THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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THE CORPORATE GOVERNANCE ALLIANCE DIGEST SPECIAL EDITION on CORPORATE GOVERNANCE REFORM

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Special Previews: Join us in special previews during the month of August and September of our new educational portal "Corporate Governance and Value: Building a Bridge of Trust™" produced in conjunction with AthenaOnline which includes over 600 best practice videos and written materials (the size of 14 books) readily searchable, spanning all aspects of corporate governance and value for boards of directors and institutional investors. For an invitation or to attend, call 614-571-7020 or email ebloxham@thevaluealliance.com.

It is rare that we issue a Special Edition of the Corporate Governance Alliance Digest on Corporate Governance Reform. In fact, the last one was August, 2003 when we summarized the corporate governance guidelines that Richard Breeden developed for MCI/Worldcom.

Today's news warrants a similar highlight. This Digest is devoted to highlighting a 23 page set of recommendations published by the CFA Institute and the Business Roundtable's Institute for Corporate Ethics today issuing a call to "Break the Short-term Cycle" which was reported in the Financial Times today. The full report and an executive summary are available online at www.cfapubs.org/toc/ccb/2006/2006/1

This digest has four main sections.

I. Highlights, Context and Background
II. Whose on Board?
III. The Recommendations from the Report
IV. What This Means

I. Highights, Context and Background

In its report issued today, the CFA Institute and Business Roundtable Panel called for an end to earnings guidance, a linkage between pay and long term performance for both CEOs and asset managers, a focus on long term strategic objectives, and a commitment to communications and education around the value drivers of company performance.

We applaud this step forward as a milestone event as this is a subject about which we and others have been authoring articles, books and speeches for over a decade. While it is not strictly a US matter, this issue has been most pertinent in US governance. The changes advocated in this report represent a significant alignment and movement forward on this very important issue and the reverberations as implemented will have significance worldwide.

As context and of particular interest to those concerned that heretofore good governance and/or governance reforms, on the one hand -- and corporate innovation and informed risk taking, on the other -- diverge, they will be pleased to know that the findings and recommendations of the CFA Institute and Business Roundtable today echo the data and recommendations in the National Innovation Initiative of the Council on Competitiveness. In fact, a 3 page memo we authored for the Initiative entitled "5 Pronged Approach: Long Term Valuation - Education, Incentives, Management Systems, Metrics, and Disclosure/Communication" exactly parallels the 5 recommendations and findings in the Panel's report.

For those who may not have seen the report, the publication of the Council on Competitiveness' Innovate America Report which came out of its National Innovation Initiative addressed the need for "new forms of collaboration, governance, measurement – and a new sense of purpose and mission – that enable America's workers to succeed, not merely survive, in the global economy, that restore America's uniquely positive culture of risk and reward, and that create new societal mechanisms to drive the pace and quality of the national innovation enterprise."

Specifically, we noted that:

- Short investment horizons pressure CEOs to focus on near term results
- Firms are giving up long term value because of short-termism (a survey of financial executives indicates that 78 percent would give up long-term value creation in exchange for smooth earnings. Fifty-five percent would avoid long-term investments that might result in falling short of the current quarterly targets. (John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "The Economic Implications of Corporate Financial Reporting," Journal of Accounting and Economics, vol., 40 (2005): 3–73), and
- CEO compensation packages are not geared to long-term value creation. "Over the decade from 1990 to 2001, the share of equity-based compensation in total CEO compensation – how much was

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coming from options and other forms of equity – grew from 8 percent to 66 percent. (Kim B. Clark, “At the Center of Corporate Scandal: Where Do We Go From Here?,” *Harvard Business School Working Knowledge*, March 17, 2003.) Unfortunately, the shift to equity may have, in fact, reinforced the tendency to manage to Wall Street’s expectations, rather than long-term value creation.

Strong and effective corporate governance ensures that companies provide the information that investors need – and deserve – to make sound decisions. Specifically, to address these issues, the Innovate America report called on companies and boards of directors to "consider incentive and compensation structures that more effectively encourage long-term value creation and innovation." and Industry to "initiate voluntary and supplemental disclosure of intellectual capital, innovation performance and indicators of expected future value" to recognize the impacts of intangible assets and provide investors with the information they really need.

II. Who's on Board?

The Council's report suggests the building of broad based support and this is clearly signalled by The CFA Insitute and Business Roundtable's report today. The bottom line? Investors, Analysts and Directors Now Agree.

As the report notes John Bogle, founder of The Vanguard Group and author of The Battle for the Soul of Capitalism, who participated in the Panel convened by the Business Roundtable and the CFA Institute wrote in his book that "the role of management should not be beating abstract numeric estimates but improving the operations and long-term prospects of organizations".

The following link (http://www.thevaluealliance.com/corporate_governance_videos.htm) will take you to a video conversation with Mr. Bogle on the effects of short-termism and what's realistic in terms of earnings (made available through our educational portal "Corporate Governance and Value: Building a Bridge of Trust™" produced in conjunction with AthenaOnline.)

The report also notes that in the CFA Institute March 2006 survey, 76% of 2,686 respondents to the question “Should companies move away from focused quarterly earnings guidance?” answered “yes” and, of those, 96% believed companies should provide additional information on the fundamental, long-term drivers of the business.

The report also cites the views of directors from a March 2006, Directors & Boards magazine poll that asked its eBriefing subscribers, “Should companies end the practice of giving earnings guidance?” Almost 74% of respondents answered “Yes” according to the report.

III. The Recommendations from The Report

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"The Panel encourages corporate leaders, asset managers, institutional investors, and analysts to:

Earnings Guidance

1. End the practice of providing quarterly earnings guidance.
2. However, companies with strategic needs for providing earnings guidance should adopt guidance practices that incorporate a consistent format, range estimates, and appropriate metrics that reflect overall long-term goals and strategy.
3. Support corporate transitions to higher-quality, long-term, fundamental guidance practices, which will also allow highly skilled analysts to differentiate themselves and the value they provide for their clients.

Incentives and Compensation

1. Align corporate executive compensation with long-term goals and strategies and withlong-term shareowner interests. Compensation should be structured to achieve longterm strategic and value-creation goals.
2. Align asset manager compensation with long-term performance and with long-term client interests.
3. Improve disclosure of asset managers’ incentive metrics, fee structures, and personal ownership of funds they manage.
4. Encourage asset managers and institutional investors to develop processes for ensuring that the companies in which they invest use effective, long-term, pay-for-performance criteria in determining executive compensation.

Leadership

1. Endorse corporate leadership in communicating long-term strategic objectives and related performance benchmarks rather than in providing quarterly earnings guidance.
2. Support analysts and asset managers in using a long-term focus in their analyses and capital investment decisions.
3. Promote an institutional investor focus on long-term value for themselves and when evaluating their asset managers.

Communications and Transparency

1. Encourage companies to provide more meaningful, and potentially more frequent, communications about strategy and long-term vision, including more transparent financial reporting that reflects a company’s operations.
2. Encourage greater use of plain language communications instead of the current communications dominated by accounting and legal language.
3. Endorse the use of corporate long-term investment statements to shareowners that will clearly explain—beyond the requirements that are now an accepted practice—the company’s operating model.
4. Improve the integration of the investor relations and legal functions for all corporate disclosure processes in order to alleviate the current bifurcated communications that confuse, rather than inform, investors and analysts.
5. Encourage institutional investors to make long-term investment statements to their beneficiaries similar to the statement the Panel is asking companies to make to their shareowners.

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Education

1. Encourage widespread corporate participation in ongoing dialogues with asset managers and other financial market leaders to better understand how their companies are valued in the marketplace.
2. Educate institutional investors and their advisors (e.g., consultants, trustees) on the issue of short-termism and their long-term fiduciary duties to their constituents.
3. Support education initiatives for individual investors in order to encourage a focus on long-term value creation."

IV. What this All Means

What this all means is a clarion call for work from a range of constituents and a new (old?) way of thinking. Reporting and corporate and investment management focused on long term value drivers, incentives linked to long term value creation, and education for everyone around those changes. From my own work in this arena, the changes can be profound and the support of all constituents called for in this report is vitally needed - and that is where education, experience and patience will be key. As the report indicates, the efforts require a partnership between analysts, asset managers, companies and their boards and the media.

What does it mean in light of recent regulatory mandates? What it means in terms of certification is an implementation of the spirit of Sarbanes-Oxley which asks CEOs and CFOs to certify not that they are simply providing earnings information in accordance with GAAP but they are asked to certify that "information contained in the periodic report *fairly presents in all material respects* the financial condition and results of operation of the issuer" i,e, the economics, the whole of operations, not just a rules based approach to following GAAP).

What it means in light of the new SEC compensation disclosure requirements is the recognition (outlined in the SEC letter we submitted http://www.sec.gov/rules/proposed/s70306.shtml) that: (1) The CD&A should not be a "separate" review --rather the discussion should describe if and how the compensation structure links to what the company has said In the MD&A long-term is important to the business and (2) Compensation is a strategy, all strategies have risks and benefits, and the CD&A should disclose these potential risks, what if anything has been done to mitigate them and what the strategy hopes to achieve.

In terms of education, the implications are far-reaching.

This link (http://www.thevaluealliance.com/corporate_governance_videos.htm) will take you to a video where we discuss some simple steps impacting communications, disclosure and incentives in moving from short term to long term thinking ((made available through our educational portal "Corporate Governance and Value: Building a Bridge of Trust TM" produced in conjunction with AthenaOnline.)

If you are interested in learning more about the task ahead including the views from other directors and policy heads, please let us know. In addition, if you would like an invitation or to attend our upcoming Previews, call 614-571-7020 or email ebloxham@thevaluealliance.com.

Special note: Of interest to audit committee and boards, the Open Compliance and Ethics Group (OCEG - www.oceg.org) has released an 88 page internal audit guide for use in auditing compliance & ethics programs.

We hope the new report issued today which signals greater support for more ethical awareness will manifest itself in these realities. This is a milestone indeed.

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