

21st Century Governance and Financial Reporting Principles¹

**Corporate Governance Center
Kennesaw State University
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The Enron bankruptcy and widespread financial reporting problems call the governance and financial reporting practices of U.S. public companies into question. We believe that the attached principles represent the foundation of corporate governance and financial reporting and should be at the core of current and future reforms. Accordingly, we offer these 17 principles to advance the current dialogue and to promote investor, stakeholder, and financial statement user interests.

Kennesaw State University's Corporate Governance Center is a leading provider of corporate governance information to directors, researchers, professors, advisors and other interested parties. Composed of over 20 professors from several universities, the Center promotes effective corporate governance for public, private and nonprofit enterprises, with particular emphasis on audit committees and entrepreneurial companies.

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Within 48 hours, these recommendations were endorsed by the Institute of Internal Auditors (IIA). The IIA presented our recommendations to the New York Stock Exchange (NYSE) and later distributed them to the U.S. Securities and Exchange Commission (SEC), American Stock Exchange, National Association of Securities Directors (NASD), National Association of Corporate Directors (NACD), Financial Executives International (FEI), all members of Congress and the White House staff assigned to address these matters. On August 1, 2002 the NYSE approved governance principles consistent with many of our recommendations.

21st Century *Governance Principles for U.S. Public Companies*

1. **Interaction** – Sound governance requires effective interaction among the board, management, the external auditor, and the internal auditor.
2. **Board Purpose** – The board of directors should understand that its purpose is to protect the interests of the corporation’s stockholders, while considering the interests of other stakeholders (e.g., creditors, employees, etc.).
3. **Board Responsibilities** – The board’s major areas of responsibility should be monitoring the CEO, overseeing the corporation’s strategy, and monitoring risks and the corporation’s control system. Directors should employ healthy skepticism in meeting these responsibilities.
4. **Independence** – The major stock exchanges should define an “independent” director as one who has no professional or personal ties (either current or former) to the corporation or its management other than service as a director. The vast majority of the directors should be independent in both fact and appearance so as to promote arms-length oversight.
5. **Expertise** – The directors should possess relevant industry, company, functional area, and governance expertise. The directors should reflect a mix of backgrounds and perspectives. All directors should receive detailed orientation and continuing education to assure they achieve and maintain the necessary level of expertise.
6. **Meetings and Information** – The board should meet frequently for extended periods of time and should have access to the information and personnel it needs to perform its duties.
7. **Leadership** – The roles of Board Chair and CEO should be separate.
8. **Disclosure** – Proxy statements and other board communications should reflect board activities and transactions (e.g., insider trades) in a transparent and timely manner.
9. **Committees** – The nominating, compensation, and audit committees of the board should be composed only of independent directors.
10. **Internal Audit** – All public companies should maintain an effective, full-time internal audit function that reports directly to the audit committee.

21st Century *Financial Reporting Principles for U.S. Public Companies*

1. **Reporting Model** – The current GAAP financial reporting model is becoming increasingly less appropriate for U.S. public companies. The industrial-age model currently used should be replaced or enhanced so that tangible and intangible resources, risks, and performance of information-age companies can be effectively and efficiently communicated to financial statement users. The new model should be developed and implemented as soon as possible.
2. **Philosophy and Culture** – Financial statements and supporting disclosures should reflect economic substance and should be prepared with the goal of maximum informativeness and transparency. A legalistic view of accounting and auditing (e.g., “can we get away with recording it this way?”) is not appropriate. Management integrity and a strong control environment are critical to reliable financial reporting.
3. **Audit Committees** – The audit committee of the board of directors should be composed of independent directors with financial, auditing, company, and industry expertise. These members must have the will, authority, and resources to provide diligent oversight of the financial reporting process. The board should consider the risks of audit committee member stock / stock option holdings and should set audit committee member compensation at an appropriate level given the expanded duties and risks faced by audit committee members. The audit committee should select the external auditor, evaluate external and internal auditor performance, and approve the audit fee.
4. **Fraud** – Corporate management should face strict criminal penalties in fraudulent financial reporting cases. The Securities and Exchange Commission should be given the resources it needs to effectively combat financial statement fraud. The board, management, and auditors all should perform fraud risk assessments.
5. **Audit Firms** – Audit firms should focus primarily on providing high-quality audit and assurance services and should perform no consulting for audit clients. Audit firm personnel should be selected, evaluated, compensated, and promoted primarily based on technical competence, not on their ability to generate new business. Audit fees should reflect engagements’ scope of work and risk.
6. **External Auditing Profession** – Auditors should view public accounting as a noble profession focused on the public interest, not as a competitive business. The profession should carefully consider expanding audit reports beyond the current “clean” versus modified dichotomy so as to enhance communication to financial report users.
7. **Analysts** – Analysts should not be compensated (directly or indirectly) based on the investment banking activities of their firms. Analysts should not hold stock in the companies they follow, and they should disclose any business relationships between the companies they follow and their firms.