

THE CORPORATE GOVERNANCE

ALLIANCE DIGEST

September 16, 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/

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

This edition of the DIGEST has 8 major sections:

- I. IN THEIR OWN WORDS
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I. IN THEIR OWN WORDS

"Directors out there are using a huge number of boardroom innovations to provide more and better governance oversight with less time and effort. But these remain spread out among individual board pros, are anecdotal, and are too rarely shared with the boards that need this governance wisdom the most...

This book has collected some of these boardroom tools and offers them as effective counters to the major failings of our governance model. They are not panaceas; they're more like workarounds for built in bugs in the boardroom system." Saving the Corporate Board (John Wiley and Sons, 2003) by Ralph Ward

"Achieving a balance of power between the board and CEO requires trust, free flow of ideas, and a board that is comfortable challenging even the most powerful CEO." Bill George: Authentic Leaders "Get" Governance (Directorship Sept. 2003)

II. YOUR RESPONSES

Here are your responses to: "What % of Boards do you think are effective and what are your criteria for effectiveness?" (A Kennesaw State Corporate Governance study states: "Only 10 – 15% of US companies have effective boards.")

You said 10% of public companies; 30% of private companies; and 60% of non-profits are effective.

Criteria for effectiveness included: Separate CEO and Chair and only 1 executive on the Board. Objective director selection process. Up-to-date and expanded charters for the Board and its Committees. Formal Board/Committee/Individual evaluation process conducted annually. Standing Governance and Strategic Review Committees. Formal CEO evaluation process by the full Board. Committees staffed entirely by independent directors, with a very strict definition of independence, i.e., beyond regulatory requirements. Regular retention of outside advisors. Adequate D&O insurance. Budget for director education, development, and skill set upgrading. Diversity of experience and expertise of the directors, combined with the quality of their boardroom interactions such as openness and direct but respectful challenging of management.

Your response to "What do you think of the WorldCom recommendations?"

This is very valuable material. I miss the two lines that would answer so many problems: "10% of the shareholders may call a special meeting... At which a majority of those present may remove any or all of the directors with or without cause." So much simpler than the problem of who nominated them or whether they satisfied the over lawyered definitions of independence.

III. COMPENSATION

INCENTIVE COMPENSATION – EVOLUTION OF COMMON LAW

Since 1998, when Walt Disney shareholders' challenge to the \$140m severance package for Michael Ovitz was thrown out by the Delaware Chancery Court, court cases, and common law have evolved. The Delaware Supreme Court itself has reversed a half dozen chancery court decisions that favored directors and the Disney complaint has been resurrected and is expected to go to trial in early 2004. Chancellor Chandler wrote: "Plaintiffs' new complaint suggests that the Disney directors failed to exercise any business judgment and failed to make any good faith attempt to fulfill their fiduciary duties to Disney and its stockholders. Chief Justice Veasey explains: "It's the same chancellor; it's the same law, but we use the common law. The common law is always evolving. As so, the expectations of directors are evolving...[Directors ask] if the business judgment rule is still alive I say, 'Yes, it is. We will not second-guess your business judgment, but we are going to look at your process... Directors need to do their homework and realize that they're the boss' " Opening the way for more cases to actually be litigated, Chancellor Strine says he expects plaintiff attorneys to press courts to assume, for purposes of motions to dismiss, that directors have suspect connections to management. (ABA Journal – Sept.)

CEO COMPENSATION QUESTIONED

Shareholders of Royal Ahold voted to appoint Anders C. Moberg, (former Ikea executive) CEO, but some said that \$6.5m for his first two years on the job is too much pay. (NYTimes 9/5)

Cisco's board compensation committee, made up of outside directors, angered some investors with the timing of an options grant made shortly before comments by CEO Chambers sent the stock up 3.3%, boosting the potential value of the options \$94m. "You're transferring value from existing shareholders," said Kenneth Broad, a portfolio manager at Transamerica Funds (WSJ 9/4)

In a letter to the chair of Freddie Mac, OFHEO Director Armando Falcon gave the board 10 days to explain why the departures of former CEO Leland Brendsel and former CFO Vaughn Clarke should not be classified as terminations "for cause," a move that could make them forfeit much of their compensation packages. (FT, WSJ 9/5)

Dick Grasso's pay package came under fire as it was disclosed that his contract was extended to 2007, it was revealed he had been paid \$140m in deferred comp and pension benefits and that he was entitled to \$48m in additional benefits (which some board members were unaware of and which he won't take). The conflict between business and regulatory functions, the process of committee nomination, the lack of written reviews, the loose performance guidelines and the comparables chosen. Comparables included major Wall Street firms like Citigroup and Merrill Lynch. The analysis by the law firm Vedder Price revealed that Grasso's pay at \$31m in 2001 far exceeded that of the top quartile of these comparables and they noted it was unusual to include long term compensation in calculating pension benefits. Some board members, floor traders, and exchange members expressed concern over the flap. Others called for a clean sweep of the board. As a matter of historical perspective: Donaldson's annual pay, when he held the post, did not exceed \$1.85m. In 1995, Donaldson was asked to disclose his pay. He declined, and the SEC allowed the pay to go undisclosed. After

a special meeting, Dick Grasso resigned and Larry Sonsini has been asked to serve as interim chair. (FT, NYTimes, USA Today, WashPost, WSJ 9/3; FT, NewsDay 9/9; FT, Newsday, NYTimes, WashPost, WSJ 9/10; Newsday, NYTimes, USA Today, WashPost, WSJ 9/11; Newsday, USA Today, WashPost 9/12; FT, Newsday, WSJ 9/13; NYTimes 9/14; Newsday 9/15; WashPost 9/16; WSJ 9/17)

IV. AUDIT COMMITTEE ALERT

MAXIMIZING THE VALUE OF INTERNAL AUDIT AND ITS RELATIONSHIP TO THE BOARD

From the August issue of Tone at the Top (published by the IIA), "The organization's chief audit executive (CAE) who ideally reports directly to the audit committee on a functional basis and to the CEO administratively can provide assurance that appropriate policies and procedures are followed in preparing the annual financial statement and there are adequate controls in place to mitigate the risks." This issue may be found at the following URL: <http://www.theiia.org/iia/publications/newsletters/ToneAtTheTop/TATAug2003.pdf>

NOTE: The IIA is offering readers of this Digest a complimentary subscription to its newsletter for directors and executives. To subscribe, please e-mail your name, title, and mailing address with CODE CGA in the subject line to PR@theiia.org.

CUSTOMER/VENDOR ARRANGEMENTS

Contravening accounting rules that bar companies from recognizing revenue from deals that may later be canceled, a former sales executive at Northrop Grumman was charged with aiding and abetting securities fraud at supplier Legato Systems by helping two salesmen at Legato boost the company's net income by \$2m (146%) by entering into a side agreement that allowed Northrop to back out of a software purchase. Legato restated its financials and settled its own civil charges with the SEC last year. (WashPost 9/9)

"SPECIAL" INSURANCE ARRANGEMENTS

AIG agreed to pay \$10m and retain an independent consultant to make binding recommendations concerning AIG's internal controls in order to settle SEC charges that it helped Brightpoint conceal \$11.9m in losses by selling a nontraditional insurance product intended to "income statement smooth" and failed to cooperate with the SEC investigation. AIG created a policy backdated five months and issued a letter to Brightpoint auditors that made it appear that Brightpoint was paying premiums in return for assumption of risk by AIG but in reality, Brightpoint was depositing cash with AIG that AIG would then refund to Brightpoint. The two companies had an oral side agreement. Presentations were made to various AIG divisions and regions to prepare them for marketing the product to possible buyers but no other sales were made. Brightpoint agreed to settle a related civil action by the SEC by paying \$450k in fines. (FT, NYTimes, WSJ 9/11; USA Today, WashPost, WSJ 9/12)

DISCLOSURE

A jury ordered CIBC, the bank that underwrote a bond issue for Renaissance Cosmetics, to pay almost \$52m to three institutional investors for losses they suffered when they bought the bonds. The plaintiffs asserted that both the investment bank and the company had access to data showing that retailers had had a bad Christmas season 1996. (NYTimes 9/9)

The East West Institute released a study of the websites and annual reports of the ten largest market cap companies in the Czech Republic, Estonia, Latvia, Lithuania, Slovak Republic, and Slovenia and found in their annual reports 73% disclose audit information, 52% governance structure, 25% shareholder rights' policies, 25% compliance with environmental standards, 20% energy and water use, and 32% health and safety policies. More information at http://www.ewmi.hu/capitalmarkets_research.php

EXTERNAL AUDITORS

A group of tax lawyers has defected from PwC saying restrictions recently imposed on accountancy firms' tax work made staying with an audit firm less

attractive. The PCAOB, the profession's new regulator, has promised to revisit the issue of offering tax services to audit clients. (FT 9/4)

AUDIT FEES – FTSE 100

For the FTSE 100, the Big Four received a 17% increase in fees from statutory audits, despite the economic downturn. The Accountancy Magazine survey also reveals that Shell Transport & Trading paid the highest audit fees to any firm, followed by HSBC Holdings, and Unilever British Sky Broadcasting was the fastest audit, taking just 24 days, while AstraZeneca and Scottish Power each took 31 days. The amount of non-audit work is expected to fall further as companies start to adopt new policies. For example, GKN, the automotive and aerospace group, states in its annual report: "The auditors are excluded from invitations to undertake assignments of a consultancy nature". (FT 9/8)

PATTERNS OF RESTATEMENTS (WSJ 7/3 – 9/16)

REVENUE RECOGNITION

Symbol Technologies Inc. – Accounting issues related to stock options being exercised and revenue recognition.

Biolase Technology Inc. – Due to language on its purchase orders, revenue recognition will be changed to when payment is received rather than when product is shipped.

Imaging Technologies Corporation – Revenue recognition due to changes in accounting rules.

I2 Technologies Inc. – Accounting practices have overstated revenue for 5 years.

Riverstone Networks Inc. – Examining the timing of revenue recognition from certain customers.

EXPENSE RECOGNITION

Duke Realty Corp. – Recognize non-cash charges for redemption of preferred shares as an expense.

BrandPartners Group Inc. – Federal tax laws are allowing a tax loss carryback that will generate a tax refund for 2002.

AmeriCredit – Revised accounting for interest rate swaps used to hedge interest rate risk.

Metlife Inc. – Expense recognition.

FirstEnergy Corp. – Recognition of noncash expenses due to asset revaluations.

Intrepid Capital Corp – Expenses for a compensation agreement not properly recognized.

Electro Scientific Industries Inc. – An accounting review uncovered understatements of cost of sales.

Western Wireless Corp. – Related to the costs of closing facilities as per FAS 143.

Midwest Express Holdings Inc. – Correct accounting errors in expenses for aircraft taken out of service.

MULTIPLE ISSUES

Tyco International – The company had previously taken a \$1.6bn charge for prior period problems but will now restate results instead.

Footstar – Accounting irregularities, internal controls and systems problems are resulting in restatements to accounts payable, inventory, fixed assets, operating profits and net income for a 5½-year period

BearingPoint (previously KPMG Consulting) – To correct "certain acquisition related and other accounting adjustments" primarily involving misapplied goodwill and restructuring costs.

LIABILITIES

Elan Corp. – To reflect the consolidation of Special Purpose Entities.

Hanover Compressor Co. – Change in accounting for a lawsuit settlement.

Questar Corp. – Courts rejected attempt to charge customers for certain costs.

Cummins Inc. – Accounting errors resulted in accounts payable understatement.

RESERVES

Amerco – Change in treatment of insurance reserves and equity accounting of losses in one of its operating units.

Western Digital – The settlement of a vendor lawsuit will result in a liability that is larger than was reserved.

UnionBancorp – Reserves increased to reflect impairments in large commercial loans.

Smith & Wesson Holding Corp. – Increase in reserves for environmental and product liability costs.

DTE Energy Co. – Weather related damage was not as covered by insurance as was expected.

Asante Technologies Inc. – Old reserves will be reduced.

ERRORS

eUniverse – Accounting errors

Willis Lease Finance – Correct accounting error in cost of engine-related equipment from its subsidiary that was subsequently discontinued.

Seneca Foods – Convertible preferred stock will be added to the calculation of EPS.

First Southern Bancshares Inc. – Accounting errors.

Millennium Chemicals Inc. – Correct accounting errors.

Quest Software – Errors in the computations for consolidation of foreign operations.

Northeast Pennsylvania Financial Corp. – Accounting errors in calculating interest income on loans.

ASSET IMPAIRMENT

Fisher Communications Inc. - Changes in the method for testing goodwill impairment resulted in an asset reduction.

V. REGULATORY OVERSIGHT

SOX COMPLIANCE

From a CFO Magazine survey of 220 financial execs (139 from public companies), when asked who is responsible for SOX compliance, 85% said the CFO or controller. 56% said they were not tracking SOX costs, but of those, 45% plan to in the next year. Of those tracking, excluding board related costs, but including first year increase in external audit, legal, consulting new hires, and software purchases, 75% spent less than \$1m and 52% less than \$500k. Going forward, 87% expect to spend less than \$1m and 65% less than \$500k. 10% of the companies saw an increase in director costs and insurance of 51% or more. 48% saw an increase of less than 10%. 85% have spent 20% or less of their time on SOX, 65% 10% or less. 62% said at least some internal processes had changed related to SOX efforts; 49% believed these had yielded benefits: 23% in more efficient reporting processes and 10% in more accurate numbers. (CFO Sept.)

By early October, the SEC is expected to approve reforms to exchange listing requirements. (FT 9/9)

Mutual fund directors came under fire as Spitzer reached a \$40m settlement with

hedge fund Canary Capital Partners and its managing principal, Edward Stern related to charges Canary colluded with 30 mutual fund families including Bank One, Bank of America, Janus, and Strong to engage in illegal after-hours trading and market timing allowing them to book tens of millions of dollars in profits at shareholder expense. Similar arrangements may also have been made available to Stern by Alliance Capital and Invesco. BOA installed special equipment on Canary's trading floor to ease the fund's ability to make the after-market trades. BOA and Janus plan to reimburse shareholders for losses due to the Canary relationship. Disclosure of holdings, a matter under SEC review, came into focus when it was revealed that Stern received holdings updates not available to other shareholders. The SEC sent a letter to about 100 institutions, responsible for 75% of assets under management, to inquire if they are involved in similar schemes. ProFunds, Rydex and Potomac Funds do not limit market timing. The NY Attorney General's office issued subpoenas for data related to mutual-fund trading activity at hedge fund Millennium Management plus ten others, and to Vanguard and Invesco. The Massachusetts Securities Division, has been investigating mutual-fund sales practices at brokerage firm Morgan Stanley and instances of market-timing at Prudential Financial. Illegal trading occurs in at least one out of every six mutual fund families and in 30% of international funds, and costs investors about \$400m a year, and about 5 cents for every \$100 invested in international funds according to findings by Stanford University professor Eric Zitzewitz. (Fortune 9/3; FT, NYTimes, USAToday, WashPost, WSJ 9/4; FT, NYTimes, USAToday, WashPost, WSJ 9/5; NYTimes, WashPost 9/6; NYTimes 9/7; NYTimes, WSJ 9/8; FT, NYTimes, USAToday, WashPost, WSJ 9/9; WSJ 9/11; FT, USAToday, WSJ 9/13)

SEC ACTION

Goldman has agreed to pay more than \$9m to settle insider-trading charges by the SEC due to traders taking positions ahead of news in 2001 that the Treasury Department was ending sales of 30-year bonds. (FT, WSJ 9/4)

TENET

The Senate Finance Committee has opened an investigation into allegations of wrongdoing at Tenet and criticized Tenet's retention of certain managers, including the General Counsel. Tenet's newly constituted board appointed Mr. Fetter as CEO. (NYTimes 9/6, 9/8; FT, NYTimes, WSJ 9/17)

ENRON

Enron's former treasurer became the first Enron executive to be sentenced to prison for his role in designing Enron's off-balance-sheet partnerships that allowed the company to exaggerate its earnings by as much as \$1bn. (FT, NYTimes, WSJ 9/11)

HEALTHSOUTH

A US Congressional committee is widening its investigation of the alleged \$3bn accounting fraud at HealthSouth, sending subpoenas to several former employees and requests for information to two major law firms, because of concerns that the Fulbright & Jaworski report concerning Scushy's trades may have been misleading, biased, and not independent. (FT, NYTimes, WSJ 9/11)

VI. ISSUES FOR BOARDS

A REPORT CARD

Regulators A- Quickly put new governance rules in place; Need tougher prosecution of offenders

Auditors B- Compliance with SOX good; Need to hold to high accounting standards and not attempt to co-opt regulators

Boards C+ Meeting more often, more independent; Comp committees need to remove excesses and demand pay for performance

Analysts C Progress on Chinese wall; Need to get more research in the hands of investors

CEOs D Still paid large sums; Need to take the lead on reform not lobby against it

Investors D Slow to demand reform; Fought release of votes on important issues; Need to more closely monitor boards and management and deal with conflicts of holding stock in a company whose pension fund they would like to manage. (BusWeek 9/22)

COST OF BAD GOVERNANCE

A study of about 1,600 major U.S. and foreign firms by GovernanceMetrics International shows companies that score poorly on Board accountability or financial disclosure and internal controls also have poorly performing stocks. (WSJ 9/9)

EMPLOYEE SAFETY

OSHA is again citing employers for not protecting workers from ergonomic injuries, citing Tri-State Coca-Cola Bottling for requiring workers to perform various repetitive and awkward manual tasks -- lifting, pushing, pulling, bending and twisting -- while handling heavy boxes, beverage cases and carbon-dioxide tanks. The citation suggested handcarts and handhold cutouts on boxes. The agency cited the Supervalu warehouse for requiring employees to frequently lift objects weighing 77 pounds or more while twisting, bending and reaching. OSHA also has cited two of Dallas-based Mariner Health Care's nursing homes for requiring assistants to lift patients without mechanical hoists or other devices. (WSJ 9/9)

IBM is facing a series of lawsuits alleging workers have contracted cancer and other serious illnesses from chemicals they were exposed to in semiconductor and disk-drive manufacturing, laboratory work and other very basic industrial operations. (NYTimes 9/4)

MANAGEMENT ISSUES

While 70% of employees profess loyalty to the boss, only 53% of employers believe it, according to a recent telephone survey conducted by Randstad North America, an international staffing firm. 77% of managers say they are loyal to their workers, but only 41% of employees believe them. (CFO 9/4)

CLASS ACTIONS

In addition to suing Exegenics for mistreating its investors, Mr Mel Weiss, a class action attorney, is, for the first time, going after the directors. Mr Weiss has filed with the SEC in an effort to remove Exegenics' board. (FT 9/5)

RISK AVOIDANCE

Ratings for long-term corporate bonds and commercial paper are inconsistent and may cause managers to be risk averse. Within investment-grade, there are 10 term-debt ratings, and just 2 for commercial paper. That means that a minor change in term-debt ratings can cause a precipitous drop in a company's short-term creditworthiness. When a company is lowered to an A-minus rating (which is still well within investment grade), its CP rating drops from Tier-1 to Tier-2. A rule that restricts money-market funds—the primary investors in commercial paper—from investing more than 5 percent of their assets in lower-rated Tier-2 CP makes matters worse. (CFO 9/4)

BOARD TRAINING

In early September, The IIA surveyed to determine what, if anything, companies were doing related to training of the board of directors. Based on 125 responses (over 80% from US based companies) to the question “Do your Directors receive periodic training related to their performance as a member of the Board?” 22% said yes, it is required by the board, 24% said yes, it is something they do on their own, and 53% said no, they did not receive periodic training. In response to the question, how often does the board meet? 49% responded quarterly, and 30% responded monthly or every other month. The rest of the respondents said their boards either met more frequently or less frequently than that.

VII. INVESTOR INITIATIVES

At an annual conference of institutional investors in California, New York State comptroller, Alan Hevesi called for the creation of the National Coalition for Corporate Reform, which would influence the behavior of companies through proxy voting, litigation and lobbying. He called on investors to use lawsuits as a means of obtaining restitution and reforming corporate governance. (NYTimes 9/4; CFO 9/8)

A group of 27 leading institutional investors from the US and Europe that collectively manage \$1.5bn of assets have committed to work together on corporate governance issues such as executive pay. One priority is to lobby

the SEC to support reforms of director nomination rules. They may also back calls by CalPERS, the US pension fund giant, to vote against stock option plans that do not include performance targets. US institutional investors at the meetings included the New York State Common Retirement Fund, TIAA-Cref, the State of Wisconsin Investment Board, CalPERS and the Ohio Public Employees Retirement System. European institutional investors included USS, Henderson Global Investors, Morley, Railpen and APB, the Dutch pension scheme. (FT 9/13)

More than 2/3 of 112 professional money managers, in a survey by Broadgate Consultants, said recent governance changes would not be enough to prevent future accounting scandals. 23% said recent antifraud measures from regulators had been effective, and 60% said they doubted that the recent Wall Street settlement would improve the quality of brokerage-firm research. Managers also voiced support for state regulators' moves against securities law violators and said the regulators' authority should not be curbed. (NYTimes 9/4)

VIII. WHAT'S NOT IN THE NEWS

Comments on SEC Nomination Policy Disclosure were due into the SEC on September 15. Some of the repetitive comments from shareholders on nomination disclosure include calls for boards to disclose their policies with respect to diversity. This is not surprising given a study by Professors David Carter, Betty Simkins, and Gary Simpson that examined board diversity and firm value in the Fortune 1000 and found significant positive relationships between the percentage of women or minorities on the board and firm value. (Financial Review Winter 2002) The September listing in Directorship of director adds to Fortune 1000 boards show companies are not taking full advantage. Of those added to the boards, 15% were women, approximately the same % held by women currently.

TALK BACK:

Do you agree with the grades? (See Section VI. ISSUES FOR BOARDS). Regulators: A-, Auditors: B-, Boards C+, Analysts: C, CEOs: D, Investors: D. If not, what grades would you give out?

Abbreviations:

ASE - American Stock Exchange
E&Y – Ernst & Young
FASB – Financial Accounting Standards Board
FERC – Federal Energy Regulatory Commission
IASB – International Accounting Standards Board
IIA – Institute of Internal Auditors
NASD – National Association of Securities Dealers
NYSE – New York Stock Exchange
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