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Financially oriented director: New role and new responsibility

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THE FINANCIALLY ORIENTED DIRECTOR

New Role and New Responsibility

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Is the role of the financially oriented director different from that of other corporate directors? To a degree it is.

Most directors tend to see themselves as directors first, placing their primary occupations, skills, personal interests, and even their board committee memberships in a context of broad responsibility—a view that is both appropriate and necessary. A financially oriented director, like any other, needs this breadth of vision because, ultimately, his job is *directing*, not *doing*. A director with a financial background should not assume a broader responsibility for *all* financial problems, nor should he narrow his responsibility to exclude other matters.

Lawyers might argue that all directors bear the same responsibility, but whether they would advise all director-clients to assume the same role is open to question. What is certain is that the roles of these directors have changed. In his testimony before the Senate Judiciary Committee's subcommittee on citizens' and shareholders' rights and remedies in 1977, J. Wilson Newman, a retired chairman of the board of Dun & Bradstreet and a director of Lockheed Aircraft Corporation, raised an important point about the changing role of directors: "Added responsibilities are being placed on directors and being demanded now, in terms of legal concept. They have been there all the time, but now they have surfaced."

Before Watergate, for example, how many directors would have bothered to ask about corporate codes of conduct, illegal political contributions, or bribery of foreign government officials? Or, until recently, how many directors would have asked about women or minorities in their organizations? Few, probably. Now, under the law, directors must concern themselves with such questions.

Adapting to Reality

A 1975 Conference Board report suggests another important area of change. The report, entitled "Corporate Directorship Practices: Role, Selection and Legal Status of the Board," cites the "increasing legal recognition of the complexities of modern business, and of the divergent backgrounds, experience, and responsibilities among directors on the board." Moreover, the article argues, there is a trend toward "more flexibility, with the law adapting itself to the problems at hand." No longer do the same principles necessarily "govern the directors of all corporations—whether a thousand or a billion dollar operation or whether a service or a manufacturing organization." Nor does every director bear "the same responsibility, whether he be an insider, an officer, an outsider, an attorney, an investment banker, an educator, an environmentalist, or whatever. Significantly, there are more and more instances of courts looking to the realities of the facts presented."

Those "realities" are far from clear. But one thing is becoming more apparent—specialized knowledge does influence the role a director will play while serving on a board. An officer-director, for example, can gather more from the information the board receives about corporate activities than a director who has not served as a member of corporate management. Similarly, the financially oriented director is expected to apply his experience and insight to the board's business. As an example, the accountant or investment banker is presumably better at spotting inconsistencies in a draft annual report than an environmentalist or clergyman.

In many states, statutory law reinforces these assumptions. The Model Business Corporation Act, as revised in 1975, authorizes a director to rely on information, opinions, reports, or statements—including financial statements and other financial data prepared by corporate employees, outside experts, or a board committee of which he is not a member. *The exception is when he has knowledge which would cause such reliance to be unwarranted.*

According to the act, the financially oriented director must be ready to apply his knowledge of accounting, auditing, or other financial matters should events warrant. He can and should evaluate the credibility of the data furnished him, "reading" financial statements, reports, and even discussions at board meetings to determine if anything is unusual or inconsistent. Directors are not required to verify all information on which they base their decisions; the Model Business Corporation Act says that a director can rely on the data furnished him when he does so in good faith.

In *Litwin v. Allen*, the court ruled that although directors are not liable for mistakes of judgment while acting with reasonable skill or prudence, they must not be negligent. In the *Stirling Homex* case, the SEC publicly criticized two outside directors for failing to fulfill their responsibilities, even though neither had reason to believe that the Stirling Homex financial statements were false and misleading. In this case, the commission also cited the infrequency and perfunctory nature of the board's meetings, the absence of an audit committee, and the directors' failure to inform themselves about and exercise control over the accounting principles used.

The *Stirling Homex* case should serve as a warning to the financially oriented director, suggesting strongly that he educate himself about the increasingly complex nature of financial reporting. Merely keeping up with the new developments in this area is a major undertaking, as a glance at the many sources of generally accepted accounting principles will confirm. They include:

- The statements of the Financial Accounting Standards Board.
- Technical bulletins issued by the FASB staff.
- The ASRs and other promulgations of the SEC.
- The statements of position issued by the accounting standards executive committee of the AICPA.
- Other AICPA publications, such as audit and accounting guides.

The SEC Role

As formidable as this list appears, financial reporting encompasses more than generally accepted accounting principles. The SEC plays a major role in shaping reporting practices in the U.S., requiring disclosure of everything from the properties owned by an issuer to details about management compensation and perquisites. And these requirements change, and sometimes radically.

One especially important example of SEC intervention is its ongoing interpretation of the Foreign Corrupt Practices Act. The commission's ASR 242 has already addressed the accounting standards requirements of the act and the reporting of questionable payments. The SEC has recently circulated new proposals, including a requirement that will have far-reaching effects on all publicly held businesses. The commission wants management to represent that its systems of internal accounting and control provide reasonable assurances that the broad objectives stated in the act are achieved "without materiality of amounts." Obviously, the financially oriented director should monitor the commission's activities in this area with care. He should do more, however. Because of his special knowledge, he can "educate" his fellow directors about the implications of the SEC's deepening involvement.

The financially oriented director should be familiar with principles, requirements, and the relevant activities of regulatory agencies which affect the company. The knowledge required will vary, depending on the depth of the company's involvement with the agency.

While an acquaintance with the legal climate is extremely important for all directors, it is particularly so for the financially oriented director. Legal requirements are imposed by the courts, the Model or State Business Corporation Act, and by applicable federal law and regulations. Obviously, each director should keep up with the trends in case law and statutes and make some attempt to recognize where these are likely to lead. Information on legal developments can be found in a number of publications, in the administrative actions brought by the SEC, and in speeches given by the SEC commissioners and staff, as well as by law professors and others.

Aiding the director in his quest for information about his legal responsibilities are such publications as "The Corporate Director's Guidebook," prepared in 1976 by an American Bar

Association subcommittee, and the excellent Conference Board research reports. The Conference Board, the National Association of Corporate Directors, and a number of reputable academic institutions hold educational seminars for directors. Finally, each year, both specialized and general publications address the legal needs of directors. Even though these publications and seminars do not usually deal with matters concerning the financially oriented director specifically, they disseminate much valuable information.

Using the Advantage

At first glance, having a financial background may appear to place excessive burdens on a conscientious director, while increasing his exposure to liability. In reality, a financial orientation can be turned to advantage, for it enables a director to contribute more to the company in his capacity as a director while he also protects himself legally.

If I myself were serving as a director of a corporation, I would ask to be appointed to the audit committee. Membership on that committee would allow me to make the most of the time spent in fulfilling the portion of my directorship obligation allocated to financial matters. Not only could I use my experience as an accountant, but I would also have greater access to financial information. With both the information and the time to consider it, I could significantly reduce the likelihood that I would miss something important—the *something* I might be expected to discover because of my financial background.

One of the most difficult challenges for directors may be coping with the manner in which influential critics and groups have interpreted their role—everyone who seriously considers this subject recommends some improvements in the system. In important instances, the courts are providing interpretations. The *Killearn* case offers a good example.

The consent judgment resulting from the SEC's enforcement action against Killearn Properties, Inc., mandates an audit committee composed of three outside directors. It also prescribes ten specific duties, such as reviewing the engagement of independent accountants, the company's procedures for internal auditing and its accounting and financial controls, and all information about the financial condition of the company and its subsidiaries which will be disseminated by the company to the public. No responsible director can afford to ignore the implications of this ruling.

The Board's Duties

In satisfying these demands, what should the financially oriented director do? I can best approach this question by sharing some thoughts about what I would do if I were a director today. My thinking is based on a simple premise: individual board members must have a clear idea of the board's duties.

First, the board should spend a few minutes at certain meetings to consider formally the scope of both its activities and those of its various committees. Then, the financially oriented director should try to influence the audit committee to consider whether it should undertake each of the ten activities listed in the Killearn court order.

A financially oriented director also should develop some criteria to guide the audit committee. For example, I would not insist that the audit committee automatically review and approve all public releases containing financial information if: 1) The outside auditors performed quarterly reviews of interim information. 2) The results were reasonably in line with budgets or plans. 3) Past audits had not revealed that significant errors escaped timely detection by the company's system of internal controls and review of financial management. Audit committee involvement will become essential if the independent CPAs discover a problem or if the results represent a significant departure from plan.

A director should oppose overloading the board's agenda. If the board cannot deal with normal business in its meetings, it should consider forming additional standing committees or special committees to deal with important matters in sufficient detail. The board can define its role, in part, by identifying matters that require in-depth attention.

Boards have built-in mechanisms for fulfilling their responsibilities and protecting their members. If corporate officials and employees are not functioning as they should—thus weakening the reliance that may be placed on them—the board has a clear duty.

Reasonable Expectations

While these suggestions are certainly far from exhaustive, they do point to some matters that the financially oriented director might keep in mind. Richard Whately, a 19th century Archbishop of Dublin, once observed that "It is folly to expect men to do all that they may reasonably be expected to do." Tailoring Archbishop Whately's remarks to our own time, we can unfortunately anticipate that someone will always expect a board to do *more* than it may reasonably be expected to do. In the face of these demands, all we can do is try.