The legal pitfall in following best practices

Many companies cite the fact that they follow generally accepted industry standards, so called "best practices" when it comes to their approach to corporate governance, but experts warn that this is a risky strategy.

To be sure, "best practices" within a given industry may be transparent, out in the open, well vetted, and even acknowledged by regulators. But that isn't an effective means of defense in court, according to these experts.

"Sadly, how many times have we seen and heard very well educated, smart, CFOs and CEOs stare into the camera and say, 'It is an industry practice, many companies are doing this!'" asked James Walker, Jr., chair of the Institute of Management Accountants Committee on Ethics. "I ask myself, what were they thinking? Because in the light of day, away from their group think team, it ends up being unacceptable ethical industry practice," he added.

Michael J. Shepard, partner with the law firm of Hogan & Hartson, offers an example.

"From stock option backdating to the bribery of government officials in certain countries," Shepard told CFOZone, "we've heard this myth repeatedly and seen it drive companies into expensive litigation and settlements."

However, the reality is, the Department of Justice and the SEC do not accept as a defense that everyone in an industry is engaging in the same conduct. "To the contrary," Shepard insisted, "that fact just tells the government that the case has more significance -- that there is more reason to deter the conduct, and that the cases are therefore more, rather than less attractive."

This misconception creates a bigger target on the back of the corporation. "What this means is that a corporation needs to give meaningful scrutiny to the legality of each of its material policies and practices, no matter how long it has engaged in those policies and practices and no matter how many of its competitors are engaged in the same activities," said Shepard.

It's not as if it's difficult to figure out how one size might not fit all, said Kevin Espinola, a partner with the law firm Jones Day. "It doesn't require a great deal of critical thinking about what makes sense for each company."

To make it even simpler, Parveen Gupta, professor and department chair in accounting at Lehigh University's College of Business and Economics, explained that the trick is not to blindly implement best practices across the board.

"This is not the right approach," said Gupta. "If you went to the doctor and have symptoms similar to another patient, the doctor can't make assumptions. He'll have to take into account factors like your living and eating habits or body constitution, to determine what medicine is appropriate for you. No two people are alike, no two companies are alike. Each prescription should be unique," he explained.

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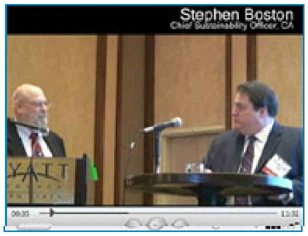

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Then, too, some boards mistakenly believe that they will put their company at a disadvantage by being more accurate or transparent in reporting, says Gary Patterson, author of *Stick Out Your Balance Sheet & Cough: Best Practices For Long-Term Business Health*. "This is a fast changing world. A lack of transparency in the past may really be why an industry practice in the past was acceptable," said Patterson.

He cites the use of Repo 105 transactions by Lehman Brothers to mask debt levels as an example. While the transactions may have conformed with accounting rules, not caused Lehman's failure, and may even have been widely used by other banks, "Lehman and all its prior employees are now tarred with Enron level bad press, and legal exposure to the extent of what is now being deemed misrepresentation," said Patterson.

Yes, other banks may not have gone as far as Lehman with repos, but off balance sheet gimmicks like it were indeed industry practice. And pushing the envelope on industry practice was fatal. "To the extent that Lehman allowed those inaccurate numbers to influence remaining over leveraged and postpone addressing real problems is a stick your head in the sand practice, it may have contributed to the firm dying a loud, highly visible, rapid death," added Patterson. What's the take away? Said Patterson, "With the new flatter world of information access and transparency, accepting industry practice in marginal or questionable situations can be a career ending decision."

Ultimately, industry practice is not best practice if it does not address this question: "What would your stakeholders, your customers, your employees, your partners, your investors think of your practice?" asks Mary Adams, author of *Intangible Capital: Putting Knowledge to Work in the 21st Century Organization*. "Judge all your behaviors against this transparency standard. In the long run, nothing else matters. You may make your numbers this year, but if you do it in a way that reduces your reputation capital with stakeholders, then you may not make your numbers next year. This is why we call reputation the new bottom line."

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