THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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THE CORPORATE GOVERNANCE ALLIANCE DIGEST - SPECIAL EDITION

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Published by:

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Ms. Bloxham is founder and CEO of The Value Alliance and author of *Economic Value Management*, a book on value, governance, strategy and risk. Mr. Nash founded the National Association of Corporate Directors, is President Emeritus and was responsible for launching NACD's highly successful Blue Ribbon Commission Reports on governance.

This special year-end edition contains significant events in corporate governance for 2005 and a look ahead to 2006, as well as initial coverage on the new disclosure rules proposed yesterday by the SEC.

Join us February 23 and 24 in New York at On Board Boot Camp, an interactive seminar designed to introduce you to experienced directors and search executives who will share with you "lessons learned" and what you should know about board seat selection. We will be there showcasing our new educational video series on good governance practices "Corporate Governance and Value: Building a Bridge of Trust™," For more information about On Board Boot Camp please contact Jessica Crowell: partcom@verizon.net or call 212.987.6070

"THE GOVERNANCE YEAR IN REVIEW AND TRENDS TO LOOK FOR IN 2006"

Plus Initial Digest of News Coverage on the SEC Disclosure Rules Proposed January 17, 2006

This Digest is broken into five major sections.

I. 2005: REGULATORY, ACCOUNTING AND LIABILITY ISSUES
II. 2005 CASES: COMPENSATION AND OTHER SHAREHOLDER AND GOVERNANCE RELATED ISSUES
III. 2005: BOARD AND BROADER GOVERNANCE PERSPECTIVES
IV. WHAT'S AHEAD FOR 2006
V. PROPOSED SEC DISCLOSURE RULES - JANUARY 17. 2006

Source for the first four sections: The Value Alliance's Governance Year in Review video. Transcription provided courtesy of AthenaOnline, the educational firm**. I**nformation on specific best practices for boards and companies can be found in our educational series produced in association with AthenaOnline entitled "Corporate Governance and Value: Building a Bridge of Trust™," a series of educational video talks and interviews on corporate governance, value, risk and compliance topics. For information on the good governance series, please contact Eleanor Bloxham (ebloxham@thevaluealliance.com). To view the video go to http://www.thevaluealliance.com/governance_review_2005.htm

I. REGULATORY, ACCOUNTING AND LIABILITY ISSUES

Turnover: One of the major events that we saw in 2005, related to regulators, was the turnover at the SEC and at the PCAOB as Donaldson left the SEC and Cox came in to take his place as the SEC chief.

Turf Battles: A number of turf battles occurred around regulation associated with the financial services industry. Some questioned the SEC's authority in terms of mutual funds and the regulations associated with the independence of their boards. We saw the SEC step in to start to regulate and require registration for hedge funds. We also saw a battle between financial services regulators and jurisdiction of the state of New York. And we saw issues arise in the Refco scandal associated with commodities futures, who should regulate them, and the overlap of jurisdictions that occurred there.

Liability: 2005 was a big year in terms of liability and concerns over liability. In 2005, directors had to pay out of their own pockets for their participation in the Enron and WorldCom scandals and we also saw heightened liability concerns coming from external auditors.

External Audit: External auditors' liability concerns were evidenced in their interaction with boards and companies, creating some strains there in addition to higher fees. External audit firms also had concerns, of course, because of their new oversight regulator, the PCAOB, and the kinds of report cards, which weren't always favorable, that were being generated out of the PCAOB related to the largest accounting firms as well as the smaller ones.

404: This change in the relationship with the external auditor was also evident in the 404 Implementations within companies and high fees there in terms of external audit firms, not only in terms of their audit function, but also in terms of their participation in consulting around 404. What we witnessed in the implementations was a need for some diverse or multiple perspectives and later in the year, the PCAOB stepped in and provided some clarifications with a different perspective and the use of top down or, risk-based ways of implementing 404 that focused on the major risks in order to avoid a laundry list approach. Going through the process of 404 implementation, companies started to learn about internal controls at a much deeper level, in some cases, than they understood before, and started to see the linkages between financial controls and broader enterprise risk management.

Accounting: 2005 was also a year where we saw some accounting "wars" and also international convergence in terms of accounting. In the EU, some of the wars centered on mark to market and fair value, particularly as that impacted financial services firms and insurance firms in particular. In the US, the issue in terms of accounting was the expensing of stock options, which moved closer to international convergence, but was not popular with some companies although it started to reflect more fully some of the economics in terms of stock option compensation. Some companies recognizing that there was a cost to stock option compensation started to eliminate or modify stock option programs they had for their employees.

II. CASES: COMPENSATION AND OTHER MAJOR GOVERNANCE & SHAREHOLDER RELATED CASES

Disney: One of the most important cases that came to trial in 2005 was the Disney case related to the severance pay to Michael Ovitz. The courts ruled in the favor of directors, articulated the fact that governance is evolving, and made a distinction between what was required in terms of good practice versus what might be considered a legal liability. Disney as a company demonstrated that governance is evolving, through its adoption of majority vote rule.

H-P: At Hewlett-Packard we saw tumult at the top, the CEO leave, and the issues related to succession planning at that firm.

Morgan Stanley: Another case of note was Morgan Stanley where Phil Purcell left as head of that organization after much tumult, and that tumult was expressed by concerns on the part of former employees who were also shareholders - and concerns of current employees as well. In this case, we saw the intersection of interests come into play and we saw a board having to deal with these issues, heightening, more generally, the importance of ongoing board relationships with shareholders and employees and board duties in that regard. Also, in the Morgan Stanley situation, when John Mack was hired, there were issues around compensation that caused general shareholder concern and, in reaction, John Mack, in terms of his own pay, made changes to it to address shareholder concerns about the linkage between pay and performance. More recently, we've seen at Morgan Stanley the installation of a new board for the most part: a new CEO and new board.

Gillette: One of the most dramatic pay stories in 2005 involved James Kilts of Gillette and the pay he received related to change-in-control in the merger with P&G. There were concerns expressed over the multi-million dollars that he received there and it raised heightened concerns in the broader shareholder and corporate community related to these kinds of change-in-control and severance pay practices.

Coke: Towards the end of the year, we saw Coke adopt a resolution that if severance pay were 2.99 X regular salary and bonus or higher, that shareholders would be able to vote on that pay issue, and so this kind of measure which had been adopted on other boards, like HP, came to the forefront and received shareholder attention.

Pay Equity: The other major issue in terms of pay that came to the forefront in 2005 was the continued discrepancy in terms of the rise in CEO pay versus that of worker pay. No longer just part of the lexicon of the media and of workers themselves, this became part of a broader conversation that was starting to take place among directors beginning to look at these issues, with no resolution seen in 2005.

III. BOARD AND BROADER GOVERNANCE PERSPECTIVES

Strategy Oversight: One of the issues that came into play related to board governance was the issue of oversight and broadening that beyond just a regulatory definition. So, we saw more and more boards really getting involved in oversight from the perspective of strategy in 2005.

CEO tenure: We also saw that CEO tenure was starting to shorten, perhaps a reflection of the fact that boards were taking more control over what was happening with the CEO.

Board tenure: One of the issues that was a concern for directors in 2005 related to retirement ages or term limits, for themselves. More boards were examining their own practices, what that meant in terms of who should sit on the board, how long they should sit, and the linkage of these issues to the board evaluation processes themselves

Director pay: Another issue that was brought to attention in 2005 was an escalation in the pay for directors. As directors were spending more time, there was also escalation in pay. Now director pay was coming under scrutiny just as CEO pay had been in the past.

Donations: Political issues came to the forefront with directors reviewing political contributions as potential scandals arose in terms of how corporate monies might have been used.

Health and Retirement Plans: We saw a number of pension plans terminated or scaled back within the larger political environment/context of issues surrounding health and retirement plans. Director understanding about fiduciary duty around pension plans, not only conflicts that could be occurring related to pension consultants, but also the fiduciary duties overall (that really came to awareness in the Enron scandal) became a focus of discussion at some firms. These issues were also reflected in terms of labor negotiations and how those moved forward in 2005.

Economics vs Accounting: We also saw the articulation of broader views from regulators for example in the publication in the summer by the SEC of its off-balance sheet recommendations in which it recognized a difference in roles between transparency and the actual inclusion of information in the financial statements, and also, a recognition of the distinctions between economics and accounting (again, an Enron legacy). We also saw discussions along these lines at the PCAOB related to the role of external audit and we saw these issues expressed by major pension funds in the US and the UK taking a look at long-term pay versus long-term economic value performance, instead of looking at stock performance or performance related to earnings.

Corporate Social Responsibility: This broadening of perspectives was also reflected in greater reporting and awareness around corporate social responsibility issues and also, in terms of broader definitions of what governance means: governance as stewardship. In 2005, IFAC put out recommendations on environmental accounting; accounting for these issues came to the forefront, both from a management standpoint and also from a reporting standpoint.

IV. WHAT'S AHEAD FOR 2006

Shareholders: Shareholder rights is a major issue where we will see additional dialogue. Whether it be majority vote rule, the way in which votes are cast (electronically or the like) shareholder rights and shareholder communications and an extension of the trends in 2005 are what we'll see going forward in 2006.

In terms of shareholders, there will be more and more shareholder attention, not just to companies, but also to boards themselves and how they're governed. Just as we've seen media attention move beyond a focus on the company itself to include more attention to the directors and their roles, we're going to see more and more shareholders look at board oversight of itself, look at disclosures in terms of nominations, look at disclosures in terms of not only CEO but also board pay and how that operates.

Economics vs Accounting: The second major trend will be the continuing extension of this dialogue about economics versus accounting and we're going to see it play itself out in mark to market discussions in terms of accounting, in terms of fair value accounting, and we're going to start to see it being brought in to the compensation discussion. We'll also see it being brought to bear when we're talking about issues of performance management and the implementation of enterprise risk management systems and here the lessons from financial services will start to move into the risk framework discussions as well as the economics discussions, and we're going to start to see more metrics that more fully deal with the risk and return equation.

International Convergence/Dialogue: In 2006 we're going to see a continuation of international efforts and international convergence around accounting issues and also, best practices more generally in terms of governance. Another area where we'll see this come to the forefront is in terms of compensation oversight and the practices overseas being scrutinized by an even broader shareholder population in terms of some of those activities and a focus on practices elsewhere that give shareholders a greater voice and ability to influence that compensation discussion.

Board Governance: In 2006, we'll see a continuation in terms of boards' broader involvement in strategy, toward bigger picture concerns, the intersection of interests and understanding the roles of all stakeholders, -- as well as greater scrutiny in terms of oversight of themselves and trying to put in place governance mechanisms to ensure that they as a board, not only in terms of their oversight of the company, but they as a board, are well governed.

Intersections of Interest: Finally, this understanding of the role of a variety of stakeholders and intersections of interests is going to continue to push forward the conversations related to corporate social responsibility concerns. It's also going to push forward issues related to a conversation around the role of the corporation in the world, more generally and more broadly. And in addition, it's going to play into some of the conversation that happens politically, but in relation to public goods versus private goods, and whether that be in the sphere of health, retirement and pensions or whether it be in the area, for example, of external audit where there is a public good -- and the question will be one of balance and how in fact, to make this all work in a private free society.

V. PROPOSED SEC DISCLOSURE RULES, INCLUDING RULES ON EXECUTIVE COMPENSATION DISCLOSURE, THE FIRST SEC RULES ON EXECUTIVE COMPENSATION SINCE 1992

Includes: Changes to executive and director compensation disclosure as well as changes related to disclosure of related party transactions, director independence, and corporate governance.

Impacts: Annual reports, proxy and registration statements and current reporting requirements of Form 8-K regarding employment/compensation arrangements

Related party transactions: Slight expansion in the categories of related parties. Less disclosure required as the annual threshold for disclosure is raised from $60k to $120k, Disclosure if the company is a participant in a transaction in which a related person has a direct or indirect material interest.

Independence: Disclosure of whether each director and director nominee is independent, a description of any relationships not otherwise disclosed that were considered when determining whether each director and director nominee is independent; and disclosure of any audit, nominating and compensation committee members who are not independent.

Governance: Consolidates and includes disclosure regarding board and committee meetings, specific disclosure about nominating and audit committees, and compensation committees and a narrative description of their procedures for determining executive and director compensation.

Security Disclosure: Disclosure of the number of shares pledged by management.

Compensation: in "plain English"

Executive Compensation:
(1) A Compensation Discussion and Analysis outlining the objectives and the most important factors underlying each company's compensation policies and decisions.

(2) Executive compensation for CEOs, CFOs, and the next three highest paid executives organized into three broad categories:

(a) A Summary Compensation Table showing salary, bonus, restricted stock and stock options (measured at grant date fair value), and all other compensation (including the aggregate increase in actuarial value of pension plans accrued during the year and all earnings on deferred compensation that is not tax-qualified) along with the total compensation for each person over the last three years. Perks of $10k or more would be disclosed and in the same section two supplemental tables would include delineations of grants of performance-based awards and grants of all other equity awards.

(b) Two tables related to outstanding equity interests: An Outstanding Equity Awards at Fiscal Year-End Table, which would show outstanding awards representing potential amounts that may be received in the future; and the Option Exercises and Stock Vested Table, which would show amounts realized on equity compensation during the last year.

(c) Two tables, the Retirement Plan Potential Annual Payments and Benefits Table, which would disclose annual benefits payable to each named executive officer and the Nonqualified Defined Contribution and Other Deferred Compensation Plans Table, which would disclose year-end balance, and executive contributions, company contributions, earnings and withdrawals for the year.

(d) Disclosure of payments and benefits (including perks) payable on termination or change in control, including amounts.

Director Compensation: A Director Compensation Table, similar to the Summary Compensation Table, and related narrative would disclose director compensation for the last year.

(Sources: 1/17 - CFO, FT, NYT, SEC, USA, WP, WSJ)

SPECIAL NOTE:
International standards for internal auditors at http://www.theiia.org/index.cfm?doc_id=124
Tone at the Top at http://www.theiia.org/download.cfm?file=42122

