THE CORPORATE GOVERNANCE ALLIANCE DIGEST

July 10 , 2003

As a service of John M. Nash and Eleanor Bloxham, below are complimentary summaries of up to date news, information and perspectives on issues in value and corporate governance. We hope you find this service useful. If you don't want us to send you this information in the future, please just notify Eleanor Bloxham (ebloxham@thevaluealliance.com).

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www.corporategovernancealliance.com/

Published by: Eleanor Bloxham and John M. Nash (John M. Nash is the founder and President Emeritus of the National Association of Corporate Directors. Eleanor Bloxham is a pioneer of economic value management and its application in good corporate governance, and author of two books including "Economic Value Management." They advise Boards to implement powerful, straightforward processes that answer the critical questions that must be addressed to improve oversight AND add value.)

A listing of abbreviations is available at the end of the digest.

This edition of the DIGEST has 7 major sections:

On July 25, 1934, then Chair of the SEC Kennedy said: "Everybody says that what business needs is confidence. I agree. Confidence that if business does the right thing, it will be protected and given a chance to live, make profits, and grow, helping itself and helping the country. The rules are simple and honest. Only those who see things crookedly will find them harsh." (BW 6/29/03)

I. BOARD PRACTICES

HIRING

A new trend in due diligence being exercised by individuals considering board seats: intensive reviews of the numbers, speaking with 2 dozen people inside and outside the firm, reviewing audit committee minutes, questioning directors and CEOs on the level of information reviewed in the boardroom, and even sitting in on a couple of board meetings. (WSJ 6/23)

CEO SUCCESSION

"Even when companies have time to groom CEO candidates, they often don't adequately prepare them for 3 critical tasks: working with boards, dealing with Wall Street and facing the press." Making this a bigger issue today: nearly 40% of Fortune 1000 companies named an outside CEO; 20 years ago, it was about 7%. (WSJ 6/17)

As issues unraveled the Freddie Mac Board had to choose a new CEO. "Parseghian had attended or was briefed on meetings where top executives, including Brendsel and Glenn, discussed strategies to meet earnings targets. He or his staff would come up with possible transactions that had different effects on the timing of when earnings had to be recognized. It was then up to Clarke and his staff to say if the deals met accounting rules." The board chose Parseghian as the new CEO after being assured by an outside attorney, PWC auditors, and other executives that he acted properly. (WashPost 7/10)

INVESTOR PRESSURE

Calls for investors to focus on the long run rather than immediate results have "largely fallen on deaf ears." The pressure to meet a single earnings per share number every quarter may have diminished, but it is still intense. (Reuters 7/3)

BROADER DEFINITIONS OF INDEPENDENCE

The NASDAQ is considering rules to limit donations to nonprofits if their executives sit on the company's board. Some companies have guidelines: ADP, Aetna, Dell, EDS, GE and Prudential Financial. Understanding the conflicts, some directors are leaving their nonprofit positions while others are leaving committee assignments. (WSJ 6/20)

Opening the way for class-action lawsuits, a Delaware Judge found a special litigation committee (established to review insider trades made one month before an earnings announcement by Oracle CEO and 3 board members) was not independent and did not properly disclose Stanford related financial and personal ties between the board and committee. (WSJ 6/17)

Boards have paid over $100m to lawyers for reports "mired in controversy because of fraud they missed, millions they cost, and relationships between investigators and investigated." Some suggest newer board members (who were not in place at the time of misdeeds) be chosen to work with investigators. (USAToday 6/18)

Conflicts questioned at Freddie Mac: Audit chair, at Citigroup, an underwriter of Freddie Mac securities; Chair of board is former chair of PwC, named Freddie Mac's auditor after his appointment; and director, worked for a firm Freddie Mac pays for lobbying services. (WSJ 6/25)

D AND O INSURANCE LUCK

Any UK company that has a 100% increase in D&O premiums is "lucky," increases of 300% to 400% have been much more common. (FT 7/7)

CEO SUES BOARD

A lawsuit by former HealthSouth CEO and current director Scrushy accuses company directors of wrongly excluding him from board meetings, not providing him with financial information, and making it impossible for him to fulfill his duties because the board conducts business through special committees and Scrushy is not on any of them. (USAToday 6/18)

BEYOND INTEGRITY TO PREPAREDNESS

In a PwC / Wilmer Cutler & Pickering survey, 61% of execs said economic crime should be reported directly to the board (big companies more susceptible to these crimes); 33% said it was the board's job to handle issues of misdeeds; and execs feared that manipulation of balance sheets or earnings reports was rampant (although there were few instances). (NYTimes 7/8, CFO 7/11)

The SEC brought 598 cases in 2002, an increase of 24% over 2001. Former SEC chair, Harvey Pitt, told a business meeting last week: "You cannot assume it won't, or can't, happen to you; the issues are 'when' and as to 'what', but not 'whether'." "What large company can honestly say for sure that it does not have a single employee with something to hide?" Suggestions? If you may have an issue, suspend any shredding (paper or electronic); put the audit committee in charge of the investigation: they should hire outside counsel that is not the normal outside counsel, contact the D&O insurer, inform the SEC, and keep the SEC up to date, and cooperate with the SEC and the Justice Dept. (FT 6/30)

Secrecy, blame, isolation, avoidance, passivity, and feelings of helplessness arise during difficult times in ways that can escalate. To turn it around, encourage collaboration and restore confidence through empowerment—replacing denial with dialogue, blame with respect, isolation with collaboration, and helplessness with opportunities for initiative. (HBR June, HBS Working Knowledge 6/30)

"In the heat of battle many CEOs and boards procrastinate…Boards need more information and ultimately they are responsible for getting it" (Directorship June)

WHISTLEBLOWERS

The False Claims Act, encouraging people to come forward, protects whistleblowers from being fired and says they can recover 15% to 25% of any settlement and in some cases up to 30%. As part of the settlement agreed to by HCA, in the biggest payment yet, 8 people will share more than $150m for helping uncover billing fraud against government-funded health programs fraud, following a 6-year investigation. A doctor awarded $41.5m from the settlement, received death threats, was ostracized by most of his colleagues and suffered a stroke blamed on the stress. A former pharmaceutical executive, was awarded $47.5m for uncovering a drug pricing scam at AstraZeneca and $77m in 2001 for exposing fraud at Tap Pharmaceutical. (FT 6/28)

II. AUDIT COMMITTEE ALERTS

IASB CHANGES

One IASB proposal would require insurers to discount reserves, to better represent their current value. Despite negative reactions from insurers some professional investors welcome the disclosure. S&P's insurance ratings group cautions: "The last thing we want to see, with the reserving-credibility problems that are already apparent, is for the companies to have the ability to discount those reserves." IASB accounting proposals are expected to be far reaching and earnings statements and balance sheets could look very different. Companies should consider releasing earnings and balance sheets under both current and the proposed rules as soon as possible so readers can familiarize themselves with the impacts. (FT, WSJ 6/19)

ASSET SALES (AND PURCHASE) DISCLOSURE

When GE announced it would sell some of its insurance operations to AIG for $2.15bn, it did not disclose the gain it expected from the sale. GE's earnings include numerous purchases and sales of businesses. A separate line on the income statement for these transactions would improve investor transparency. (NYTimes 6/29)

PENSION PLAN DISCLOSURE

Under rules that could take effect as early as December, FASB has issued a preliminary rule that companies that maintain defined-benefit pension plans for their workers and retirees make quarterly financial disclosures that detail the plans' impact on earnings, the particular line items impacted and by how much and provide projections of what their planned funding will be. (WSJ 6/27)

GM will be able to add dollars to its income statement by borrowing at one rate if it assumes a different rate of return on its pension funds. An instant boost to income (with no economic meaning) (WashPost 7/1)

COST AND REVENUE SHIFTING and RECOGNITION

Following a whistleblower lawsuit, Coca-Cola acknowledged it had made improper "financial arrangements" with three suppliers of its soft-drink-fountain dispensers, manipulated the results of a market test at Burger King, and improperly valued equipment. The lawsuit also claims Coke pushed concentrate onto delivery trucks just before the end of each qtr to log extra sales. (USAToday 5/28, FT NYTimes USAToday WSJ 6/18)

Cablevision said it dismissed 14 employees after an internal audit found $6.2m of marketing expenses that should have been booked in 2003 had been accelerated to 2002. External vendors said the company had found false invoices that appear to have been used. Improper accruals in 2000 and 2001 were "similar in size", the company said. By accelerating the timing of expense, it makes it easier to hit profit targets in future years. The company has hired a law firm and forensic accountants to investigate. The SEC opened up a formal investigation and subpoenaed documents. (FT Newsday NYTimes USAToday WashPost 6/19, FT WSJ 7/3, NYTimes 7/4)

Lucent engaged in revenue mis-statements in part through complicated arrangements with customers, to post date credits that offset the value of sales.

The SEC has given two former Lucent employees, Nina Aversano and Bill Plunkett, "Wells notices," although former CEO Rich McGinn who allegedly pressured employees to meet earnings estimates has not been charged. (Fortune 6/23)

The SEC filed a civil complaint against Peregrine Sys over accounting irregularities that added $509m to its revenues over a period of three years. This was often achieved by counting revenues on contracts that turned out to include secret side agreements that allowed customers to cancel the deals. (FT 7/1)

Understated costs for the US sub of Alstom's related to a railcar contract, as well as non-recognition of costs "in anticipation of shifting them to other contracts", and understated forecasts for costs on the remainder of the contract, will generate a $58m charge and have resulted in the suspension of the SVP and VP of finance of the US sub. (FT WSJ 6/30)

Freddie Mac said it engaged in transactions and adopted accounting policies aimed at smoothing out volatility in its earnings growth and deliberately manipulated accounting rules so profits would be near Wall Street's forecasts. Some of its senior executives did not understand accounting. In July 2002, after SEC discussions about its reserve accounting, the company reduced its reserves for loan losses by $246m. In 4th quarter, it donated $225m to charities. The SEC is re-examining the timing of those gifts, given the fact that in previous years, contributions had averaged only $11m annually. In a change in disclosure going forward, Freddie Mac plans to report its fair market balance sheet each quarter. (WashPost 6/25, FT NYTimes USAToday WSJ 6/26, 7/8)

MERGER ACCOUNTING

Merger accounting rules require intangible assets be identified, valued, and amortized over their useful lives Following a junk bond issue, Jacuzzi disclosed the SEC was reviewing its intangible asset accounting for the distribution network of a company it acquired, that Jacuzzi says has an indefinite life, but the contracts with distributors need to be renewed periodically. (NY Times 7/4)

STOCK OPTION EXPENSING

FASB and the SEC will need to provide additional guidance as some companies are changing option valuation assumptions prior to new expensing rules, including reducing vesting periods and option life assumptions (Capital One) or reducing volatility assumptions (Siebel, Broadcom, Hilton). (BusWeek 7/14)

AUDITOR ISSUES

E&Y has stopped: some tax shelter advice to senior executives, some operational audit work and work with 200 high risk private and public clients ($50m-$100m in annl rev). The firm is sending a code of conduct to staff. (FT 6/23)

5 consumer groups have called on the SEC to overhaul audit fee-disclosure rules, writing, "The fact is, firms have a strong incentive to characterize services as audit-related." Based on reports from E and Y, HealthSouth mischaracterized fees related to a software-installation project. (WSJ 7/1)

Schemes similar to E&Y's for Sprint executives were widely marketed to executives by PwC, KPMG and Andersen. (WSJ 7/8)

Internal emails by Jeffrey Stein, KPMG's no 2, show KPMG knew about issues with its FLIP tax-shelter product as early as the fall 1997 but continued to sell through the end of 1998. (WSJ 6/25)

In a case similar to Levi-Strauss, a senior manager put on administrative leave after refusing to sign off on questionable tax shelters sold to an audit client, is suing KPMG, saying KPMG changed its opinion after the VP of tax at the KPMG client became upset. KPMG's Western area leader allegedly told the senior manager that KPMG's role isn't to ferret out problems but rather to be "partners with its audit clients." (WSJ 6/26)

E&Y will pay the IRS $15 million (non tax deductible) for failure to properly register tax shelters and similar transactions or maintain lists of people who bought them. Details of the deals and customer names will be turned over to the IRS. (NYTimes USAToday WSJ 7/3)

First Union and auditor KPMG established relationships to promote tax shelters, "violating the SEC's long-established rules that an auditor is prohibited from 'direct or material indirect' business relationships with an audit client outside of the normal course of business." (WSJ 6/18)

PATTERNS OF RESTATEMENTS (WSJ 5/30 – 7/02)

REVENUE RECOGNITION:
Catalina Marketing - Revenue recognition.
Cryo-Cell Int. – Revenue recognition on revenue sharing agreements.
Symbol Technologies – Additional revenue adjustments resulting from previous accounting fraud.
Freddie Mac – Revenue recognition and reserves
Monro Muffler Brake – Accounting adjustments for barter credits.

EXPENSE RECOGNITION:
Zindart – Expense recognition for advertising costs.

MULTIPLE ISSUES:
Cryopak Industries – Sales revenue recognition, stock compensation expenses, inventory valuation, prepaid expenses, accrued liabilities, liabilitiy reclassifications, and acquisition costs.
National Vision – Reserves, liability reclassifications, expense reclassifications, and tax accounts due to external audit.
Fleming – "Significant business issues and developments" related to bankruptcy actions.

ACQUISITIONS:
Asyst Technologies – Noncash acquisition costs correction.
US Dataworks – Change in accounting for an acquisition from pooling of interests to purchase accounting.

LIABILITIES:
Singing Machine Co. – Increase income tax accrual
Video Display – Recognition of foreign currency translation losses.

ERRORS:
Cypress Semiconductor – Correct accounting error in calculating stock option expense.
Hancock Fabrics – Correct billing error by insurance carrier.
Microtune – Accounting errors and inaccuracies related to customer agreements.

RESERVES:
Rural/Metro Corp. – To increase reserves for Medicare, Medicaid, contractual discounts and doubtful accounts.

III. COMPENSATION

SHAREHOLDER APPROVAL

NYSE and NASDAQ listed companies must obtain shareholder approval before granting stock options and other equity compensation under rules cleared by the SEC. Brokers holding shares for their clients are barred from voting on equity-compensation plans unless the owner has given voting instructions. While recognized as a good step forward, CA, NY, CT, KY, ME, NC and OR, listed other key areas of reform needed: director elections and rules so accountants who audit do not also provide tax consulting (WSJ 6/27, FT NYTimes Reuters WashPost 7/1)

CalPERS will vote against any comp plan that does NOT: (a) prohibit repricing of options or eliminate evergreen provisions (automatic increases in the shares available for grants) (b) include a significant performance based components and require vesting periods of at least 4 yrs and (c) disclose the use of severance packages and other forms of compensation.. Calpers plans to identify 10 to 15 companies with bad and good compensation policies by comparing to its peers and will post information on their website. (FT 6/18)

At Reuters, almost 25% of the group's shareholders voted against the CEO pay package Yet Brandes Investment Partners, Capital Group and Franklin Templeton Investments - 3 US investors with a combined 30% stake - were absent. (FT 7/7)

PENSION IMPACTS

As legislators review options, some companies have contributed to their own funding issues by using pension assets, when they had surpluses: to pay for severance (Lucent, SBC), for retirees' medical expenses (Lucent, SBC and Dupont), by reducing their funding as part of conversion to cash balance plans (Midland) or to pay pension consultants (IBM). (WSJ 7/10)

Many pensions are under funded. GM will sell $13bn in bonds to fund its plan. The airlines and companies like GM are seeking relief from needing to fund. If defined benefit plans are not funded properly, taxpayers will have to step in. Greyhound is seeking to make permanent permission it received from Congress in 1997 to stop putting more money into its drivers' pension fund. (NYTimes 6/22)

In the 90’s company's investment gains on pension plans boosted executive pay. As that source of income has evaporated, some comp committees are now excluding pension losses in calculating the results for bonus purposes: example GE and Delta. (WSJ 6/18)

CEO CONTRACTS

Vivendi will fight an arbitration panel ruling that they must pay former CEO Messier $23.5m in severance. CEO contracts that guarantee salary and benefits, along with severance pay and postretirement perquisites, limit director’s ability to do their jobs. Examples: Cendant (the former president of baseball's National League chairs comp committee); contracts of Nardelli, Wachner and Eisner at Home Depot, Warnaco, and Disney..35% of the top 500 US companies have contacts, most with 3-year terms; few longer than 5 years. Robert Whitman, chair and CEO of Franklin Covey is an exec on a long term contract who hasn’t held the Board to that contract. He asked the directors not to pay him a salary or bonus in 2002. (NYTIMES, 6/28;USAToday WSJ 6/30)

STOCK OPTIONS

Microsoft plans to end its employee stock-option program and begin awarding its 50K employees actual shares of MS stock. All employees will become eligible to receive awards of restricted shares, which vest over a 5-year period and gradually transfer ownership of the stock to them. As part of its new plan, which would be voluntary, employees could receive cash from the sale of their underwater options to a financial services institution, a plan that must be approved by the SEC. (FT NYTimes USAToday WSJ 7/8)

LEVEL OF PAY and IMPACTS ON ACCOUNTING

A Corporate Library study of 1,019 public companies shows the median bonus for CEOs in their posts in both 2001 and 2002 increased about 9 %. Long-term incentive payouts went from a median value of around $500K in 2001 to over $900K in 2002. (WashPost 6/19) One reason for inflated pay? Some argue it is because attorneys work with CEOs to negotiate the arrangements. (WSJ 6/25)

Barclays CEO makes more than 10 UK High court judges. Some argue: performance based pay can be a threat to prudential accounting, At Barclays, there has been an "unusual" drop in the bad debt provision as a percentage of loans outstanding that may be related to the need to meet bonus targets. (FT 7/7)

IV. REGULATORY OVERSIGHT

POLICY MATTERS

The NYSE, NASDAQ, and the ASE were asked by the SEC in April to consider new listing standards to prevent the widespread problem of corporations retaliating against analysts who issue negative ratings. Actions by companies have included public derision and withholding investment-banking business against companies that include Morgan Stanley, BB&T and J.P. Morgan. (WSJ 6/19)

NASD has said that securities brokers and dealers that use computer instant messages to contact clients and fellow employees must save such communications for at least 3 years. (WashPost 6/19)

The SEC wants the rules proposed by the NYSE and the NASDAQ to be more closely aligned before approving them. (WSJ 7/7)

The SEC opposed a change that would allow a firm that advised a company prior to bankruptcy to advise the same company afterwards since conflicts could arise if it was hired to scrutinize the advice it had earlier proposed. (NYTimes 7/9)

The SEC staff plans to recommend that the agency give shareholders more power in nominating and electing corporate directors Details TBD. (WSJ 7/10)

OSHA issued rules to protect whistle blowers as outlined in SOX. SOX has two enforcement regimes--one civil, one criminal. The criminal provision makes it a felony to retaliate against a whistle-blower. The civil provision provides for reinstatement, back pay and damages. The SEC is notified of any complaint filed with OSHA and OSHA proceedings are public under the Freedom of Information Act. Individual HR or other managers can also be charged with unlawful retaliation and face up to ten years in prison and a $250K fine. (Forbes 6/18)

“Some shareholder voices are only reaching the companies by the transitive property of Congress or the SEC. Of course, a fire sale in the market has always been an effective agent of change.” One EU official remarked (related to governance): "If recommendations don't work, we can always come up with legislation." (FT 6/16, Forbes 7/1)

ACTIONS

An EU probe of Coke focuses on "fidelity bonuses" - price rebates offered by Coke to retailers that sold a set volume of its products, in return for favoring Coke’s products over those of its rivals. Coke may be subject to significant fines. (FT 6/19)

FERC barred Enron from selling electricity and natural gas anywhere in the US, becauset it manipulated Western power markets in 2001. (NYTimes WashPost 6/25)

The SEC will charge the former global stock research chief at Citigroup with civil-rule violations. (WSJ 7/9)

The SEC, NASD and NYSE have begun investigating IPO spinning at US Bancorp. (WSJ 6/30)

Shareholders and bondholders hit by WorldCom's multibillion dollar fraud will receive $250m in common stock in the reorganised company. This is in addition to the $500m fine agreed to with the SEC in May. (FT 7/3, 7/4)

The SEC obtained an order barring two former Xerox executives, Barry Romeril, permanently and Gregory Tayler, temporarily, from practicing as accountants (WSJ 7/8)

Martin L. Grass former head of Rite Aid pleaded guilty to conspiracy in a billion-dollar accounting scandal. He faces an 8-year prison sentence and penalties totaling more than $3.5m under a deal submitted by federal prosecutors. (NYTimes 6/17, USAToday 6/18)

West Virginia filed a $300m lawsuit against 10 investment banks, saying the $4m the state would receive from the April $1.4bn settlement is "inadequate and doesn't punish people who engaged in blatant wrongdoing." (WashPost 6/26)

Huntington Bancshares is being formally investigated by the SEC after a former employee alleged wrongdoing in the company's financial reporting and an E&Y review resulted in Huntington’s restatement of results in mid-April. (DJ 6/27)

The PCAOB, set up eight months ago, hasn't inspected anyone. (Reuters 6/20)

V. INVESTOR CONFIDENCE

Fund managers will demand a greater say in the way their products are sold, amid growing concern that they are being bought by the wrong kinds of investors. The move is likely to change how funds interact with investment consultants, who advise major pension funds, and the banks, insurance companies and independent financial advisers who distribute fund managers' products to private investors. (FT 6/30)

Trust between the fund management industry and clients is at a crisis point. “In my 35 years in the industry, I have never seen such a low level of trust between intermediaries and investors," John Towers, vice-chair of State Street, told the Fund Forum conference. "It will take years for that trust to be rebuilt." (FT 6/26)

Trial lawyers, as demonstrated at the “Mass Torts Made Perfect” event, are moving their attention to securities litigation. One attorney said: "The money from Spitzer is a drop in the bucket. [Investment bank] reserves need to be in line with the major pharmaceutical companies." (FT 6/26)

VI. THE MOST IMPORTANT ACTION COMPANIES SHOULD TAKE

RESPONSES TO OUR QUESTION: WHAT DO YOU THINK IS THE MOST IMPORTANT ACTION COMPANIES SHOULD TAKE TO BUILD A BRIDGE OF TRUST WITH SHAREHOLDERS? Make assuring the integrity of the organization the number one job of the Board. Show some courage on the subject of executive compensation. Make pay more equitable. Don’t sweep the exec comp issue under the rug. Spend less money currying favor with government employees. Stop pretending there is no problem. Stop viewing shareholders as adversaries. Establish regular conversations with shareholders as proposed in the UK by the Higgs commission. Spend enough time to make acquisition decisions properly – the revelations about WorldCom and AOL Time Warner are disheartening. Apply the same standards to selves as do to others. Allow shareholders to nominate members to the Board. Disclosure, Disclosure, Disclosure. Disclose what they are up to. Play fairly and squarely, and eschew the quarterly earnings circus.

VII. BOARD EFFECTIVENESS

“They [are] more focused on maintaining collegiality than maximizing long-term profitability.” (Wash Post 6/18) A Kennesaw Corporate Governance Center study states, “Only

10 to 15% of US companies have effective boards.” (Directorship June)

TALK BACK: A QUESTION FOR YOU:

WHAT % OF BOARDS DO YOU THINK ARE EFFECTIVE? WHAT ARE YOUR “CRITERIA FOR EFFECTIVENESS”? Please send responses to: ebloxham@thevaluealliance.com

Abbreviations:

ASE - American Stock Exchange
E&Y – Ernst & Young
FASB – Financial Accounting Standards Board
FERC – Federal Energy Regulatory Commission
IASB – International Accounting Standards Board
NASD – National Association of Securities Dealers
OCC - Office of the Comptroller of the Currency
PCAOB – Public Company Accounting Oversight Board
PwC – Pricewaterhouse Coopers
SEC – Securities and Exchange Commission
SOX - Sarbanes-Oxley