's management, the board cannot be passive in relying on management to provide it what it needs. I do not subscribe to the suggestion of Justice Arthur Goldberg that boards should have their own staffs, although I appreciate the frustration a director can experience in trying to gather and evaluate adequate information -- particularly when he is not fully confident of the completeness and frankness of the information which management does provide. But, such a degree of distrust is not compatible with the constructive working relationship necessary among directors and management. In my view, where such an unfortunate situation exists, all reasonable efforts should be made to resolve it. If it cannot be satisfactorily resolved, then the negative impact of such distrust warrants that either management should be changed or that the affected directors should terminate their relation to the corporation.

The idea that directors should look to management to be kept adequately informed is no different -- and no less appropriate -- than management relying on its subordinates as informational sources. And, just as within management, the standard of "no surprises" -- favorable or unfavorable -- should apply to the information flow to the board. A director who is confronted with a "surprise" is on notice that management is either not in control or is not keeping him adequately informed -- and the director should respond to this lapse with an appropriate degree of intolerance.

Being faced with a major decision without prior notice or involvement is also a "surprise." The insights and independent perspectives so significant to corporate decisionmaking are essentially lost when the board is presented with a prepackaged management determination for "yes" or "no" disposition or with eleventh-hour alternatives. Rather, when vital corporate decisions are to be made, the board should have the opportunity to consider the project as it evolves past its various decision points, in the contexts of the corporation's objectives and resources, of the alternatives available, and of the implications of the various courses of action.

Moreover, affording a board the opportunity only to accede to or refuse a finalized management decision risks the possibility of confrontation between these parties over concerns which might have been more easily resolved at an earlier stage. When directors believe that they do not have an adequate opportunity to have their questions and concerns fairly and openly considered -- but that they nonetheless may be held responsible for the corporation's actions -- a gulf often develops between the board and management. A board which feels closed out of the decisionmaking process is less likely to be confident in, and supportive of, management when something goes awry -- the very time when management most needs the backing of the board.

In contrast, a management which effectively communicates with its board throughout the decisionmaking process will more likely enjoy the degree of trust which is the most effective way of keeping the board from intruding into management's proper domain while encouraging the board's support of management when unusual risks or problems arise.

Indeed, given the significance of the information flow to the operations of the board, its relations with management, and, ultimately, the corporation's welfare, I would expect that the board would include the timeliness and adequacy of the information provided to it by management among the criteria on which it evaluates management's performance.

III. Appropriate Performance Standards

However, even a full flow of information can adequately communicate the corporation's condition only if it is measured against accurate and meaningful standards. Many boards of directors rely on measures of corporate performance which do not adequately convey the corporation's actual performance and financial position. The result is that, based on such erroneous perceptions, many boards are taking actions by which they unknowingly exacerbate critical corporate weaknesses.

It is, of course, impossible to generalize the appropriate performance standards applicable to every corporation. Nor can standardized check-lists adequately meet the individual needs of particular enterprises. Instead, the responsibility to determine the appropriateness of the standards against which information is -- or should be -- measured lies with each corporation's board. Nonetheless, it would be instructive for directors who are undertaking such an analysis to review some of the most common failings.

First, in the contemporary economic environment, a serious problem arises if a board tries to analyze the corporation's financial condition without considering the effects of inflation or if it avoids tackling the difficult task of determining how the corporation is faring under the burdens of inflated dollars and expensive capital. Inflation, we have come to appreciate, can render superficially imposing financial figures meaningless, since historic-based earnings bear little necessary correlation to economic reality. Traditional financial standards and rules of thumb no longer seem to apply. Thus, boards should be looking at inflation-adjusted financial reports on a regular basis -- and they should recognize that, if management does not have a similar practice, it is a warning that management may be operating with a distorted view of the corporation's performance.

Indeed, availability of inflation-adjusted reports allows an understanding of a corporation's condition which is unavailable to those who rely exclusively on conventional historic-based accounting principles. As a general matter, this information has only recently become widely disseminated, as a result of the Financial Accounting Standards Board's promulgation of Statement of Financial Accounting Standard No. 33. Several analyses of the inflation-adjusted information included in 1979 financial reports have already been published and they are quite alarming.

One such analysis by a national accounting firm shows that inflation-adjusted corporate income among the industrial companies included in the analysis is only 60 percent of the figure that had been reported, under traditional accounting methods, to represent corporate income. The 40 percent disparity would have been even greater except that it excludes companies for which the adjustment results in a loss. Moreover, rather than having a 17 percent composite return on assets, as computed according to historic-based standards, the real, inflation-adjusted figure is less than half -- only 8 percent.

Since corporate income is substantially lower than previously perceived, distribution is a much higher percentage of income than traditional measures and rules of thumb have reflected. For example, it was widely believed that corporations are taxed at an effective corporate tax rate of 39 percent. In fact, inflation accounting methods reveal that the composite of industrial corporations pay a significantly higher, 53 percent, real tax rate. Similarly, the general assumption, using historic cost accounting, had been that cash dividend payments on common stock are about one-third of corporate aftertax income, when in reality they are double -- two-thirds of inflation-adjusted income after taxes.

Most disturbing, however, is that the aggregate of those composite figures for taxes and dividends paid on an inflation-adjusted basis approaches -- and in some industries exceeds -- corporate income. That means that much of the corporate community is distributing more than its real income in taxes and dividends. These figures indicate that portions of the industrial sector must be paying their taxes and dividends out of capital resources. That, for all practical purposes, means that a substantial part of American industry -- the historic keystone of our prosperity -- has begun to liquidate.

Inadequate capital resources can severely impair a corporation's future operations. In failing to maintain existing facilities, a corporation, in effect, devours its present capacity for production without providing for its replacement. And, by not providing the new capital necessary to build new facilities and to develop new products or improved generations of current product lines, a corporation defaults on its future growth.

Thus, it has become urgent that directors determine, as a first priority, whether the corporation is providing for its capital requirements on an on-going basis. For example, they should consider the corporation's current dividend policy only in the context of a broader analysis which also evaluates the corporation's capital budget and the impact of inflation upon it. And, only when it has determined the amount needed by the corporation for both capital maintenance and growth -- and, thus, maintain or, more appropriately, enhance the corporation's financial viability as a continuing entity -- should the board consider the amount of dividends which it should pay out to its then-current shareholders.

The second problem area deserving a board's particular consideration is the role of earnings and their relation to the corporation's financial posture. Indeed, there is a growing question whether the presently accepted definition of earnings adequately communicates the reality of a corporation's revenues and cash flow. As an illustration, a corporation which consolidates a 20 percent-owned company can, under current accounting principles, include as earnings a portion of the income of the 20 percent-owned company which has not been -- and may never be -- received and whose disposition is beyond the corporation's actual control. These so-called "equity earnings," therefore, produce corporate earnings which may not be necessarily translatable into corporate revenues or cash flow. Yet, they are nonetheless included without qualification in such traditional performance indices as profit margin, return on equity, and price-earnings multiples.

Because of the limitations of such information, the effective director must recognize that corporate earnings reports communicate, at best, only part of the story. And, their most critical omission -- in recognition that insufficient cash resources are a major cause of corporate problems, particularly in inflationary times -- is their failure to speak to a corporation's cash position. Indeed, in my view, cash flow from operations is a better measure of performance than earnings-per-share.

Directors should, therefore, also consider the more revealing analytical concepts of cash flow or cash-flow-per-share, which reflect the total cash earnings available to management -- that is, earnings <u>before</u> expenses such as depreciation and amortization are deducted. An even more sophisticated -- and, in my opinion, more informative -- analytical tool is free cash flow, which considers cash flow <u>after</u> deducting such spiralling corporate costs as capital expenditures. This technique allows directors to evaluate the costs of maintaining the corporation's present capital and market position -- costs which are, in essence, expenses and cash flow obligations that should be considered by the board in determining the corporation's financial position.

There is, in fact, evidence that the market multiple reflects net free cash flow more closely than earnings. And institutional investors are clearly devoting increased attention in an effort to assess "distributable" income and project the likelihood of dividend increases.

The third area of concern results from an undue reliance by some boards on short-term performance measures. An on-going business has both a short-term and long-term perspective. In many corporations, the board relies exclusively on current performance figures to determine the corporation's position, as well as to evaluate and reward management. This situation compounds management's own frequent tendency to have a short-term, bottom-line oriented focus -- a myopia which could have a severely negative impact on the corporation's future.

In fact, in many situations, a reliance on short-term performance standards may be inconsistent with the interests of the corporation as an on-going enterprise. Current outlays for research and development, equipment maintenance, new machinery, advertising and personnel development diminish the corporation's current earnings -- a standard yardstick of short-term performance. Similarly, milking a product may make the corporation look good for the present, but it may also injure the corporation, over time, by encouraging potential competitors to enter the market and by leading consumers to switch to substitute products. And, most disturbingly, in some corporations the excruciating pressure to meet profit goals is so severe that some managers have committed illegal acts to induce sales, and falsified corporate books to conceal improper accounting entries designed to improve earnings or put a better face on corporate performance. In essence, racing on a treadmill of never-ending "todays," an unduly short-term orientation may not leave either the time or the interest -- and, indeed, often places some real disincentives -- to a concern for the future direction of the corporation.

The board which succumbs to such a short-term orientation -- that unduly relies on current performance figures and fails to provide or monitor a long-term direction for the corporation -- has, to my mind, a heavy burden in establishing that its decisions are being made on the basis of adequate information. Indeed, before it so narrowly limits its perspective, a board should carefully determine if a short-term orientation accurately communicates, and is consistent with, the financial posture of a continuing enterprise. Moreover, in such circumstances, the board should consider whether its focus on measuring and rewarding short-term performance is inappropriately rewarding -- and, indeed, encouraging -- performance which may not be in the overall best interests of the corporation. If the board measures and provides incentives to management heavily skewed to short-term performance, it may be encouraging management to short-change the corporation's future. And, a board which operates with such a perspective cannot then absolve itself of responsibility for its consequences.

Conclusion

In conclusion, as I have discussed today, I believe that the director has a special responsibility and a pivotal role to play in the corporate structure, but can be seriously frustrated by an inadequate information flow. It is, therefore, incumbent on the board to assure itself, on an on-going basis, that it is receiving the information necessary for it to identify and to understand the issues vital to the corporation it serves, as well as to make and justify intelligent business decisions affecting those issues. Indeed, in my view, both the needs of the corporation for an informed, effective board and the larger society's emerging expectations of directorial responsibility could not be satisfied with any less a standard.