

1 ABA Public Hearing - 10-25-02

2 Mr. Krogman.

3 MR. KROGMAN: I'm delighted to be
4 here. My name is Dean Krogman, I'm vice
5 president of Technical Activities and
6 Conferences for Financial Executives
7 International. I would like to thank this
8 task force of the ABA for giving me the
9 opportunity to discuss proposals on
10 corporate responsibility. I'm here as a
11 member of FEI, which is a leading advocate
12 of the views of senior corporate financial
13 managers, we represent 15,000 members,
14 CFOs, treasurers and controllers from
15 companies worldwide, primarily in North
16 America.

17 We at FEI have been very concerned
18 about the rash of corporate governance and
19 financial reporting failures that have
20 recently been uncovered, failures that have
21 shaken the faith of the investing public in
22 corporate America and we agree with the
23 opinion of the ABA task force that most
24 executives officers, directors and
25 professional advisers act honestly and in

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2 good faith. Unfortunately honest or not,
3 we all suffer from the fallout of these
4 high profile failures.

5 We agree with the task force that
6 these failures are historic in their scale
7 and scope, and that they point to
8 weaknesses in corporate governance and that
9 these weaknesses cannot be overlooked. So
10 we applaud this task force in its efforts
11 to identify weaknesses and make
12 recommendations.

13 FEI did something similar in January
14 of this year, we formed a task force of 12
15 prominent members who assembled a set of
16 observations and recommendations that were
17 published in March. We have been
18 publishing them and promoting them, we have
19 them posted on our web site. These
20 recommendations suggest steps to be taken
21 in four areas, strengthening financial
22 management's commitment to ethical conduct;
23 rebuilding confidence in financial
24 reporting, the accounting industry and the
25 audit process; modernizing financial

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2 reporting and reform the accounting
3 standards-setting process, and finally
4 improving corporate governance and the
5 effectiveness of auditing committees.

6 So it's not surprising that some of
7 the ABA recommendations are very similar to
8 the ones that have been made by the FEI
9 task force. We agree with the majority of
10 the recommendations made by the ABA task
11 force regarding improvements in corporate
12 governance. We believe that establishing a
13 requirement that public company boards of
14 directors include a substantial majority of
15 independent directors will help assure
16 their effective independent oversight of
17 senior corporate management.

18 That require all public company
19 boards to have a governance committee,
20 audit committee and compensation committee
21 made up of independent board members is
22 also an important step in this regard. We
23 agree with the proposed assignment of
24 responsibility to the board committee,
25 outlined in recommendations, namely

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2 corporate governance committee being
3 responsible for identifying potential new
4 board members, assigning the audit
5 committee responsibility for engaging,
6 overseeing and approving the work of the
7 outside auditors and compensation committee
8 with authority over senior executive
9 officer compensation.

10 We also agree with the
11 recommendation that the corporate
12 governance committee and audit committee
13 meet regularly and in private with the
14 corporate officers responsible for
15 implementing internal controls, codes of
16 ethics and compliance policies.

17 In particular, we fully support the
18 ABA task force recommendation for the
19 adoption of codes of conduct. FEI has
20 recommended to Congress, the SEC and the
21 Stock Exchange this year that they require
22 companies to actively promote ethical
23 behavior by adopting a code of ethics by
24 giving employees training to ensure their
25 understanding of the code and by providing

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2 them with a means of confidentially
3 reporting those violations.

4 However, we further advocate that
5 corporations require that all their
6 financial executives adhere to a
7 specialized code of conduct. We believe
8 it's important that corporations obtain a
9 formal commitment from their financial
10 executives to avoid a conflict of interest
11 relationships, provide information that's
12 accurate, complete and objective and not
13 misrepresent material facts or allow their
14 independent judgment to be subordinated.
15 We discussed this particular recommendation
16 with legislators and were pleased to
17 support that provision in the
18 Sarbanes/Oxley bill.

19 MR. KELLER: Could you expand on
20 what you mean, the SEC has really just
21 proposed their rules to implement
22 Sarbanes/Oxley on requiring codes of
23 conduct for senior financial officers and
24 they broadened it to other executives
25 officers. Are you promoting a separate

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2 code for financial officers and two, are
3 you promoting it as in fact a sign on
4 pledge approach, as opposed to just a
5 blanket code that is understood is part of
6 the terms of employment?

7 MR. KROGMAN: We advocate a separate
8 specialized code for financial executives,
9 separate from our code that would apply to
10 all employees of corporations, it's similar
11 to the code that lawyers adhere to. We
12 believe it's important that there are
13 enough specialized aspects to financial
14 reporting that it's appropriate for senior
15 financial executives to adhere to a code, a
16 specialized code.

17 We have a code that we feel provides
18 a good example of the kind of code we think
19 is appropriate, we have it on the web site,
20 we're promoting it. I know Harvey Pit,
21 chair of the SEC, has mentioned it is a
22 good example. What we propose is that
23 senior financial executives sign off on the
24 code once a year and submit it to the
25 board.

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2 Concerning the ABA task force
3 recommendation that a committee of
4 independent directors approve any
5 transaction between the corporation and its
6 directors and executive officers and
7 approve all material related party
8 transactions, we believe these
9 recommendations have merit.

10 Although we're not sure that these
11 recommendations will deal with the type of
12 abuses that occurred at Enron and Adelphia
13 and Tyco. The audit company of Enron was a
14 committee made up entirely of independent
15 board members and they specifically
16 approved the infamous related party
17 transactions that occurred between Enron's
18 financial executives and its special
19 purpose entities. The accounting rules
20 that govern those are visibly being debated
21 and reconsidered by our organization.

22 What's more, the audit committee in
23 the case of Enron waived the company's code
24 of ethics to approve these involvements.
25 To some extent the boards of these

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2 companies also approved some of the loan
3 arrangements that are now considered to be
4 excessive. We think it's possible that the
5 line between what is acceptable and what is
6 excessive regarding executive loans is
7 moved in reaction to the events of this
8 past year.

9 In any event, we already have new
10 legislation on the books, specifically been
11 section 402 of Sarbanes/Oxley, dealing with
12 executive loans, legislation and it's
13 become a challenge for many companies to
14 implement, as you are probably aware, by
15 issuing an extensive prohibition of
16 personal loans to directors and executives.
17 The legislation appears to call into
18 question a lot of what appeared to be
19 perfectly justifiable loans for relocation,
20 401K plans, loans for the cashless exercise
21 of corporate stock options.

22 We hope for further clarification in
23 legislation, but we believe that the best
24 way to avoid abuses in this area is careful
25 scrutiny by the corporate boards and

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2 directors.

3 With regard to the recommendations
4 concerning corporate governance
5 enhancements. We suggest that the task
6 force recommendation that companies
7 consider use of a lead independent director
8 be left to the discretion of company
9 boards. From what we see in most cases,
10 independent board members do not have a
11 problem effectively expressing their views
12 directly in board meetings. While it may
13 make sense for independent directors to
14 appoint a spokesperson concerning cases,
15 mandating a permanent arrangement of his
16 client could become awkward and effectively
17 serve a dual chairmanship that would
18 contribute to factionalism and unnecessary
19 friction within the board.

20 There is an article in the Wall
21 Street Journal today talking about a number
22 of large corporations moving in this
23 direction. It seems in each one of the
24 cases it's clear who the chair of the board
25 is. There are arrangements being made for

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2 a spokesperson.

3 MR. MUNDHEIM: Could you clarify
4 that, what do you mean it's clear who the
5 chair is as opposed to the outside
6 director?

7 MR. KROGMAN: The article I was
8 referring to in the Journal gave the
9 example of GE with a lead independent
10 director reporting to the chair of the
11 board of directors.

12 MR. MUNDHEIM: Would that be
13 something that you would approve of?

14 MR. KROGMAN: Again, I think it's
15 most appropriate for each board to decide
16 what arrangement works best for them. An
17 independent board member be designated as
18 the lead board member.

19 MR. MUNDHEIM: What would be the
20 advantages that you would see of strongly
21 recommending a lead board member?

22 MS. PETERS: If any?

23 MR. KROGMAN: The advantages of
24 what?

25 MR. MUNDHEIM: Recommending a lead

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2 board member.

3 MR. KROGMAN: My view is it would
4 ensure the views of those board members are
5 considered, that they are voiced
6 adequately. I don't believe that most
7 independent board members have a problem.

8 HON. TENNILLE: Does your
9 organization have any sense of how many
10 general counsels might report to the CFO as
11 opposed to the CEO, or does it have any
12 position on whether or not that's a good or
13 a bad idea?

14 MR. KROGMAN: I haven't seen that in
15 my experience, it's hard for me to comment
16 on that. The general counsel would report
17 to the CFO, I would expect that to be
18 unusual. I don't have statistics on that
19 one

20 MR. OLSON: Who should the head of
21 the internal audit report to?

22 MR. KROGMAN: I think it's important
23 that the head of the internal report to the
24 chairman of the audit committee, that's
25 often problematic.

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2 MR. OLSON: What about within the
3 corporation structure?

4 MR. KROGMAN: As a practical matter,
5 normally the head of internal audit reports
6 to the CFO. On a day-to-day basis it's
7 difficult for director of internal audit to
8 look to the audit committee since the audit
9 committee normally doesn't convene.

10 MR. OLSON: Some of the
11 recommendations we looked at say the head
12 of the internal audit should report to the
13 CEO or COO or someone other than the CFO,
14 because one of the jobs is for the internal
15 audit to take an independent look at work
16 done by controllers and others who directly
17 report to the CFO. It is a question which
18 I think people don't look at probably as
19 often as they should.

20 Clearly they always have a reporting
21 relationship to the audit committee, but
22 the audit committee is only there four to
23 six times a year for a couple of hours. So
24 day-to-day who does the head of internal
25 audit go to if he or she has questions or

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2 has something she wants to recommend to the
3 organization or query whether it's right to
4 the CFO?

5 MR. KROGMAN: I would think CEOs
6 feel comfortable with delegating that to
7 their CFO if they had strong comfortable
8 relationship working relationship with the
9 CFO and if they are interested in getting
10 more involved with the internal audit, they
11 certainly have the option to do that. I
12 think as a practical matter, the details of
13 what the internal audit director gets
14 involved in are probably better understood
15 which the CFO, that makes more sense on an
16 ongoing basis for the CFO to be overseeing.

17 I think it's important for the audit
18 committee to make an effort to reach out to
19 the director of internal audit, meet with
20 him independently as often as would be
21 appropriate, which would be several times a
22 year, and make it clear to that director of
23 internal audit that the channels are open
24 for direct discussion of what's going on
25 out there directly to the audit committee.

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2 MR. OLSON: Have you worked in an
3 organization that has an ombuds program?

4 MR. KROGMAN: No, I have not. I
5 know it's been considered.

6 MR. OLSON: I'm curious as to
7 whether you had any learning or thoughts as
8 to how an ombuds program relates to an
9 internal audit or relates to the audit
10 committee. You heard the testimony of our
11 prior witnesses who talked about that
12 during the last half hour.

13 MR. KROGMAN: An ombudsman I think,
14 as a practical matter, makes sense for the
15 ombudsman to report up to general counsel
16 or through internal audit, one or the other
17 or both. I would expect that some of the
18 issues that get surfaced through an
19 ombudsman program would be financial, some
20 would be legal, some would also involve HR.
21 I think it's important to have the hard
22 line reporting go up to a group that's
23 independent.

24 I've seen situations where the
25 reporting is outsourced to a group entirely

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2 outside the corporation. What happens with
3 these ombudsman programs, you get
4 oftentimes a large volume of complaints,
5 calls, concerns, some of which are not as
6 significant as others, it doesn't make
7 sense to report them all to management, you
8 have to sort through them and identify them
9 as significant.

10 MS. PETERS: That happens when you
11 have a hotline situation as well, being
12 investigated on a preliminary stage by say
13 a business conduct officer on the spot, it
14 all gets filtered up to the higher levels.

15 MR. KROGMAN: In fact, an ombudsman
16 could act in that capacity too to sort
17 through those hotline calls and identify
18 the areas that he needs to get involved in
19 and making sure that they are properly
20 addressed and reporting up to the senior
21 management.

22 MR. JACOBS: Mr. Krogman, do you or
23 your organization have any view on whether
24 chief financial officers should serve as
25 directors of their company?

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2 MR. KROGMAN: That's an interesting
3 question.

4 MR. JACOBS: Do you have any views
5 on whether there is any valuable purpose
6 served by any executive officers of the
7 company serving on its board?

8 MR. KROGMAN: I would imagine it
9 would very unusual for boards not to have
10 some CFOs.

11 MR. JACOBS: It certainly has been
12 historically. The question is in an ideal
13 world how would it be structured?

14 MR. KROGMAN: I see the board as a
15 collegial group and I see senior management
16 building that group and being a part of it.
17 A lot of what they discuss is strategic in
18 focus in the direction of the corporation.
19 I can see where the CFO, it would be
20 appropriate for him to participate in that
21 at that level of strategic planning and
22 being part of the board, I think that would
23 be fine. What we do feel is important is
24 to have financial expertise on the audit
25 committee.

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2 CHAIRMAN CHEEK: The code of ethics
3 for financial executives, let's focus on
4 that a second with me. If you take the
5 increased emphasis from Sarbanes-Oxley and
6 list of standards and so forth, disclosure
7 controls, internal controls, fraud
8 involving any person involved in the
9 internal controls and so forth. I'm trying
10 to bring this around to some of the issues
11 we're thinking about, which is this issue
12 of counsel, outside counsel taking
13 reporting issues to general counsel,
14 general counsel going up the ladder or
15 outside counsel going up the ladder.

16 If counsel were to come to the CFO
17 and say I've been alerted to a question
18 about internal controls or thought
19 involving Mr. X who is involved in internal
20 controls or accounting irregularities that
21 may occur; does your code of ethics deal
22 with the obligation of the CFO to act in
23 that kind of context and to communicate
24 that up the ladder of the organization?

25 MR. KROGMAN: I think clearly it

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2 does. It calls upon the CFO to assume
3 responsibility for the quality of the
4 information he reported. If there is a
5 flaw, a significant problem within his
6 control structure, if there is a
7 responsibility he needs to deal with it and
8 correct it to make sure that the quality of
9 the reporting that goes up the line is
10 accurate.

11 CHAIRMAN CHEEK: Would the CFO fail
12 to go above the CEO to the board saying I
13 know there is a question about this, but
14 you're going to keep on booking it like
15 that?

16 MR. KROGMAN: It calls upon the CFO
17 to consider the shareholders and investors,
18 as well as his superiors and constituents
19 that he needs to ensure the quality of
20 reporting.

21 MR. KELLER: Can I press another
22 aspect of this which you raise in your
23 testimony which is really questioning 1.13
24 proposal of reporting up the ladder.
25 Congress, essentially the Edwards

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2 Amendment, has taken over and questioning
3 the chilling effect on officers talking
4 with counsel, consulting with counsel if
5 counsel were in the position of going up
6 the ladder to top management of the board.

7 In light of certainly what Congress
8 has mandated to the public companies, do
9 you still see that as an issue, a problem,
10 or is it that the organization at the end
11 of the day is the client and therefore
12 there is no particular privileged
13 confidentiality with respect to any
14 employer or agent of the organization, if
15 it ends up there is serious wrongdoing that
16 deserves to be reported.

17 MR. KROGMAN: It's not often a
18 clear-cut easily identified distinction
19 between what's appropriate and what's not,
20 that's the concern I've heard from some of
21 our members with respect to what might get
22 reported up the line, that there is a kind
23 of an open frank and honest discussion of a
24 particular sensitive area that the CFO has
25 with general counsel. The thought of

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2 potentially having to deal with the issue
3 getting reported up the line to senior
4 executives of the board is a concern. I
5 don't know if that's changed. Again, you
6 have to weigh that against the need to
7 curtail that kind of behavior.

8 MR. KELLER: What gets reported up
9 is evidence of wrongdoing, as the statute
10 says. So that still allows for a number of
11 consultations as long as at the end of the
12 day you do the right thing. I suppose if
13 there is individual wrongdoing then there
14 needs to be recognition that general
15 counsel is counsel for the organization,
16 and the individual officer might need their
17 own counsel to consult with and not mix up
18 the rolls.

19 MR. KROGMAN: Fair enough.
20 Sometimes the line between what's
21 acceptable and not moves a bit though.

22 MS. PETERS: Would you agree that
23 in certain circumstances where you felt one
24 field is obliged to consult with general
25 counsel, that although from different

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2 perspectives the line may be not so well
3 defined, that once a judgment is made by
4 general counsel that that is the final
5 conclusion that gets acted upon, you would
6 agree with that?

7 MR. KROGMAN: Yes. I think we kind
8 of covered through Q&A some of the comments
9 I had with respect to rules of professional
10 responsibility. Again, I don't propose to
11 be an expert in the area and neither do
12 most of the members of our organization. I
13 think our concerns were expressed in the
14 testimony that you read through and
15 questioned me on.

16 MR. HAMERMESH: Speaking of your
17 written testimony, there is one part you
18 haven't talked about yet, that is at the
19 very end where you questioned the procedure
20 in which outside counsel would contact
21 general counsel.

22 MR. KROGMAN: Formal channels being
23 set up in every case for all outside
24 counsel.

25 MR. HAMERMESH: You were concerned

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2 about establishing that as a practice is it
3 purely a matter of cost?

4 MR. KROGMAN: I know the new law,
5 Sarbanes-Oxley, called upon lawyers to take
6 the initiative if they see something that's
7 inappropriate to report it to general
8 counsel and if that's not satisfactory take
9 it up the line. We see that as adequate as
10 opposed to in every single case trying to
11 set up some formal channels and meeting on
12 it in a formal basis.

13 MS. HENNESSY: Would it really be
14 more hours if it was done in conjunction
15 with the audit process, since the auditor
16 already goes to outside counsel?

17 MR. KROGMAN: I would imagine that
18 it's done already. We're talking about the
19 outside auditors checking with the outside
20 counsel.

21 MS. HENNESSY: From having a process
22 that says the outside auditors report to
23 the general counsel's office, if it were
24 done in conjunction with the annual audit
25 they are already reviewing what engagements

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2 they've had.

3 MR. KROGMAN: Oftentimes outside
4 counsel, I'm not sure if they have a broad
5 enough scope to really be expected to make
6 judgments, I'm not sure how much reporting
7 you get, that's why I'm thinking it might
8 be an unnecessary step, they are not in a
9 position to really recognize.

10 MR. KELLER: If we said this wasn't
11 a formal listing bureaucratic process, but
12 rather a tone in making clear in connection
13 with the engagement that the lines of
14 communication were open and if you outside
15 counsel saw any activity behavior that you
16 thought was troublesome, you should
17 understand that you are encouraged to bring
18 it to the attention of general counsel.

19 MR. KROGMAN: That I think is
20 certainly appropriate.

21 MR. KELLER: That was the flavor, as
22 opposed to any kind of formal listing, but
23 rather as part of the engagement make it
24 clear that you as outside counsel are
25 expected to abide by our policy of

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2 reporting problems to the general counsel.

3 MR. KROGMAN: I would agree.

4 CHAIRMAN CHEEK: We have no more
5 questions. We stand adjourned until.

6 (Time noted: 2:30 p.m.)

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