

THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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This edition of the DIGEST has 4 major sections:

- I. BOARDS: NOMINATIONS, SUCCESSION, COMPOSITION, CONFLICTS, ETHICS
- II. COMPENSATION TRENDS & ISSUES
- III. AUDIT COMMITTEE ALERTS
- IV. SHAREHOLDER, EMPLOYEE, AND CUSTOMER RELATIONS

S&P's chief economist David Wyss points out that China has the capability of taking over world production of just about everything. Talking about China today as though it were Japan 20 years ago might not accurately size up the situation of this fast-growing empire, which may just be beginning to build its power as an economic force. (AP 8/19)

I. BOARDS: NOMINATIONS, SUCCESSION, COMPOSITION, CONFLICTS, ETHICS

Disney adopted majority vote rule as a policy for its board. Majority vote rule is gaining momentum as investors and more and more best practice companies endorse it as a good governance practice. (Under a majority-vote standard, shareholders are able to vote for or against each candidate for director - rather than just withhold their votes from a candidate and if a director wins one vote, the person is elected, as currently is the case in most US corporations. Under majority rule, to win a board seat the candidate must receive a majority of the votes cast in his or her election.) The Disney board also adopted a "greenmail" rule that would require Disney to have shareholder approval before buying back shares at above-market prices from any holder of more than 2% of the company's stock. These actions follow a number of governance initiatives at Disney. (WSJ/DJ 8/19)

Despite the fact that former SEC chair Richard Breen, reportedly played a major role in helping Verizon land MCI in the face of a higher bid from Qwest, Verizon has set forth a closing condition for its \$8.5 b acquisition that it shouldn't be required to abide by the MCI corporate governance guidelines (See digest edition (8/27/03)) which include the requirement that the chair and CEO positions be held by separate people, that the board consist entirely of

independent directors, with the exception of the CEO and that shareholders have the right to submit resolutions and nominate board members and have requested that U.S. District Court Judge Jed Rakoff no longer require that Mr. Breen serve as monitor or them to abide by the MCI governance policies. Shareholders vote on the merger in September. (CFO, FT 8/26)

During the period just ahead of its quarterly report Abercrombie's chair and CEO Michael Jeffries sold 1.5 m shares. Its stock price rose to a 52 week high prior to the quarterly report as the company provided investors with good news about denim sales while withholding more downbeat information about margin compression. The 1.5m sale contrasted with Mr. Jeffries' normal pattern of selling only 100k shares per week. Despite recent shareholder litigation related to compensation, the board modified Mr. Jeffries' employment contract reducing some benefits but retaining for him 2.67 m shares of the company's stock if he stays through 2008. The share award was worth \$153.9 m at the closing price on 8/30. After 15 months on the job, COO Robert Singer resigned. (WSJ 8/29, CoLD 8/30)

The Singapore Code of Corporate Governance is effective for annual meetings held after January 1, 2007 and requires listed to companies to explain any deviations from the code. One of the provisions of the code specifies a separate CEO and chair.

When Directors and Boards asked readers where they saw the "Getting on a Board" process going over the next year, 74% answered that it will be "about the same" -- with the focus "still on the usual suspects" -- while 26% see the process as getting easier, i.e., that the net is truly widening for prospective candidates. One director said: "More

and more board seats are going to be open to a wider circle of competent individuals as boards reduce interlocks and search for directors with more diverse skills and abilities." (D&B 8/31)

The ConAgra board is separating the chair and CEO positions, appointing Steven Goldstone, an outside director, as its chair and Gary Rodkin as CEO replacing Bruce Rohde who held both positions. Directors decided to split the two top jobs because they knew the new CEO would face extensive challenges "from an operational point of view," (WSJ 9/1)

According to CFO's review of Fortune 500 company proxy information, more than 1/2 of the approximately 850 people named as financial experts on audit committees are current or former CEOs; while 16% were former CFOs, 8% were public auditors and only 7% current or recently retired finance chiefs. (CFO 9/1)

The board of directors of Molson Coors has launched an investigation into the exercise of 1.9 m in stock options by Molson CEO Dan O'Neil 11 days before the merger closed netting him \$6.9 m in addition to his \$4.8m in severance and into the stock sales by CEO Leo Kiely and CFO Timothy Wolf which netted them profits of nearly \$700k and over \$1250k respectively following the 2/9 closing of the merge but before Molson Coors announced a \$46.5 m net loss for the 1st quarter. The probe may also examine why the company disclosed in a May filing, and not in its official merger proxy, that Brazilian authorities were claiming Molson's operations owed more than \$500 m of unpaid taxes. The SEC has opened an informal inquiry into the quarterly loss. Shareholder class-action lawsuits say Molson and Coors executives knew about the negative sales trends before the merger was approved. (Bloomberg, CFO, RockyMtNews 9/2)

II. COMPENSATION TRENDS AND ISSUES

Based on a Harris-Bromley University of Minnesota study of 435 companies, restatements rise when a firm is not doing well -- or if it has an exceptional year - or when CEOs receive a very high % of their pay in stock options. When CEOs receive 92% of their pay in stock

options, there is a 20% chance the company will restate in the next 5 years;; companies where it represents less than 50% of pay, there is less than an 8% chance. (NYT 8/5)

A Moodys' study shows that companies with higher paid CEOs (for a given level of performance or size) are more likely to default on debt or suffer cuts in bond ratings. (NYT 8/5)

The Disney case involving a \$140m severance payment to Michael Ovitz was settled in favor of directors. The case likely will have an ongoing impact as executive compensation practices and large severance agreements are likely to continue to receive scrutiny. (Boardroom Insider, NYT, WSJ 8/10, AP 8/12)

When companies make errors in reporting compensation information in proxies, they should inform investors rather than simply using new information the next year. (Cincinnati Bus Courier 8/22)

MCI CEO Michael Capellas would get about \$39.2 m if he leaves the company after Verizon's purchase is completed including \$11.3 m in severance, \$18.5 m in restricted stock and \$9.4 m in payment for taxes that may be assessed on the bonus. (Bloomberg, WP 9/3)

III. AUDIT COMMITTEE ALERTS

A total of 77 companies (more than 2 1/2 x the same quarter last year and the same as 1st qtr 2005) with market cap > \$100 m filed for an extension to 2nd qtr filings. (CFO 8/22)

For companies in the movie business, the SEC is exploring whether showing a gathering of analysts a prescreening of a movie constitutes disclosure of material information to a group of select people. (WSJ 8/26)

Rather than fighting FASB or ignoring it, CEOs need to recognize it as the standard setting body and work with it to shape the GAAP. (Chief Exec Aug/Sept)

The IIA has published guidance on resourcing alternatives and expressing opinions on internal control.

http://www.theiia.org/index.cfm?doc_id=5175 and on IT controls http://www.theiia.org/index.cfm?doc_id=4706

IFAC (the Intl Federation of Accountants) has issued guidance on environmental accounting. <http://www.ifac.org/store/Details.tmpl?SID=1123595939318284>

Effective for periods after 9/15 FASB's "Hierarchy of GAAP" should have little or no impact on the practice of preparing financial statements, in part because it has been effective since 1975 when the AICPA established the five levels of hierarchy in Statement on Auditing Standard No. 69. The new hierarchy unlike the previous one does not allow exceptions. (CFO 8/29)

The SEC scrutiny of the MD&A is evident in the civil action against KMart officials. (CW 8/29)

Because management's assessment of internal controls includes outsourced functions, SAS 70 "Reports on the Processing of Transactions by Service Organizations" audits are being required of more and more vendors. (CW 8/30)

A report by Glass Lewis on 899 cases in which companies reported material weaknesses in 2004 and during the first 4 months of 2005, shows investors sold stock in companies that made such announcements, driving their average share price 4% lower relative to the market. Share price also dropped when 404-compliance efforts led companies to delay their 10-K filings. 36% of material weaknesses were in financial systems and procedures; 23% in personnel issues. (CFO 9/1)

M & A

Delaware corporate law allows all shareholders -- even those who bought shares just before the vote on a takeover -- to seek an independent valuation in court if they believe the price being offered for their stock is inadequate, even if a majority approves the takeover. Shareholders can seek an appraisal even if they can't vote on the deal, but the holders must formalize their requests in court within 60 days of the approval of the merger or takeover. New York funds

Millenco and Porter Orlin, which together hold about 16% of Transkaryotic, have joined investor Carl Icahn in seeking an appraisal of their Transkaryotic shares in the wake of a takeover by Shire Pharma. Mr. Icahn bought his Transkaryotic shares after June 10, the date on which investors had to own shares to vote on Shire's acquisition. Millenco more than doubled its Transkaryotic holdings after that date. (WSJ 8/17)

Various studies show that from 60 to over 70% of acquisitions fail; a third study reports that 89% of acquired businesses actually lose market share. Studying more than 1,700 companies, David Harding and Sam Rovit found companies that do a lot of small deals produce much better results, as frequent acquirers learn from each deal. Advice from 5 frequent acquirers is know what you want, keep shopping til you find a good target, set ROI hurdles, do the due diligence, be prepared to walk away and structure specific deals. (CFO 9/5).

AUDITORS and AUDIT FEES

KPMG will pay \$456 m, admit wrongdoing, and accept former SEC chair Richard Breeden as an outside monitor, but was not required to name former partners involved in the tax-shelter transactions, 8 of whom have been indicted by prosecutors. The firm still faces numerous civil suits. At the end of July, the PCAOB said accounting firms could not sell tax programs to audit clients if they did not think the chance of a favorable IRS ruling was higher than 50%. (Bloomberg, CFO, NYT, WSJ 8/29, WP 8/30)

ACCOUNTING, CONTROL, AND DISCLOSURE ISSUES

Pixar is under informal investigation by the SEC (although it has not disclosed it to the markets) related to disclosures that heavier-than-expected returns of its "The Incredibles" DVD forced them to miss their 2nd quarter earnings forecast. (WSJ 8/26)

An informal SEC inquiry into DreamWorks is looking at the company's miscalculation of DVD sales of "Shrek 2" and how it handled other movies such as "Madagascar," and

whether it should have informed investors earlier of its "Shrek 2" problems, especially given shifts in the market that have resulted in DVDs having a shorter shelf life than before. DreamWorks said on Jan. 3 that it had sold more than 37 m "Shrek 2" DVD and VHS units world-wide. But the studio later indicated in SEC filings that it had sold only 33.7 million units. The studio then predicted that it would sell 40 m units by the end of the 1st quarter and in 1st qtr results on May 10, showed it had sold only 35 m units. (WSJ 8/26)

U.S. Attorney for the Southern District of New York has subpoenaed Doral Financial's accounting records from 2000 to the present less than a week after they fired their CFO. The SEC is examining Doral's accounting for "strips" — floating-rate, interest-only securities (CFO 8/26)

The SEC is conducting an informal inquiry of the accounting for mortgage loans FirstBanCorp (San Juan) purchased from two other financial institutions between 2000 and 2004. (CFO 8/26)

Professor Henri Servaes says "Decision-making inside a company, for example, such as how an investment decision is made, is in some sense still in its infancy." Marsh CEO. Michael Cherkasky "called a meeting of top executives and asked for a breakdown of profits, client by client. He recalls being greeted with an awkward silence. Marsh didn't keep track of how much money it made from which customers. With profit margins boosted by commissions, there [had been] no need." (FT, WSJ 8/29)

The SEC may fine Morgan Stanley \$10m for failing to preserve emails in the SEC's investigation of the use of tainted stock research to gain investment banking business. (WSJ 8/30, CFO 8/31)

The SEC is now investigating Terex's recent restatement related to how it booked and reconciled certain intercompany imbalances and its failure to eliminate certain accounts during consolidation. (CFO 9/1).

In a test of Reg FD, a federal judge threw out a lawsuit against Siebel Systems saying when an executive made comments to institutional investors in 2003 about the company's business activity those comments were pretty much as those said earlier and that they had not disclosed material nonpublic information. (WSJ 9/1)

FASB will hold a public roundtable on October 10 to discuss its proposed interpretation, Accounting for Uncertain Tax Positions, which applies to Statement No. 109. The proposal requires that in order for a company to recognize a tax break in its financial statements, it must meet a "probable recognition threshold" — that is, the company must have a high degree of confidence that the tax break "will be sustained upon audit by a taxing authority." (CFO 8/22)

IV. CUSTOMER, EMPLOYEE, SHAREHOLDER, and COMMUNITY RELATIONS

CUSTOMERS

Following the decision against Merck in the Vioxx trial, drug makers are trying several approaches to improve their image, including curbs on consumer ads, expanded access to low-cost drugs for the poor, and more open disclosure of clinical trial data. What they aren't doing: a public-image campaign. (WSJ 8/26)

Pressure on Dell related to customer service has intensified due to blog activity. (BW 9/5)

EMPLOYEES

A survey by Kronos and Harris Interactive shows in the last 6 months, employed adults say it's more difficult to balance work and home responsibilities 43% have increased the hours they work (up from 32% last year), 55% have received no raise, 77% are planning to quit their current jobs and 39% are job hunting online at the office. (Fortune 8/29)

SHAREHOLDERS

The Altera Corporation, acknowledging that it was wrong to tell an analyst who had published negative comments about it that they would no longer take his phone calls, let him ask questions on analyst conference calls or give him information he needs to analyze its business, apologized to the analyst. (NYT 7/29)

At the annual conference of the CFA Institute, John Bogle called upon institutional investors to unite and pursue an activist path. Charles Ellis, the founder of Greenwich Associates, called upon the investment profession to "move beyond your short-term, self-serving interests and return to fulfilling your fundamental purpose of helping individuals meet their longer-term financial needs." (Valuation Issues 8/31)

Like individual stocks with smooth returns, Professor Andrew Lo finds far from proving that hedge funds are safe, smooth returns may be a warning sign for the industry. His research indicates that the industry may have already entered a period of lower returns that signal a prelude to crisis. He points to a downturn in April that hit virtually every category of hedge fund pursuing every kind of strategy. (The paper is at <http://web.mit.edu/alo/www/Papers/systemic2.pdf>). (NYT 9/3)

COMMUNITY

According to Lehman Brothers accounting and tax analyst Robert Willens, the tax code allows companies to write off payments to cover private litigation by claiming that the activities that initially led to the lawsuits took place during the normal course of business. That means the costs to settle could be considered "ordinary and necessary" expenses. They also get to write off their legal fees. "It doesn't really matter how heinous or reprehensible the conduct was," Willens said. "They still get to take the deduction." While companies like Time Warner who settled and will get to deduct from taxes the \$2.4 b it has agreed to pay investors, the 12 former board members of WorldCom who

reached their own settlement for \$24.75 m won't get any tax breaks. (AP 8/16)