

# Corporate Governance Update



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In the wake of corporate scandals and deep erosion in the value of stock portfolios, the American government and investors have mandated changes in the business practices of publicly held companies. This *Corporate Governance Update* will focus on two distinct, yet inter-related, changes which have emanated from this mandate: one is driven by investors; the other by the government – we refer, respectively, to the firms now rating a company's corporate governance practices and Section 404 of the Sarbanes-Oxley Act (SOX). The message of both to corporate America is loud and clear – new metrics and regulations have been established by which your business practices can and will be measured; a failure to measure up will have financial consequences. Fortunately, WGA is prepared to assist companies in meeting both of these new challenges.

## Do you know your company's CGQ?

A new cottage industry replete with new acronyms has been spawned as investors demand both better corporate governance practices from companies and a better understanding of these practices so that they have a context to evaluate the practices of one against others. While there are several firms which are currently providing the service of rating the corporate governance practices of publicly held companies, the best known, and likely the one with the most clout, is Institutional Shareholder Services Inc. (ISS) – an influential proxy advisor that has recently added the scoring of companies on governance issues to its already substantial toolbox. What ISS does is to provide each company with its own CGQ (Corporate Governance Quotient) which indicates the company's rank within its own industry and against all other companies which ISS has scored. As an example, a company may have a CGQ of 48/63 which would indicate that ISS has ranked its corporate governance practices as being better than 48% of the industry and better than 63% of all publicly held companies.

If you are unfamiliar either with ISS or the importance most boards are attaching to their CGQs, you need only look at the front page of *The Wall Street Journal's* June 6<sup>th</sup> edition. The article cites the efforts that both Aetna and General Electric undertook to implement changes in their corporate governance practices when they learned of their initial CGQ scores. Additionally, the article notes that companies must pay \$17,000 to access the ISS rating system in order to find out what steps they need to take to improve their CGQ scores. **However, if you are a client of WGA for Directors' & Officers' Liability insurance, we will provide you (at no additional cost) with both your CGQ scores and the specific areas which you need to improve in order to boost your scores.** Since the focus of our Directors' & Officers' Liability insurance practice has always been on corporate governance/risk management, we strive continually to find new and better tools by which our clients can protect themselves against shareholder litigation. We believe that ISS's CGQ is one of those tools.

## Preparing for 404 Compliance

With the recent reprieve granted by the SEC to publicly-traded companies extending the time by which they need to comply with Rule 404 of the Sarbanes-Oxley Act, we believe the opportunity now exists for these companies to conduct

William Gallagher Associates (WGA) is a leading independent commercial broker, specializing in providing risk management, employee and executive benefits services to companies with difficult and complex risks. These include a focus on Life Sciences, Technology, Energy, Healthcare, Financial Risks, Environmental and other industry groups. WGA has offices throughout North America and Europe, including Boston, MA; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris, France.

more thoughtful due diligence. Rather than implementing a “quick fix” just for the purpose of meeting the “letter of the law” as prescribed by SOX; the extension offers companies extra time to thoroughly review the overall adequacy of their internal controls. For the purposes of this Corporate Governance Update, our focus includes the sections of Rule 404 which pertain to management’s assessment of, and report on, a company’s internal control over financial reporting. In particular, we will look at the newly finalized definition of “internal control over financial reporting” and the measures companies can take to demonstrate that they have “a process . . . to provide reasonable assurance regarding the reliability of financial reporting”.

Accordingly, let’s start with the definition of “internal control over financial reporting” as prescribed by the final rules:

“**A process** designed by, or under the supervision of, the registrant’s principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant’s Board of Directors, management and other personnel **to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles** including those policies and procedures that:

1. Pertain to the **maintenance of records** that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrar;
2. Provide **reasonable assurance that transactions are recorded** as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
3. Provide **reasonable assurance regarding prevention or timely detection** of unauthorized acquisition, use or disposition of the registrant’s assets that could have a material effect on the financial statements.”

Bearing in mind the above definition, consider how it fits within the overall thrust of 404 which is to require companies subject to the reporting requirements of the Securities Exchange Act of 1934 (save for registered investment firms) to **include in their annual reports a report from management citing** the company’s internal control over financial reporting. The other specific issue of 404 on which we want to focus attention is the **need for this internal control report to include a statement** identifying the framework used by management in evaluating the effectiveness of the company’s internal control over financial reporting. Management is required to disclose any material weakness in internal control over financial reporting and cannot conclude that internal control over financial reporting is effective if there is any material weakness. Independent auditors are required to report on and attest to management’s annual internal control report. This particular requirement is one for which many companies are seeking solutions, particularly since companies are not allowed to use their public accounting firms in establishing/identifying the “framework”.

While there are many different products and services being offered as solutions, most pundits agree that an **enterprise software system** will be the likely backbone of the “framework” noted above. Given that the internal control systems defined and required by 404 have been built upon the “internal control” definitions established by COSO (the Committee of Sponsoring Organizations of the Treadway Commission was formed in the late 1980s to establish a common definition of “internal controls”), it is probable that the scope of the definition will also be construed to include the effectiveness and efficiency of a company’s operations, including performance, profitability and protecting its assets from loss. As such, many of those looking at the overall intent and potential impact of 404 believe that an enterprise risk assessment based software system can provide the most effective framework for management to use (and cite in its annual report) in evaluating the effectiveness of its internal control over financial reporting.

While WGA provides neither enterprise risk assessment software nor consulting services, we realize that this is an important issue for our publicly traded clients and we can provide clients with information about software systems and/or consulting services. With respect to software, we recommend consideration of the following factors in your evaluation of a potential software system:

- Length of time the software company has been in business.
- Experience with, and support of, similar software systems.
- Scalability of system with respect to size and complexity of your company.
- Ease of use with respect to experience, expertise and size of your team.
- Ability to integrate with existing systems.
- Local support structure.
- Cost - systems range from \$10,000 to well into six figures.
- Ability to provide the BOD and Management Team with:
  - Substantiated and consolidated information to assist with the decision making process.
  - Evidence of control processes.
  - Framework tailored to their company's specific needs.

With respect to the consultant services, we recommend consideration of the following:

- Independence of the consulting company.
- Subject matter expertise.
- Practical experience in similar projects.
- Local support structure.
- Senior Consultant involvement.

Finally, we believe that WGA can play a role in assisting publicly-traded companies in evaluating the strength of their internal controls with respect to the risk factors cited in their public documents. In particular, WGA can provide an audit of the risk factors to "test" the process used by companies for identifying, quantifying, controlling, and monitoring them.