

Below are the speaking notes of Gregory Hanson, FCA, from his appearance as a guest speaker at a luncheon sponsored by the Institute of Chartered Accountants of Manitoba on April 3rd, 2003. Gregg is President and CEO of Wawanesa Mutual Insurance.

Ethical Aftershock

Institute of Chartered Accountants of Manitoba
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Thank you for that kind introduction. I was pleased when the Institute asked me to speak on a topic of this nature. I always find that I learn something when I take the time to organize a presentation and I always feel I have a good handle on my subject if I can explain it to someone else coherently. When I started my preparation, I realized it was hard to put a fence around it and confine my comments to only twenty minutes or so. However, I've never been one to shy away from a challenge but if your eyes glaze over ... I'll resort to my stand-up comic routine and then you'll really be sorry!

Let me start with what brings us to our current position and why we are facing such volatile capital markets today because I think this all is tightly woven with "ethical aftershock".

Volatile Capital Markets

In the period leading up to 2001, we experienced the longest sustained bull market in history. The dot com bubble was blown out of proportion and yet many in the investment community were still trying to convince us that this was a new paradigm. People were saying that price earnings ratios of 100 or more were ok because this was a new world. Logic had fallen out of favour as some pundits suggested it was alright for a company to lose money as long as the volume was growing. Still others said that revenue wasn't necessary as share prices of some dot com companies sky rocketed in the

“pre-revenue stages”. It was in the second quarter of 2001 that reality hit home and the stress of that “irrational exuberance” caused the fractures to appear.

As we were floundering in the fortunes of our follies, along came the horror of 911. It was one of those moments in time that all of us are sentenced to remember for a lifetime. It completely destroyed our comfort level of what could and couldn't happen in the Western Hemisphere.

So where would we go from here? The markets continued to tumble. Next came the shock of Enron as a corporate giant began to crumble before our eyes. Incredible stories of mismanagement, deceit, collusion, and above all greed were filling the newspapers as we witnessed the collapse of that company and with it the collapse of Arthur Andersen, one of the largest and most respected accounting firms in the world. Rumours began to rage that Enron was not the only company that was manipulating their financial statements and deceiving investors. The list grew longer, with names like WorldCom, Global Crossing, Adelphia, Tyco, AOL Time-Warner, and the list goes on and on. The scandals were high profile and serious and the investigations, allegations, charges, settlements, fines and verdicts literally put every big American enterprise and American capitalism itself under a microscope of suspicion, doubt and distrust. Remember that if you lose confidence in the rules of a game as being unfair, no-one wants to play. The General Accounting Office or GAO in the United States said that the leading factor in the current lack of investor confidence in the United States is the impact of questionable accounting practices. This is an awful condemnation of our profession.

The volatility in the capital markets has extended throughout 2002 and the first quarter of this year. What has been the regulatory reaction to all this?

Regulatory Reaction

When something goes wrong, our first reaction is to look for a villain. Who can we blame this on? Is it the accountants? Is it the management of these companies? Is it the Boards of Directors? In our attempts to manage risk and control our environment we try to put a plug in the hole in the dam to prevent disasters from reoccurring. Investors and the public in general were demanding that some sort of action be taken and regulators are only too willing to accommodate. You know the old line “we’re from the government and we’re here to help”.

The entire concept of risk management is coming to the forefront and with it comes an increasingly complicated and rigid regulatory environment. In the U.S., the Sarbanes Oxley Act makes top executives more accountable. Under that act, public companies and Canadian corporations listed on U.S. exchanges are subject to SEC communication rules requiring senior management to certify financial statements under oath. It also significantly changes communication and governance rules of publicly traded companies.

Sarbanes Oxley results therefore in very detailed procedures required to be set up in order to back-up this certification. SOX sets the gold standard for corporate governance and financial reporting and its influence in Canada extends far beyond Canadian SEC registrants to whom the Act technically applies.

In Canada, debate is still brewing while provincial securities commissions are reviewing their procedures, regulations and policies while the TSX is examining the issues of governance and risk management of organizations. Whatever the conclusion, it is clear that organizations and their senior

management will have to comply with stricter accounting and governance standards.

Some fear that the pendulum has swung too far, from a relatively lax approach to financial management, to a policing function. Now it is important to balance the requirement for uncomplicated but strict financial controls without crippling the decision making and execution of the organization. Controls and processes cannot become an end in themselves, but rather a means to an end.

What are some of the caution indicators that may suggest that unethical behaviour may be present in a company?

Caution Indicators

- Undue pressures to meet earnings per share targets with every-increasing expectations.
- Quarter by quarter focus on meeting revenue targets with less concentration on the long-term health of the company.
- Bonus incentives that promote greed rather than the underlying honourable values of the organization.
- Executive compensation plans heavily dependent on stock options.
- Companies that place emphasis on having a high profile CEO instead of one with no skeletons in the closet who is trust-worthy and demonstrates more concern over building the company over the long-term instead of building him or herself over the short-term.
- Evidence that a company is using accounting tricks to quickly pump up its share value.
- Competitive market pressures that can cause companies to show a better financial picture

than is warranted.

Ethics and integrity are a must if a market economy is to work properly and that is not just some new post-Enron idea dreamt up by a cable news channel. It is a truism of our capitalistic system. But it is very difficult to legislate honesty or legislate against fraud.

Corporate Governance

Between all the illegal, quasi illegal and sleazy corporate behaviour that can be traced through greed, ambition, ego, envy, laziness, incompetence and even just opportunity, it all points to failed corporate governance. Governance is the process through which owners of a company can get management to do what they would like them to do if they actually ran the enterprise they owned. At the heart of governance is a Board of Directors elected by owners that stand between the owners and management. The Board and its committees and its procedures are the governance apparatus. The model is magnificently simple but stunningly effective when everybody is honest, trustworthy, competent, interested, independent and informed. The formula is simple. The Board governs the enterprise and management operates it.

A properly functioning corporate sector is absolutely crucial to the kind of high performance/high standard of living economy we want. The corporate sector cannot function properly without access to great quantities of reasonably priced capital. Reasonably priced capital will not flow freely if investors are not rock solid confident that the game is fair and honest. Rock solid investor confidence depends crucially on corporations being governed properly.

At our Company, we have spent a lot of time, energy and discussion at the Board level on continuously improving our governance effectiveness. Let me make a few practical suggestions to

improve corporate governance.

1. Create a strong team

Today's trend is towards smaller Boards which on average have twelve members. These more nimble boards can make more effective decisions more efficiently. This of course must be balanced against the work required as a member at the Committee level. Committees have an average of four members and outside Directors serve on an average of two Committees.

Board members that have sound business judgement, top management perspective, and strategic thinking capability should be sought out. You may desire some functional or sectoral experience, and most Boards require some legal and accounting expertise. Every Board should maintain an inventory of skills that they need and a standing list of potential Directors. Then when openings occur, the governance or Nominating Committee can act quickly and intelligently to attract the right person for the job. It is important to get the best possible person for the Board when the relatively rare opportunity presents itself to bring on a new Director.

In approaching a candidate, a major consideration is the commitment a potential Director can make to the Board. Retired executives may welcome making a considerable contribution of their time and talents, but there are other pools that can be explored. While preserving the team dynamic is critical, introducing new candidates can bring an important fresh perspective.

2. Build constructive communication

The Chair must create a setting that enables Board members to monitor company performance and also contribute actively to corporate strategy. Boards should spend most of their productive time looking forward. Many agenda items involve necessary work items that are required under various laws, acts and agencies that regulate companies. These items are onerous but not intellectually challenging or stimulating. If they are allowed to dominate Board meetings, they deaden any strategic dialogue. Therefore a good plan is to delay these housekeeping items to late in the meeting. Grant strategy discussions the highest priority. The CEO can be directed to give a twenty minute update on strategy and changes in the external environment providing the Directors to have an active and informed discussion.

At the end of every meeting, management should be asked to vacate the room to allow for an in-camera session of the independent Directors.

Any presentations that are made to Directors should put substance over form. Power Point presentation with flashy backgrounds, canned clip art and migrating text should not replace logical thinking, analysis and the hard facts. Any presentation should follow two basic rules:

- 1) the information should be clear so that Directors understand the issue; and
- 2) compelling so they act on recommendations.

These rules may seem obvious, but often management communications to the Board fall short of this ideal.

Encouraging Directors to meet as a group with management in a less formal setting on regular occasions helps deepen the understanding of the corporate environment and

managerial talent. A Directors dinner or Board retreat from time to time provide the perfect opportunity for more thorough discussion and debate on issues. Sight visits or branch tours provide the Board with a better understanding of the corporate culture.

3. Board performance evaluation

A Board should have an annual survey of its effectiveness in addition to regular reviews at the end of meetings. Annual surveys covering such things as corporate strategy, Board mechanics, Chair performance, committee functioning, succession planning, etc. are a good discipline to implement. If formal surveys are done they can be analyzed and summarized by a designated member of the Board, a designated member of management or an external consulting company. The Board should get a full summary, including the areas where most improvement is needed and areas that have changed most since the last survey.

4. Individual Directors' evaluations

One of the toughest jobs for the Board Chair is to evaluate performance of individual Directors. The astute Chair will recognize which Directors are contributing strongly and doing proper preparation, and which Directors are weak in the performance of their responsibilities. The Chair could talk to each Director annually discussing individual and Board performance. This gives the Chair the opportunity to provide frank comment to an under-performing Director. However, this method is not easy to execute and puts an extraordinary load on the Chair.

A more effective solution is to adopt the 360 appraisal method widely used for management

performance evaluation. Appraisal forms are circulated to each Director for annual peer review. The form can be designed as a matrix, with dimensions of performance running down the side of the form and Directors' names across the top. Each Director completes the survey row by row, rating each dimension for each Director on a scale of say 1 to 3. The surveys can be submitted to the Chair or to an external consulting company as another option.

Peer evaluation discipline can be effective in changing Director behaviour. Those who score well will be motivated to maintain their level of performance. Those who score poorly may be inclined to improve their performance or resign.

The four initiatives mentioned here provides a straight forward and practical framework for improving the performance of any Board.

Common Sense Approach

So, if we are to restore the confidence of investors, what more can be done? We have talked about the action being taken by regulators, we have looked at cautionary indicators that investors can use to avoid investing in companies that may be prone to deceit, and we have explored corporate governance practices that can strengthen the performance of Boards of Directors. And what about management? What can management do to ensure that their organization is functioning in an ethical and appropriate manner and avoid the pitfalls that can bankrupt companies and destroy careers.

Executives should set the tone from the top. Create an environment of ethical and honest behaviour where employees are treated with fairness and respect. If employees witness this in the behaviour

and attitudes of their leaders of the organization, they are more likely to follow the same behaviour pattern. To get the most and the best of your employees, it is important to be hands-on in the business. You can send absolutely the wrong message if you demonstrate that you don't want to get your hands dirty dealing with operational details. One of the reasons why the last Gulf War in 1991 was so effective was because Norman Schwarzkopf was a hands-on leader. If you get the opportunity to read his book entitled "It Doesn't Take A Hero" you will understand what I mean. If you are going to lead people effectively, it's better to park your ego at the door. One person can't achieve much unless you are able to motivate and inspire others to be the best that they can be.

Finally, if I can make one more recommendation it would be to read the book entitled "Good to Great" by Jim Collins. It's a sequel to his former book called "Built to Last". I don't have time to get into a precis of this book but I assure you it is well worth the read and will give you countless ideas of how to catapult your organization to greatness and avoid the pitfalls of ethical aftershock.