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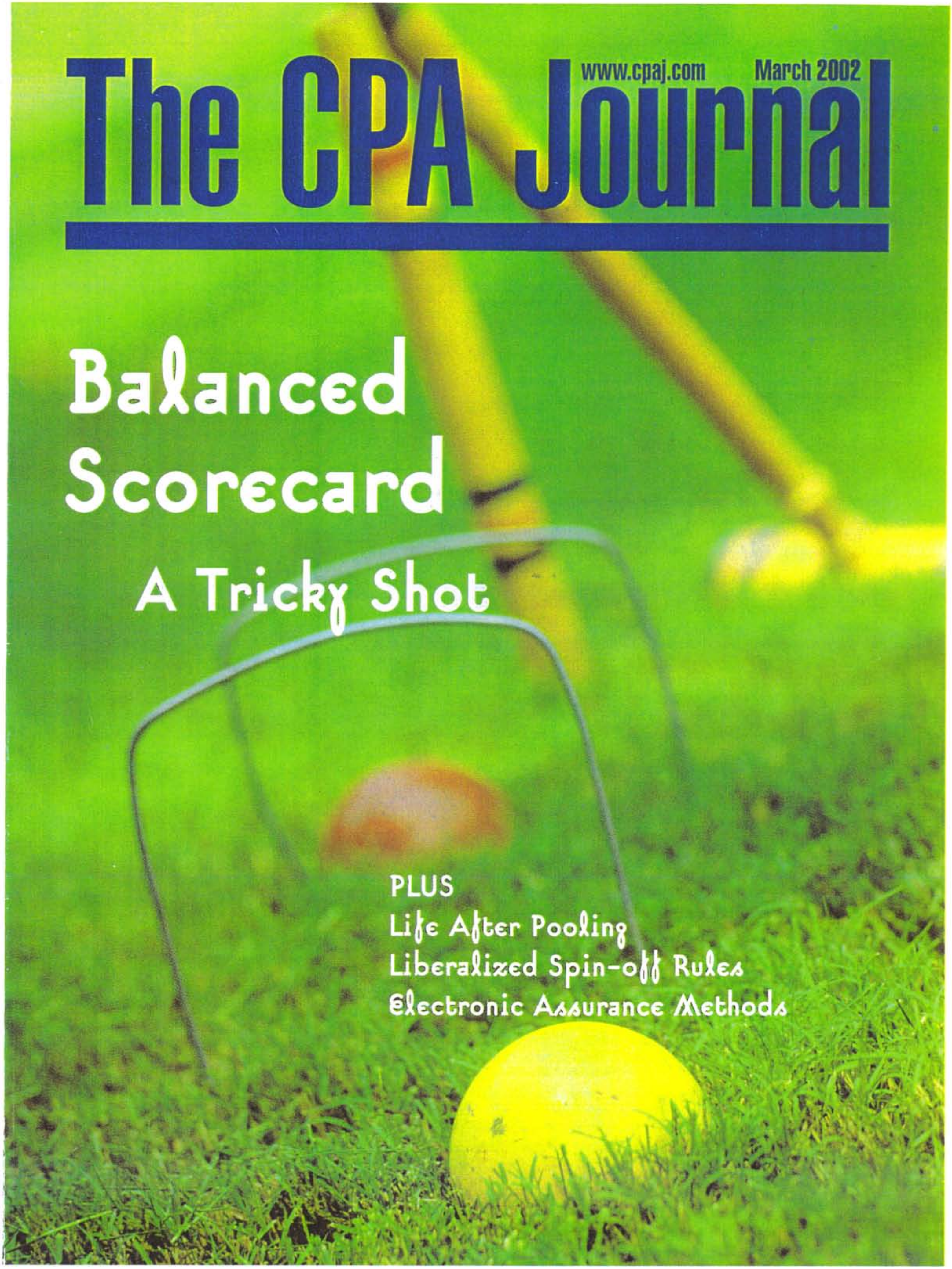

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FROM 'TONE AT THE TOP' TO 'CHECKS AND BALANCES'

By James N. Clark, R. Hartwell Gardner, H. Stephen Grace, Jr., John E. Haupert, and Robert S. Roath

For the past three decades, corporate governance experts focused on improving the "tone at the top." They believed that a strong CEO setting the right tone was the best way to ensure good management practices and adequate controls. Now, however, a distinct shift is solidly under way, focused on an improved set of checks and balances among the five fundamental elements of corporate governance: the board, the audit committee, senior management, the internal auditor, and the external auditor.

The checks and balances approach addresses the roles, responsibilities, and relationships among these five elements of the governance process. This shift is permanent, and deeply seated forces drive it. Institutional investors, individual investors, and other market and regulatory interests increasingly demand that those involved in corporate governance recognize their responsibilities, are held accountable in addressing these responsibilities, and recognize that their role is one of service rather than entitlement.

It was only a relatively short time ago that senior management wanted, and got, no outside involvement. Even when outside directors were on boards, they were usually not selected for their management or technical skills. Such board members frequently focused on the prestige of their role rather than the performance of their responsibilities.

Courtney Brown, former dean of the College of Business at Columbia and a board member of several well-known companies, highlighted this issue in the preface of his 1976 book *Putting Corporate Boards to Work*:

> Members of governing boards have a prestigious status in society—more prestigious than the present nature of their activities can support. It is a status that reflects the popular belief and expectation that governing boards do indeed govern. Building on this preconception, the work of governing boards can and should be clarified and strengthened to the ultimate benefit of corporations and society.

Nonetheless, in spite of the efforts of Brown and others, attempts at improving corporate governance continued to focus on improving the "tone at the top," stressing the need for improved character, integrity, and responsibility primarily on the part of senior management.

Learning from History

The focus on tone at the top unfortunately ignored the lessons of history. Experience has shown that governing structures which consolidate power and authority into fewer and fewer hands, while conceptually attractive in terms of potential efficiency and effectiveness, have consistently failed to meet these conceptual ideals. Lord Acton told us long ago, "Power tends to corrupt, and absolute power corrupts absolutely." Dictatorships and monarchies dominate the history of political governance, although they have consistently failed. Such failures led to the evolution of a democratic form of government, which, in spite of its seemingly time-consuming checks and balances, has proven thus far to be the most effective form of government.

The shift to an improved set of checks and balances in corporate governance is under way. Each of the key elements of the corporate governance structure—the board, the audit committee, senior management, the internal auditor, and the external auditor—must closely examine their roles, responsibilities, and relationships with the other elements of the corporate governance structure.

In the authors' view, the buck should stop with senior management, the board, and board committees. Their roles and relationships must be defined and understood in that light. The board, with and through its audit committee, must accept the ultimate responsibility for ensuring the quality and integrity of the risk and control environment. The current approach overrelies on the external auditor in fulfilling the requirements for public reporting and disclosure. While the external auditor is an essential element, its role should be understood within the context of board responsibilities rather than management functions.

The intensified level of interest in improved corporate governance and the shift toward improving checks and balances are permanent. In both advisory and litigation capacities, it has become apparent that institutional investors, individual investors, insurers, and the plaintiffs' bar are clearly focused on the requirement that each element of the corporate governance process recognize and fulfill its respective responsibilities. The sizable settlements in recent high-profile litigation confirm this.

Institutional investors have long called for all of the involved parties to recognize their responsibilities. Individual investors, many of whom are now directly responsible for the management of their savings and retirement benefits, have joined this chorus. Insurers have seen directors' and officers' insurance lines incur significant losses in recent years. These insurers are not only looking at significant premium increases but also implementing co-insurance solutions.

The shift in focus of corporate governance to an improved set of checks and balances is a win-win situation for all involved. Corporate governance is not a zero-sum game, nor are its structure and operation. This is not about shifting power from one participant in the governance process to another. An improved set of checks and balances entails the dynamic definition of the roles and responsibilities of every participant in a manner that optimizes potential synergies. Corporate governance is a win-win or a lose-lose situation—not just for the participants, but for all of society, as Courtney Brown so astutely stated over 25 years ago. ❑

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