Company perspectives on governance

Richard W. Connor, Steven C. Halstedt, Meredith Williams

Following Ms. Williams' talk, three members of the Institute's Global Advisory Board formed a panel to offer their insights and perspectives on the issues.

Richard W. Connor began his career with KPMG in 1971 after graduating from the University of Colorado at Boulder with a bachelor's degree in accounting. He was elected to the partnership in 1980. In 1996, he was appointed managing partner of the Denver office, where he has spent his entire career. He also serves as an audit partner and SEC Concurring Review Partner. His major focus is on clients in the communications and media industries, as well as the energy and mining industries.

Steven C. Halstedt cofounded Centennial Ventures in 1981, and is in his 21st year of direct venture capital investing. In June 1999, he received the Ernst & Young Entrepreneur of the Year Award in the category of Supporter of Entrepreneurship. He was the founding president of the Venture Capital Association of Colorado and currently serves on the board of the National Venture Capital Association. Halstedt holds a BS in management engineering from Worcester Polytechnical Institute and an MBA from The Amos Tuck School of Business Administration at Dartmouth College, and was named an Edward Tuck Scholar.

Meredith Williams is the chief executive officer of the Public Employees Retirement Association of Colorado (PERA), a position he assumed in March 2000. Previously, he was executive secretary of the Kansas Public Employees Retirement System. He has published and lectured widely on the subject of public sector accountability and oversight. Williams is an active member of several professional organizations and has served as the national president of the Association of Government Accountants. He has a degree in business administration and economics from the University of Kansas, and a law degree from Washburn University School of Law, Topeka.

Rick Connor, Managing Partner KPMG Denver Office

In the 1990s, it looked like the bubble would never burst, but influences were at work that would lead to what Connor described as "the perfect storm" of bankruptcies, accounting scandals and market losses.

"Investors disregarded the normal standards of what represented value and started measuring companies based on multiples of revenue. We all started believing in the New Economy," which was going to be immune to the periodic downturns of the past.

"And that created conditions where if you were going to cheat, you could really make a lot of money doing it. The opportunity was there for people who were close to the edge or over the edge."

Management found itself under pressure to perform. "And because the market was trading at huge multiples, there was enormous pressure on management to keep the performance going." Unfortunately, there was often a gap between what they claimed and what they achieved.

"And when the real numbers came out, you either had to try to bend the rules a little, or you had to suffer the consequences, maybe losing half your market cap because you missed earnings per share by two cents."
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The Securities and Exchange Commission and the accounting profession played roles in the ultimate storm. An adversarial relationship existed between those who made the rules and those who had to follow them.

"The SEC very early on developed a hostile relationship with the public accounting firms. Over time, our profession deferred to the judgment of the SEC. So if company auditors came across an accounting issue that was unclear, what they tried to do was determine what would get by the SEC, rather than what was an appropriate and fair presentation."

Connor believes the SEC was complicit in the problems that eventually came to light. "Although you will notice that they have spent a great deal of time misdirecting the blame to everyone else."

He wonders why SEC members never reviewed an Enron filing during their entire term of office.

But while the era of unpleasant surprises may be over, Connor is concerned about new legislation that he considers far-reaching.

"The best I can tell, the legislation was designed to provide a law and a penalty for every perceived transgression that occurred during this period. You can actually look at the paragraphs and see what was inspired by Enron, by Adelphia, and so on."

"All this puts added pressure on boards, particularly on board audit committees whose members must meet certain educational requirements and be experts in their fields."

The SEC's definition of expert is "overreaching," Connor said, "and it's going to eliminate a lot of people who would otherwise be good audit committee members. Furthermore, experts are targets."

Another reason why it might be hard to attract people to audit committees is "the enormous amount of process connected to their new role. Audit committee meetings that used to last an hour now can turn into day-long events."

"I think it's going to be harder and harder to go public, especially for small companies, because they won't be able to meet the standards or attract the expertise that's now required."

Connor sees "interesting times ahead while we wade through the reforms. Ultimately we'll come out the other end and we'll get used to the new regulations. But it's going to be a drain on company resources and a drain on our economy for some time to come."

Steve Halstedt, Managing Director Centennial Ventures

"Beware of the rubber yardstick," said Halstedt, talking about boards that are dysfunctional and fail to hold management accountable.

He described how one of these boards sat back and allowed the company to change its budget five times during the year. "At the end of the year, the management team demanded a big bonus for hitting the budget. This kind of behavior happens all too frequently."
Another potential problem lies in the size of the board book. Halstedt explains:

"The bigger the board book, the less successful the company. What it means is the management team is trying to dazzle you with data, rather than give you the one page, the sort of dashboard with which you can drive this car. They don't know how to drive it, they don't know what the dashboard is, and rather than admit that, they'll give you lots of information, some of which is useful, most of which is not.

"The most successful boards are those that work together in a collegial fashion. They have committees, the committees have charters, the committees know what they're supposed to do. The CEO or the chairman has been smart enough to give every board member a job so they are engaged and able to be a part of the process."

Halstedt finds it "shocking" that annual reviews of the CEO and self-reviews by the board are the exception, not the rule. "The only reviews that I see going on are those for compensation purposes."

Businesses that work well have a competent CEO, a business plan, a budget, and an operating plan for the year, he said. "If all the people on the team hit about 80 percent of the targets set for them, they hit the budget."

As a venture capitalist, he has sat on many boards, working to help companies grow from an embryonic state to where they are strong enough to go public. Finding the right leader is the first step toward achieving success.

"Leadership is a force, like gravity. If you can find a CEO who is very skilled, who can put together a team that can build a company, he provides that force of gravity to the management team and can take a company a long way."

Much of what has happened in the marketplace has to do with the "meltdown in values."

There was a lot of venture capital money floating around in the mid- to late 90s, fanning the flames of entrepreneurship. "In 1995, commitments to venture capital funds were $9.9 billion in the U.S. In 2000 commitments soared to $107 billion, a ten times increase."

Contrary to popular opinion, "there wasn't too much money chasing too few deals. There was too much money funding too many companies that were chasing the same opportunities. All of them were projecting they were going to have the same market share in a given marketplace. There's only room for two or three to really make it big, but you didn't know which two or three that would be.

"The venture capital industry started 8,000 companies. It's not a surprise that a lot of these companies are failing."

Although the market adjustment was inevitable, "I don't think anybody thought there would be the kind of meltdown in the values of these companies that has occurred since 2000." He puts the number at $5.5 billion.

"The physics of investing are such that the bubble, when it bursts, creates the opposite conditions for a comparable length of time. The bubble of the 1990s lasted for five or six years, and I would expect the opposite conditions to last for the same period of time."
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A guest suggested that well-intended laws can have unintended consequences. He referred to the increased cost of capital as an example.

Halstedt agreed that the cost of capital is a huge issue. "Audit committee members are going to be very expensive. We're putting so many checks and balances in place, and yet maybe it comes down to: Are the people honest? Are they trustworthy?"

"I think we're focusing on the wrong problem. The No. 1 problem is the ethics and morals of the CEO and the company culture he establishes."

Meredith Williams, CEO PERA of Colorado

Williams believes that shareholder responsibility has not been given the attention it deserves. "I'm a shareholder. Many of you are shareholders. Don't we have some responsibility?"

He does not expect the SEC or the stock exchange to ride to his rescue. "I think we all have a responsibility to act for our own constituencies, on behalf of our constituencies."

PERA lost $9 million when Enron collapsed. But before the collapse, PERA had made $20 million on Enron stock. "Sometimes we lose sight of that. Enron was 3/100th of a percent of our holdings."

A little more than a year ago, the Enron Road Show visited PERA to pitch an investment in a partnership. "Fortunately, their presentation was made to one of our bright young analysts, who at the end of the meeting said, "I really don't understand a thing you said, but thanks for stopping by."

Williams emphasized that there is no free lunch. "We've got some pretty complex schemes out there, and sometimes a little plain old common sense goes a long way."

A Forum member asked about the role shareholders should play, particularly relating to pension funds.

Shareholders should band together for impact on company operations, said Williams. "But it's difficult, because everybody has their own interests. A lot of public pension funds can band together, but union funds are hesitant to do so. And then there are corporate pension funds, yet another challenge.

"We're actively voting proxies, supporting proposals. But until we can band together and put some people in board positions, we're always going to be a little bit handicapped. We're always going to be outsiders looking in."

On the topic of governance, Williams said he has a simple means of assessment: Who does what? When do they do it? How and why do they do it?

"There's a natural tension between boards and CEOs. The board wants everything to be objective in the reporting of data. Yet, there's got to be a little chemistry in there, too. Some subjectives. As a CEO, you've got to be able to relate to and communicate with your board, with your various constituencies."
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"Boards are supposed to be independent. They're supposed to act on behalf of the shareholders to maximize and preserve value. They should have a variety of skill sets.

"Inside directors versus outside directors? Why should there even be a question? And how many boards should a person be able to serve on? I don't want my board members to have enough get-up-and-go to serve on multiple boards. I want all of their attention. I want them to push me, to challenge me. But at the same time, I want to challenge them. I want them to go home at the end of a board meeting exhausted. I really want them to work.

"My board self-evaluates, and I get to evaluate them. They also evaluate me once a year," said Williams. "And we lay out in very defined terms what I'm expected to do for the following year."

The recent corporate accounting scandals have seriously eroded investor confidence, from small shareholders to larger ones such as PERA. "We've got a lot of bright analysts, and they depend on the accuracy of the company's financials. If those numbers aren't right, we're in a huge mess."

A Forum member suggested that the whole system is in need of reform. "Every CEO isn't bad, every board isn't bad. I think it's hard for any one of these groups shareholders, CEOs, boards to bear the burden of what's gone on."

"Everything people are talking about is predicated on a universe of good actors," said Williams. But you're never going to come up with a system that will screen out all the bad actors. A person intent on defrauding the corporation's shareholders or anyone else is going to be hard to catch. I don't know what an audit committee can do about it."