THE CORPORATE GOVERNANCE ALLIANCE DIGEST

January 28 , 2003

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SUMMARY OF RESPONSES TO THE QUESTION RAISED IN THE LAST ISSUE: PROTECTING THE ETHICAL CFO

"There are murmurings in some quarters that to protect the CFO from an unethical CEO, the CFO should report to the Audit committee and some suggest be hired by the Audit Committee. Do you think this would be a good idea?" Responses were a mixed bag, including those who rejected the idea outright, those who said it had merit, and those who had other solutions to the dilemma. There was almost universal recognition that, in fact, there may be instances where CFOs require protection. Other solutions included the idea that all board meetings should provide for an executive session that excludes any employee board members and provides a forum for non-employee directors to address sensitive concerns, and a suggestion that to protect CFOs from losing their jobs if they speak up against the CEO that boards consider some type of employment contract for CFOs that would allow protection and/or a hearing in such a case.

DIRECTORS AT RISK

Due to the losses resulting from cases against directors, some insurance companies are removing an important clause from directors and officers liability insurance policies: the "severability clause". Without the severability feature, all directors stand to lose their coverage if any one board member is found by a court of law to have committed fraud. Given the heightened concern about corporate wrongdoing, some major insurers want to not only be released from payment claims against the perpetrators of fraud, but also the costs for other directors, whose role it was to help prevent that fraud. (WSJ) Directors can protect themselves not only by careful review of polices, but even more importantly by implementing demonstrably strong processes to guard against and detect risks and fraud in advance.

SIGNIFICANT SEC ACTIONS

AUDITOR REQUIREMENTS: New rules require that accounting firms keep audit-related documents for seven years, rotate senior partners on a corporate audit after five years and stay away from a company account for five years, that other partners with lesser roles in an audit rotate after seven years, require a one-year "cooling off" period before a member of an outside audit team could be employed by a former client (in a top-level capacity, such as chief executive, financial chief, controller, or a member of the company's board)-- or the company would have to hire a different outside audit company. And the rules bar accounting firms from providing certain services to audit clients, including bookkeeping, appraisals, brokerage services, investment banking, actuarial services, legal advice, management and personnel services, information technology consulting and financial systems design, and restricts "expert" services that aren't related to audit work. Tax-planning services and tax advice are OK under the new rules. Tax services account for at least 20% of revenue at the large firms, according to a 2000 industry study. Mandatory rotation of audit firms was not adopted. (WSJ, NY Times, USA Today, Wash Post, FT) See more on these reforms below.

AUDIT COMMITTEE REQUIREMENTS: Under the new rules, corporate audit committees must pre approve audit and non audit services and be briefed by auditors on the company's accounting, including alternative approaches that might be preferable to the company's current methods. The SEC broadened the definition of financial expert to include not just "the preparation or auditing of financial statements" but those who have experience supervising the people who prepare statements (i.e. not just former chief financial officers or accountants but also their bosses). (WSJ, FT)

ATTORNEY REQUIREMENTS: New rules require lawyers to take concerns about violations of securities laws to top executives and, if necessary, to corporate boards. The wording, however, of the provision makes it difficult to enforce. (NY Times, USA Today, Forbes, FT) Boards may need to seek answers and probe risk areas rather than relying on this provision.

MUTUAL FUND REQUIREMENTS: Beginning in July, new rules require mutual funds to disclose how they vote investors' shares. The rules do not require the funds to send a copy of their voting record to all investors, just make it available electronically. The rule does not require the funds disclose conflicts of interest when voting proxies. Pension funds, foundations, bank trusts and insurance companies are not subject to the new rules. (NY Times, FT, USA Today, Forbes, Wash Post)

DISCLOSURE REQUIREMENTS: Companies must disclose separately- audit fees, audit-related fees, fees for tax services, and all other fees over the last two years. Rules require disclosure of off-balance-sheet arrangements that are "reasonably likely" to be material to a company's financial condition in a separately captioned subsection of the "management's discussion and analysis" (MD&A) section of a company's quarterly and annual financial reports.

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New rules also require that when pro forma results are reported, GAAP must be reported also. (CFO Magazine, WSJ, FT, Wash Post)

INDEPENDENCE AND SEPARATION OF THE CHAIR AND CEO

A study by Patrick O'Callaghan & Assoc and Korn/Ferry of 313 of the largest companies on the Toronto Stock Exchange found that 62% have separated the role of chair and CEO and this statistic is 71% among companies with more than $5-billion in assets. However, the study found that in 19% of companies, the chairperson is still management. An earlier review by Globe and Mail found that 31 per cent of companies that had separated the roles still had a "related" chairperson (who might be a relative of the CEO, a lawyer or other professional working for the company, or a retired CEO who is still considered to be aligned with management). Applying these standards, the number of Canadian companies with truly independent chairpersons is closer to 40 to 45 per cent. (Globe and Mail)

In the UK, 95% of FTSE 100 companies have separated the chair and chief executive (89% of companies outside the FTSE 350 have done so), although 24% of FTSE 100 companies have chairs who were former chief executives of the same company. (FT)

UK AND SPANISH REFORMS

The Higgs report and Smith report were commissioned by British government officials and are expected to be incorporated into an existing code of corporate practices by July 1.

INDEPENDENCE AND SEPARATION: The Higgs report reaffirms that the roles of chair and CEO be separate and recommends that the chair not be the former CEO and be independent at the time of appointment, and that a majority of a company's board members, other than the chair, also be independent. To be independent under the definition excludes former employees until five years after employment has ended, those with a a material business relationship with the company either directly or indirectly within the last three years, those who have received additional remuneration from the company apart from a director's fee, have participated in a performance-related pay scheme, or are a member of the company's pension scheme, have close family ties with any of the company's advisers, directors or senior employees, are a significant shareholder, or have served on the board for more than 10 years. Appointment of a "senior independent director" should be shareholders' first point of contact should their concerns not be resolved through the chair or chief executive. (FT, WSJ)

TERM LIMITS: The Higgs report recommends a time limit on non-executive directors tenure of two three-year terms, a person be chair of no more than one major company, that full-time executives not take on more than one nonexecutive directorship or chair major company. No specific limit is set for the number of non-executive roles other individuals can hold, though care should be taken that individuals have enough time to do what is expected of them. (FT)

TRAINING AND DIVERSITY: The Higgs report recommends diversity in the selection of directors, induction programs, extra training for executives, and performance assessments conducted at least once a year. (FT)

AUDIT COMMITTEE: The Smith report, recommends that the audit committee consist of independent board members and recommend the hiring, rehiring or dismissal of the outside auditor each year. (FT, WSJ)

Spain released the Aldama report, which emphasizes greater corporate transparency and self-regulation. It recommends more independent board members, disclosure of how directors and executives are appointed, and of compensation packages. (FT)

VULNERABILITIES

In a survey by Korn/Ferry, 90% of the North American CFOs and CROs (chief financial and chief risk officers) said their risk-adjusted performance metrics were insufficient in meeting the demands of boards and shareholders, and 60 percent said incentives and performance are not sufficiently linked. (CFO Magazine)

PwC's global survey of 1000 CEOs from Europe, Asia, and the Americas shows while CEOs think public trust has declined for corporations, auditors, analysts and the capital markets, 72 percent do not think public trust has declined in their company. 49 percent say "over regulation" is a threat to growth prospects. (CFO Magazine)

A survey by Towers Perrin of 1,100 people from 1,004 companies with 500 or more employees found that workers have little confidence in their senior executives' abilities (i.e. competence). Further, 55% described their work in negative terms; 33% were intensely negative. The study found a "statistically significant" correlation between positive emotions, company profits, and five-year shareholder return. (Forbes)

A study by Huron Consulting Group shows a record number of companies restated in 2002. The average monthly number of restatements after the enactment of Sarbanes-Oxley was nearly 80% higher than before enactment. Over 50% of restatements were of previously audited annual financial statements. Revenue recognition continues to be the leading cause of restatements. Other issues include reserves/accruals/contingencies, equity, acquisition accounting, and capitalization/expense of assets. More large companies restated, with companies with annual revenues greater than $1 billion representing nearly 25% of all restatements. (WSJ, CFO Magazine)

A Washington Post examination of the enforcement record found the SEC took action against only two individual auditors it identified as working for Big Five accounting firms during the fiscal year that ended Sept. 30. "The cash-strapped agency has been slower to take actions involving big accounting firms partly because the big firms can deploy overwhelming resources in their defense, SEC insiders and private securities lawyers say." (Wash Post)

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WHAT'S NOT IN THE NEWS

While much has been reported on the Conference Board recommendations with respect to boards, the recommendations related to audit firms (particularly the "Big Four" that audit over 80% of US Public companies) have not received attention. The Conference Board Report recommends that the " Big Four" examine their business models and address questions of whether they are, in fact, properly structured to ensure that "quality audits are their number one priority" and that "they represent a "gold standard" in auditing." If, in fact, the accounting firms do not implement the recommendations or make changes beyond those strictly required by law, the reports' recommendations represent an opportunity (and a challenge) for audit committees to further assess the adequacy of their auditors' business models and the functions and roles they want audit firms to assume.

WHAT''S COMING UP NEXT

SEC decisions and studies on the role of rating agencies, on the noisy withdrawal provision for attorneys, and on an alternative rule that would require the corporation to report a lawyer's resignation. FASB rules on expensing of stock options. (WSJ) Expected new rules to be approved by the SEC in the spring and to go into effect in 2004: new corporate governance listing requirements proposed by Nasdaq and the New York Stock Exchange. (Wash Post)

PLEASE LET US KNOW WHAT YOU THINK: A QUESTION FOR YOU:

BOARDS AND AUDITORS

"Given the SEC's recent promulgations, some Boards are contemplating their own policies related to auditors, including going beyond the legal requirements to limit or eliminate the use of external auditors as tax advisors." Do you think this is a good idea and how difficult do you think it will be for Boards to enact stricter policies towards auditors? We would like to hear your views. Please email us ebloxham@thevaluealliance.com with your views and we will (anonymously) share readers' opinions with you.

As a director, do have 10 questions to ask - and only time to ask 2? We help boards put in place straightforward processes to get the answers to the other 8, efficiently, so the remaining 2, which are also critical can be answered in committee and board sessions. Implementing strong processes can help prevent liability issues and concerns. For more information, please call, email or visit wwww.corporategovernancealliance.com

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