THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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This edition of the DIGEST has 5 major sections:

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II. AUDIT COMMITTEE ALERTS
III. A MATTER OF TAXES
IV. COMPENSATION
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I. BOARD PRACTICES (AND INVESTIGATIONS)

I.A. HEALTH SOUTH

I.A.1.SENATE PANEL QUESTIONS ROLE OF AUDITOR AND BOARD

By May 6, the House committee wants letters and e-mails that passed between the company, its auditors and board members. The committee will probe concerns about the oversight by the board of directors, auditing practices of the internal and outside auditors, whether Justice Department civil lawsuits prompted E&Y or the board to heighten their scrutiny of the financial reporting, the role played by outside lawyers, and the directors' personal business relationships with the company and related enterprises.
(WashPost 4/22 and 4/23, NYTimes 4/23, WSJ 4/23 USAToday 4/23,)

I.A.2. BOARD HIRING DIFFICULT

In response to shareholder pressures last fall concerning board members' financial links to the CEO, hiring more outsiders was initiated at the end of last year; however, given the uncertainty surrounding the company, no candidates have been willing to make a commitment. (FT 4/21)

I.B. TWO PEOPLE: TWO JOBS

I.B.1.To improve governance, NASDAQ divided the top jobs in its recent appointments of Robert Greifeld, an executive of a trading technology company, as chief executive and president and H. Furlong Baldwin, an outside director, as chair. (NYTimes 4/16)

I.B.2.Recently interviewed on the subject of leadership, Andy Grove, Chair of Intel, said: "Well, bit by bit, under duress, boards are moving in the right direction. But where they started from is ... selected by the CEO, working for the CEO, doing a certain amount of rubber-stamping of the CEO's actions... Corporate governance is, or should be, exactly the other way around. The CEO is selected by, retained by, renewed by, and supervised by the board... And a parameter of how many miles to go is the percentage of Fortune 500 companies where the chairman is a different person from the CEO... If the chairman and the CEO are the same person, how the hell can the board of directors supervise the CEO?" (HBS Working Knowledge 4/14)

I.B.3.Companies that are making the two jobs/two people model work include Giga Technologies and the New York Times.(Corporate Board Member March 2003)

I.B.4.In a Directorship/McKinsey survey last year of 200 directors, more than 2/3 supported division of the jobs. (Directorship June 2002)

I.C. BOARD PRACTICES

A Korn/Ferry survey of 900 directors shows that almost 75% of Fortune 1000 boards now have written governance guidelines (up from 65% in 1995); 62% have corporate governance committees (up from 41% in 1995). 37% have formal evaluation processes (up from 26% in 1995). While 75% believe this should involve individual evaluation, only 20% have these processes in place. Only 50% report that they have effective management succession plans and only 64% have a management succession committee or process. More than 75% of the boards think retiring CEOs should leave the board. While almost 3/4 favor regular meetings without the CEO, only 42% hold such sessions. 32% with the two jobs combined have a lead director. Average board size is 12. Only 10% meet more than 10 times; nearly 50% meet quarterly. (Directorship March 2003)

I.D. LARGE COMPANIES TO GET MORE ATTENTION

The SEC is stepping up its scrutiny of big corporations, after years of focusing on small companies and initial public offerings. The SEC will review "a spectrum of companies," across sizes and industries.(WSJ 4/11)

I.E. BOARD EFFECTIVENESS CITED: COMPANIES, SOME IN THE NEWS FOR OTHER REASONS, TOP CALPERS LIST

The nation's largest public pension fund added Xerox, Gemstar-TV Guide, JDS Uniphase, Manugistics Group, Midway Games and Parametric Technology to a list of companies it says should improve their corporate-governance practices. Xerox has said that Calpers' claim that it preferred shareholders not to communicate directly with the board was wrong. Xerox tops Calpers's list because the pension fund believes the company has "one of the most ineffective boards" and wants it to add three independent directors, and split the position of chair and CEO. Calpers' list is based on corporate governance practices, an analysis of economic value, and stock performance. (WSJ 3/27, FT 3/28)

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II.AUDIT COMMITTEE ALERTS

II.A. THE 4 Rs:
ROUNDTRIP, REBATE, REVENUE AND RESTATE

II.A.1. Spending money to get it back as sales is known as round-tripping. AOL Time Warner restated $190 million in revenue last fall related to overpayments to companies designed to boost advertising sales, which passed funds through third-parties. They fired 2 executives in connection with the accounting problems. Currently, the SEC is investigating a $400 million sale of advertising to Bertelsmann, part of AOL's acquisition of Bertelsmann's stake in AOL Europe -- and an agreement the company made two years ago to sell $25 million in advertising to Vivendi as part of a deal for its stake in AOL France. The SEC is questioning whether Vivendi's payment to AOL was actually a form of rebate, used to increase AOL's revenue and earnings, instead of a legitimate purchase of advertising. Unlike the earlier deals, AOL's agreements with Vivendi and Bertelsmann were negotiated by its most senior executives and did not involve third parties. Also under SEC review: a $100 million deal with Monster.com that may be a roundtrip, $9.6 million in ad revenue from DrKoop.com that may really be a one time contractural gain, and a possible acceleration or frontloading of revenue in a relationship with Catalina Marketing. (NYTimes 4/22, WashPost 4/22, USAToday 4/22)

II.A.2. Following an SEC review, Charter Communications will restate its accounting for capital expenditures, marketing costs, and payments from programmers for launching new channels, previously recognized as advertising revenue. Although the SEC has been investigating AOL Time Warner's America Online unit, Charter's restatement raises the possibility that the inquiry in the future could include its cable-TV unit, which reported a sharp increase in ad revenues in the past couple of years, partly because of higher ad revenues for channel launches. (WSJ 4/2)

II.B. The 5th R:
RESERVE ACCOUNTING (SEE ALSO III.D.1.)

Xerox posted a 1st quarter loss after taking a $300 million pretax ($183 million after tax) charge related to a September 2002 judgement involving underpayment of lump sum retirement benefits to departing employees. Peter Ausnit, an independent analyst, "was baffled" by Xerox's view that it would overturn the case, reluctance to admit bad news, and the danger facing Xerox from continuing shareholder litigation that is "manyfold larger" than the first-quarter pretax charge. (WSJ 4/21, 4/23)

II.C. SPE ACCOUNTING:
AUDITOR SUED

Amerco the parent of U-Haul is suing its former auditor PWC for more than $2.5 billion for delays in disclosing an error once discovered and providing flawed accounting advice over a seven year period related to special purpose entities Amerco set up based on PWC recommendations, which PWC said could be accounted for off balance sheet. (FT 4/21,USAToday 4/21,NYTimes 4/22)

II.D. A MATTER OF DISCLOSURE:
VENDOR PAYMENTS

While accounting has been questioned at Ahold, Fleming and NashFinch related to vendor payments, hundreds of companies that accept apparently significant vendor payments don't disclose the amounts. Analysts have been trying to get numbers but so far have only been able to deduce the significance based on small clues in press releases. For example, analysts believe Albertsons, Kroger and Safeway get more from vendor payments than actually selling groceries. Food distributor's Sysco payments are believed to be almost equal to the company's pretax profit, $570m for 6 months and $218m for the quarter ended December, but Sysco won't comment on the amounts, calling the size of the payments "meaningless" for investors. Best Buy didn't originally report its vendor payments last fiscal year but a subsequent restatement revealed the payments totaled $721 million, 71% of pretax earnings. Analysts also say vendor payments are a large piece of department store profits but cannot determine the amounts due to lack of information. When asked, Federated Stores declines to comment or give any numbers: "This is not something we are willing to disclose." (USAToday 4/23, WSJ 3/6)

II.E. ACCOUNTING CHANGES

Over the next 18 months, Mr. Herz, chair of the FASB, is expected to implement or initiate changes in the treatment of stock option costs; pension accounting; and whether standard-setting should be based on rules or principles. (FT 4/20)

II.E.1. OPTIONS ACCOUNTING

FASB unanimously agreed that companies should be required to treat grants of stock options to executives and employees as expenses. The measure is opposed by some in high-tech industries and some members of Congress. (WashPost 4/23)

II.E.2. PENSION ACCOUNTING

The IASB plans to produce a pension accounting standard this year based on UK rule, FRS 17, which would abolish the spread of gains and losses on assets over a period of years in favour of immediate recognition of gains and losses that would be recorded in a new statement of comprehensive income rather than be reflected in the earnings statement. Mr.Herz, chair of the FASB, stated he would support adoption, stressing his goal of convergence between US and international financial reporting rules. With the change, gains on pension assets that occurred several years ago would not be included in profits and has been blamed by some in the UK for the closure of some pension plans. (FT 4/21)

II.E.3.PRINCIPLES BASED ACCOUNTING

By August, the SEC will publish a report expected to endorse greater emphasis on principles-based accounting in the US. US accounting has traditionally been more rules-based. Mr Herz of the FASB warned that a decisive shift away from rules would require a huge cultural change. Auditors would be required to use greater professional judgment --and, to-date, investors and the SEC, in punishing corporate wrongdoing have relied on detailed accounting rules to prove people guilty. A fundamental shift

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away from rules-based accounting will depend on complementary work from the SEC, FASB and the PCAOB. Instead of relying on rules to solve disputes, auditors, together with management and boards of directors, would have to change their behavior and approach for a principles-based system to work. (FT 4/21)

II.F. THE WORK OF THE PCAOB AND THE ROLE OF THE AUDITOR

William McDonough is to head the new US accountancy regulator, the PCAOB, whose job it is to register and inspect the work of all accountants that work on US-listed companies, though there is a dispute over what that will mean for non-US accountancy firms. The PCAOB will also set auditing standards - an area that concerns audit firms because the firms fear legal liability if they are required to detect fraud at clients. The PCAOB will also study auditor independence later this year when it starts to monitor the quality of work by audit firms and review the status of tax practices. The new regulatory panel named its first chief auditor Douglas R. Carmichael, an accounting professor called by some a critic of the big audit firms.(FT 4/15, 4/16, WSJ 4/18)

II.G. AUDITOR INDEPENDENCE

II.G.1. DELOITTE TO KEEP ITS CONSULTING ARM

Reacting to investor concerns that such services can impair an auditor's independence, GM said it would cease consulting projects with the big accounting firm. (WSJ 4/7)

II.G.2. An analysis by The Wall Street Journal of fees paid to auditors by most of the 30 companies in the Dow Jones shows that 62% of the $811.8 million in fees in 2002 were for services other than auditing. This figure may be understated given a recent change in definition which includes some services that in the past two years have been considered nonaudit. The new definition includes statutory audits, reviews of documents filed with the SEC, and tax and accounting consultations "to the extent that such services are necessary to comply with" GAAP. (WSJ 4/16)

II.H. PATTERNS IN APRIL RESTATEMENTS: WSJ

Fleming to correct the timing of vendor transactions and balance of reserve accounts. Ariba to correct revenue recognition timing and record expenditures for several license arrangements. Fischer Imaging to correct revenue recognition timing and rework and warranty inventory and related vendor receivables. Express Scripts to revise revenues related to rebates and administrative fees from drug makers. Financial Industries to correct the collectibility of agent balances, the amortization of deferred acquisition costs, present value of future profits, and the allowance for uncollectable receivables.

Huntington Bancshares and Provident Financial to reclassify auto leases from direct finance to operating leases. Abington Bancorp to increase mortgage prepayment assumptions and correct errors in accounting for the distribution of certain payments received on portions of its mortgage-backed securities portfolio. Midwest Banc to add to loan loss allowance, to charge off loans, and reverse accrued interest income.

Millicom International Cellular to revalue "investment in securities." Crystallex International to account for written calls as derivative instruments versus hedges. Smith & Wollensky to add a $145,000 insurance recovery.

Miller Industries to reclassify certain operations as discontinued operations. Hines Horticulture to change the loss on the sale of discontinued operations recognized in prior periods. Intasys after settling a legal dispute arising from operations the company discontinued.

Digital Video Systems to reduce reported sales which were intercompany; to be directly offset by reductions in cost of goods sold.

National Vision to correct deferred income tax assets and liabilities.

III. A MATTER OF TAXES

III.A. Corporate tax audits frequently trail (by years) specific practices. A tax shelter strategy using money-market fund shares to defer tax liabilities in the 1990s used by financial institutions is now under examination for shut-down.(WSJ 3/27)

III.B. Companies are paying fewer taxes due to a number of strategies including exploiting low tax rates overseas, setting up transactions between different arms of the company, patents being moved overseas, corporate-owned life insurance policies, and options incentive programs. On 2/27 the Treasury issued new regulations designed to curb the proliferation of abusive tax shelters -- transactions that cross the line from tax minimization to tax evasion. (BusWeek 3/31)

III.C. The Treasury and IRS have stepped up enforcement and Congress is considering legislation that might include higher penalties for tax "understatements" arising from tax-motivated transactions. Currently, the IRS can challenge aggressive transactions in a number of ways: it can recast the form of the transaction so different tax rules apply; apply anti-abuse rules; or disallow tax benefits from transactions that "lack economic substance." (WSJ 4/2)

III.D. AUDIT AND TAX

In a wrongful termination suit against Levi Strauss, former employees of Levi say KPMG assigned two tax partners last year who "questioned the propriety" of some of Levi's tax treatment and balance-sheet reserves -- and were removed by KPMG at the request of a Levi executive. (WSJ 4/18)

III.E. SENATE TAX REVIEW

As part of a broader inquiry into promoters of potentially abusive tax schemes, a Senate subcommittee has requested documents from E & Y and KPMG related to tax-shelters sold to both individuals and corporations. Separately both firms face legal action by individuals who claim they were sold faulty shelters. Last year, the IRS accused three accounting firms, including KPMG, of using tax laws to help hundreds of companies and individuals avoid billions of dollars of taxes. Last summer, PWC paid about $1 million to the IRS to settle matters relating to tax-shelter registration. IRS rules require promoters to register

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shelters that the agency has identified as potentially abusive and to keep lists of participants. (WSJ 4/22)

IV. COMPENSATION

IV.A. TIAA-CREF WINS CHANGES TO OPTIONS PACKAGES; QUESTIONS SBC COMPENSATION COMMITTEE INDEPENDENCE

When TIAA-CREF approached about 50 companies with a possible shareholder vote on pay structures, they received commitments from most of them to move a method in which top executives receive options only if their companies clear certain performance hurdles — and that when executives exercise options, they hold most of the shares for some substantial period. SBC and Siebel appealed to the SEC to prevent the pension fund's resolution from appearing on their proxy ballots and being voted on by shareholders. Both companies lost the appeals, and shareholders now will vote on the option grant plans. TIAA-CREF questioned the independence of SBC's compensation committee; SBC targets CEO Edward Whitacre's pay at the 75th%ile rather than the midrange of comparable companies. (NYTimes 4/20, USAToday 3/31)

IV.B. DIRECTORS PAY

Pay for directors at the 50 largest mutual fund companies increased 8.2 percent in 2002, while pay for directors at smaller funds rose 17.5% according to a survey by Management Practice that included responses from 60 fund companies. Mercer Bullard, chief executive of Fund Democracy, a mutual fund watchdog, believes some directors have been underpaid and that pay in the $300,000 range was appropriate for directors at large funds. The study showed that boards of smaller fund companies tended to meet 4 times a year, but directors at large funds may meet 11 times for 2 days at a time. Board meetings were generally longer than 6 hours, more than in past years. (WSJ 4/14, FT 4/20)

IV.C. UK PAY

The National Association of Pension Funds, one of the UK's largest shareholder groups, is raising objections to pay plans at 21 companies holding annual meetings in the next two weeks, including Glaxo SmithKline where there is particular concern over a "golden farewell" package for Jean-Pierre Garnier, the chief executive. The NAPF is urging members to vote against packages, which have come up for a shareholder vote for the first time this year, as a result of a new Companies Act amendment that requires quoted companies to prepare a board-approved report containing a statement of pay to directors, the performance targets attached to long-term incentive plans, or to share options, and gives shareholders the right to vote on pay reports in an advisory capacity, allowing shareholders to decide whether hurdles for pay have been set high enough. (FT 4/18 and 4/21)

IV.D. MIND THE GAP

The average chief executive's pay was 42 times that of the average hourly worker in 1980, according to Business Week. By 2000, the CEO compensation was 1,531 times as much as the hourly worker's. While executive pension plans have been improved, new studies show that workers'plans are at increasing risk. Legislators are holding hearings and considering legislation to address plans to revive conversions of traditional worker pension plans to plans that can mean cuts in benefits, especially for older workers. Shareholder proposals are also focusing new attention on the ways top executives' retirement packages have been enhanced in contrast to those of employees. (WashPost 4/13)

IV.E. EXECUTIVE PAY - Here we present the different reports on 2002 CEO pay and how directors addressed the issues.

IV.E.1. Directors are coming under more scrutiny over rising CEO pay. "There's more wariness on the part of some compensation committees and not as much rubber-stamping as you might think," says Blair Jones of Sibson Consulting. "But boards are still in somewhat of a pickle, because no one wants to be on the leading edge of change." While almost all companies use outside consultants to gauge peer compensation on the premise that pay must be competitive to attract and retain talent, whether CEOs would really exit if their pay was less, has been questioned. Some believe active CEOs continue to dominate board-compensation decisionmaking. Based on an exclusive database analysis by USA TODAY and the Investor Responsibility Research Center, CEOs running 100 of the USA's biggest companies earned median 2002 compensation of $33.4 million, essentially unchanged from 2001. CEO salaries and bonuses rose 15% while salaries for rank-and-file workers rose 3.2%. The increase in CEO pay surprised Pearl Meyers. More than 90% of CEOs received new stock-option grants, with a median potential value of $23.2 million. 36% of companies gave CEOs large blocks of restricted shares with a median value of $2.9 million. (USAToday 3/31)

IV. E.2. As investors are demanding an overhaul of CEO pay packages and how companies are governed, the response from boardrooms was mixed. A few companies, like Starbucks and Reebok, reduced executive pay despite profit increases and shareholder gains. Many others, like Walt Disney, Abbott Labs, Delta and Cardinal Health, sharply increased pay as investors suffered losses. Still others showed what some might call the excesses of the past: Clorox promised three years' tax-free use of the company plane and other perks to its chief executive after he retires. Honeywell International gave its departing CEO a $4 million bonus and his successor a five-year contract that guarantees $3.375 million in cash and more than twice as much in stock and options annually. Note: Executive sales of companies' shares in 2002 are not reported in the proxies, but instead are reported in FORM 4, which, unlike a company's proxy statement, has not been available on the SEC's website. The Sarbanes-Oxley bill, however, will require companies to file the forms electronically starting this summer, and the SEC will make the forms available on the Internet. (NYTimes 4/6)

IV.E.3. Many boards are taking a fresh look at almost every aspect of CEO pay in an overhaul that includes smaller option grants, wider use of restricted stock plus stricter stock-ownership and retention requirements. According to a study of the latest proxy statements for 350 major US companies by Mercer, CEOs in place at least two years saw a 10% increase in salary and bonuses to a median of $1,802,053. In contrast, white-collar pay increased 3.5%. and overall, US wages and benefits rose only 3.2%. The gap reflects the bonuses that

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CEOs are awarded. Bonuses of CEOs increased 15% to a median of $917,943 last year. Total direct compensation which includes the value of restricted stock at the time of the grant, gains from option exercises and other long-term incentive payouts rose 15% for CEOs last year to a median of $3,022,505. (WSJ 4/14)

IV.E.4. Many boards recognized the need to justify their compensation decisions and for the 365 CEOs in the BusinessWeek scoreboard, average CEO pay plunged by a third to $7.4 million while median pay rose 5.9% to $3.7 million. This was because more than 40% of CEOs saw their total pay decrease. Last year, the top seven execs on the pay scoreboard earned more than $100 million; this year, only two did. Last year's highest paid CEO earned $706.1 million (after exercising options) compared with $194.9 million for the highest paid this year. The numbers also reflected a handful of CEOs who, in light of weak performance and a backlash against obscene pay, elected to work for nominal sums or who gave back part of their package. Both the average pay for all CEOs and the average for the 20 highest-paid chief executives for 2002 are now, in inflation-adjusted terms, back to where they were in 1996. (BW 4/21)

IV.F. TO DISCLOSE OR NOT TO DISCLOSE - PAY, RETENTION, PENSIONS AND BANKRUPTCY

The decision to disclose (or not): More than a week before the 10-K filing, company officials at American Airlines responding to a Wall Street Journal query, said they had not created executive compensation plans similar to those of Delta. Apparently that inquiry created a debate inside American over whether to disclose the retention bonus plans for seven top executives and the trust fund set up to protect the pension benefits of 45 executives from creditors in the event of a bankruptcy-protection filing. Some inside the company urged Mr. Carty and other top executives to make the plans public but several people say Mr. Carty and top American officials made a conscious decision to delay, especially after Delta's March 25 disclosure drew such a reaction from employees and congressional representatives that Delta agreed to give up millions of dollars in compensation. American's benefits were disclosed in its 10K filing with the SEC on the night after voting on concessions had ended at two unions and almost ended at the third one. Mr. Carty said he did not disclose sooner because he believed American's benefits would appear modest compared with those granted at other carriers. He also said he would get rid of the retention bonuses, but not the executive pension trust.(A payment of $41 million had been put into trust last October.)

The question of pay: Mr. Carty said the packages were justified because the board wanted to keep executives from being lured away. Critics said such bonuses assume that the executives should be kept around, that executives' pay was already so much higher than the pay of average workers that troubled companies should not take extra measures to protect those parts of executive pension benefits not already federally guaranteed; and that American's payment last October to the trust fund indicated executives were not willing to make the sacrifices they were demanding of workers.

The question of bankruptcy: The Transport Workers Union and the Association of Professional Flight Attendants will revote. (FT 4/20 and 4/22, WSJ 4/22, NYTimes 4/21 and 4/22, USAToday 4/21 and 4/22, WashPost 4/22)

V. VULNERABILITIES - ISSUES FOR BOARDS TO CONSIDER

V.A. VULNERABILITIES: ETHICAL PRESSURES

A joint research project of The Society for Human Resource Management and the Ethics Resource Center shows 24% of HR professionals feel pressured to compromise ethics standards all the time, fairly often or periodically compared to 13% in 1997. The top 5 pressures to compromise ethical standards include the need to: follow the boss's directives; meet overly aggressive business or financial objectives; help the organization survive; meet schedules; and be a "team player". On average 35% of HR professionals often or occasionally personally observed ethics misconduct in the last 12 months - with government, health, and wholesale/retail sectors being those where unethical behavior was most often observed. One note: Effective ethics programs may amplify the results because individuals may be more aware of what constitutes misconduct. (CFO 4/23)

V.B. VULNERABILITIES: WORKPLACE PRESSURES

Few companies have established policies to deal with workplace bullies whose targets are often highly competent but non combative workers. A 1999 study by the Center for Urban Studies at Wayne State University, in Detroit, found that 1 in 6 respondents had experienced workplace bullying in the previous year and that bullies are equally divided between men and women, and between managers and co-workers. Bullies don't usually yell or scream but frequently find ways to manipulate a worker, such as denying vacation time, giving unduly harsh performance appraisals or humiliating them. (CFO 4/18)

V.C. VULNERABILITIES: WALL STREET PRESSURES

Letters were released showing the pressure placed on former Radiologix CEO to choose UBS for a bond underwriting deal which was completed by Jeffries in December, 2001. The letters surfaced last week, shortly before UBS Warburg is expected to pay $50 million in fines and payments (less than several other firms) as part of a global settlement on conflicts between research and investment banking. Senator Grassley called on the SEC to release details of the $1.4 billion settlement with big Wall Street firms before the commission votes. Two issues of concern: insurance and tax deductibility. (NYTimes 4/22, WashPost 4/22)

V.D. VULNERABILITIES: INVESTOR CONFIDENCE

The NYSE probe of specialist firms to determine whether any firms and their traders failed in the case of about a dozen stocks to match orders from small investors directly, but instead made profits by buying from one and selling to another. The exchange's rules require that specialists directly match orders whenever possible so the buyer and seller get the same price. Separately, the

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SEC has also has begun its own investigation of NYSE practices. (NYTimes 4/23, FT 4/23)

We help boards implement powerful, straightforward processes to get the answers to the critical questions that improve oversight and the ability to add value. For more information, please call, email or visit wwww.corporategovernancealliance.com.

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