

# THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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#### Published by:

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This edition of the DIGEST has 6 major sections:

- I. BOARDS: NOMINATIONS, SUCCESSION, COMPOSITION, CONFLICTS, ETHICS
- II. COMPENSATION TRENDS & ISSUES
- III. AUDIT COMMITTEE ALERTS
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#### I. I. BOARDS: NOMINATIONS, SUCCESSION, COMPOSITION, CONFLICTS, ETHICS

McDonald's and Exide Technologies were told by France's Data Protection Authority, known as the CNIL, that planned ethics hot lines at units they operate in France were illegal. CNIL is talking with companies to see whether there is a way to devise a system that would preserve the anonymity of a whistle-blower while also "preserving the right of the denounced persons to the protection of their personal data." (FT 9/6)

The Partners for Financial Stability survey demonstrates that online disclosure in Central and Eastern European countries has improved since the last survey, conducted in February 2005. In particular, the number of companies with local-language and English-language websites has increased to the highest levels recorded since the PFS Program began its surveys in August 2001 - 97% and 87% respectively.

[http://www.pfsprogram.org/capitalmarkets\\_research.php](http://www.pfsprogram.org/capitalmarkets_research.php)

The composition of Morgan Stanley's board is changing with John Mack as chair and CEO. Michael Miles, Charles Knight and John Jacob are leaving, and Ed Brennan will leave at retirement age. Three new directors have been added since John Mack took over. (NYT, WSJ 9/7, Fortune 9/8, FT 9/10)

According to Booz Allen, shareholder returns are lower when the CEO is an external candidate whether or not that person was a previous CEO. Yet more and more repeat CEOs are being hired -

12.2% of the CEOs who left office at publicly traded companies last year had previously held a similar job -- the highest rate in the 7 years that the firm has tracked. "The trend highlights a shortage of in-house talent and weak succession planning at many companies. It may also raise compensation and represent "the creation of an itinerant class of top executives unfamiliar with their employer or its industry". According to Spencer Stuart, in the 300 largest US companies, 19% of the CEOs have worked at the company for less than 5 years, up from 5% in 1980. (WSJ 9/19)

Former HealthSouth CEO Scrushy, who remains on the board, would like to aid in the company's turnaround. The company expects Scrushy to be removed from his directorship once the company finally holds an annual meeting. (CFO 9/19)

#### II. COMPENSATION TRENDS AND ISSUES

If the minimum wage had kept pace with CEO pay since 1990, it would be \$23.03 an hour according to a new report from the Institute for Policy Studies and United for a Fair Economy. In 2004, the ratio of the average CEO pay to that of production workers at 367 top corporations "smashed through the 400-to-1 barrier" to 431 to 1, for the first time since before 2000. At companies with at least 10% of revenue from military contracts, CEO pay tripled from 2001 to 2004. (NYT 9/4)

A Mercer survey of median compensation for directors who sit on corporate boards at 350 of the largest public U.S. companies rose 18% to \$155k in 2004, 10% more in cash and 30% more in equity. Equity represented 55% of director's pay, up from 36% in 2003. (Bloomberg, CFO 9/6)

Swedish state prosecutor will prosecute former Skandia CEO Lars-Eric Petersson for abusing his position of trust when he, lifted the cap on the bonus program Wealthbuilder without approval from the board, set payment of the program 185 m kronor above the amount authorized, and without approval, he added retirement benefits under which his own benefits would always reach at least 97.1 m kronor. (WSJ 9/7)

Gillette CEO James Kilt said his payout following the merger with P&G would have only been \$85m instead of \$185m if the stock had not risen but merely tracked the S&P. (WSJ 9/9)

The SEC's Bureau of Economic Analysis rejected CISCO's proposal to value stock options by selling restricted options to institutional investors because they included restrictions that might have impacted the value of the options to the employee (for example, barring an employee from transferring the option or hedging its value through trades in other securities,) but would not impact the cost to the company which is what is supposed to be measured. Instead, the SEC said a plan like this might work: At the same time they issued them to employees a company could issue fully transferable options to investors which would pay off based on the actual performance of the options granted to employees. To the extent that employees forfeited options by changing jobs, they would be forfeited by the holders of the other securities as well. If employees exercised options, the other securities would be exercised as well. For such a plan to work, there would have to be full disclosure of the historic behavior of employees who received options in that company, and there would have to be a continuing market in the securities. (NYT 9/10)

Re; the use of stock options: "It's the new reality: when you give something that's perceived as free, you're a little less careful," said Bernard Lietaud, CEO of Business Objects, a French software company whose shares are traded in the US. (FT 9/10)

SEC Chair Cox on compensation: "Over time, the prevalent forms of compensation have migrated away from what is transparent to what is opaque. In

many cases, the lion's share of an executive's compensation might come in forms that almost entirely elude disclosure. That clearly needs to be addressed." (WSJ 9/19)

CEOs in office at least 2 years received a median salary and bonus increase of 14.5% in 2004, while salary raises for middle managers on average were below 4% and are about the same this year. (WSJ 9/19)

### III. AUDIT COMMITTEE ALERTS

The Association of Corporate Treasurers, which represents many UK company accountants, says that IAS 39 (which requires companies to show "fair value" changes in the price of derivatives in income statements - unless the derivatives meet criteria on hedge effectiveness) rules governing what constitutes a hedge are too narrow. (FT 9/5)

FASB proposals which may go into effect at the end of next year would change accounting rules for acquirers requiring them to expense investment banking fees (previously booked as an asset), take charges to net income for plant closures and restructuring costs (rather than including them in the price), and amortize acquired R & D (rather than expensing it at the start). (BW 9/12)

The FASB announced that this fall it will issue an exposure draft of new guidance on the format for annual financial statements. Guidance on interim statements will be issued separately. The bottom line on the income statement is currently "net income," but the FASB exposure draft is expected to propose that "other comprehensive income," currently listed in a separate statement, be listed below that bottom line as part of a single statement. (CFO 9/6)

When the FASB's FIN 47 goes into effect in December, managers are likely to disclose more information about environmental liabilities associated with underused or "mothballed" assets. (CFO 9/8)

Greg Rogers, an environmental attorney and the author of "Financial Reporting of Environmental Liabilities and Risks after Sarbanes-Oxley" says executives of

financially troubled companies could be personally at risk under bankruptcy law, as well as the certification provisions of Sarbanes-Oxley, if management hides, understates, or fails to disclose environmental liabilities and directors of companies that hide environmental liabilities can expect scrutiny from the SEC. While corporate and bankruptcy laws do not impose financial-reporting requirements on board members, securities law provides a "strong motivation" for understanding the new risks associated with reporting environmental liabilities. (CFO 9/8)

Professors Philippon and Kedia examined 845 companies with 919 restatements from January 1997 to June 2002 (10% of publicly traded companies announced at least one restatement) and found significant job loss when the overstatements were corrected. Companies that had to restate earnings in 2000 and 2001 eliminated 250k to 600k jobs in 2001 and 2002. Accounting issues and restatements can create industry wide employment and supplier bubbles that burst upon restatement and can inhibit future hiring of same industry non-restaters. (NYT 9/11)

Research in IIA's *Audit Committee Effectiveness—What Works Best* outlines key issues for audit committees. It cites historical information on the increase in the percentage of audit committees who now have responsibility for overseeing compliance programs (82% in 1999 vs 46% 6 years earlier). (Tone at the Top 9/16)

Katrina related expenses are considered ordinary (not extraordinary expenses) according to the FASB. (CFO 9/16)

SEC Chair Cox on 404: "There have been amply expressed concerns about the costs of implementation of Section 404 of the Sarbanes Oxley Act. Those costs are not the inexorable result of the law. They are a function of the way the law has been implemented." (WSJ 9/19)

### AUDITORS and AUDIT FEES

Federal prosecutors plan to file new charges and name as many as a dozen new defendants in their investigation of questionable tax shelters sold by the accounting firm KPMG. (NYT 9/7)

Besides 404 costs, external audit fees are rising as all major audit firms continue to raise their hourly rates. Field-level or engagement partners now routinely bill \$250 per hour for their work, with national partners charge out at as much as \$1,000 per hour. It has become common practice for engagement partners to defer client questions to higher-ups at their firms. (CFO 9/9)

## **ACCOUNTING, CONTROL, RISK AND DISCLOSURE ISSUES**

Hollinger's tax returns, for 1998 and 1999, contained errors related to gains on sale of assets as well as foreign exchange calculations. Revisions in its balance sheets will decrease stockholders' equity and increase total income tax liabilities by approximately \$29.9 m for 2000 and about \$31.9 m for 2001, 2002, and 2003. The restatement will also cut net income by about \$1.7 m for 2000 and increase the net loss by about \$1.9 m for 2001. Hollinger will publish restated financials on September 15, the same day F. David Radler, the former publisher of the Chicago Sun-Times, plans to plead guilty to federal fraud charges related to so-called non competition fees. (Bloomberg, CFO 9/6)

Sun Microsystems will restate for \$45m in errors in deferred taxes in certain foreign jurisdictions, as well as the aggregate effect of corrections to provisions for state and foreign tax returns and withholding taxes. (CFO 9/14)

The SEC has brought civil charges against Biopure and its executives for failure to disclose during its IPO that the FDA had halted clinical trials of its Hemopure product on trauma victims because of safety concerns and declined to approve the product's use in orthopedic surgeries. (WSJ 9/15)

An internal investigation at Interpublic shows instances of "misappropriation of assets" and "falsified books and records" that violated laws, mainly at operations outside the US. Interpublic is in the process of restating. The main cause is "weak controls and our decentralized operational structure." Specific accounting issues include accounting for lease expense, for revenue ("it lacked

adequate procedures for reviewing customer contracts, treatment of various types of vendor credits, discounts, differences between vendor prices and client cost estimates and duplicate customer payments") and for companies that had been acquired (revenue and expenses of businesses were consolidated in its financial statements before purchase was completed). (CFO, NYT, WSJ 9/16)

The Federal Reserve Bank of New York met with representatives of 14 banks, as well as regulators from the US and overseas, to discuss cleaning up the processing of credit derivatives contracts. At year-end 2004, there were \$8.4 trillion contracts outstanding, up \$919 b from 2001. The transfers of these contracts have become frequent and there is a backlog of paperwork and it takes 13.3 business days, on average, before such trades are completed. (NYT 9/16)

The SEC civil suit against former KMart execs represents just one example of the SEC's crackdown on poor MD&A disclosure. Misleading MD&A reports were "at the heart of cases" the SEC brought in April, since settled, against Coca-Cola and Global Crossing. According to GSI the SEC makes requests for better disclosure on an ongoing basis - for example, Johnson Controls and Dress Barn both amended (BW 9/26)

## **IV. CORPORATE STRATEGY**

Gerard Kleisterlee, CEO of Royal Philips Electronics: "I'm learning from Chinese start-ups...how to be extremely pragmatic in getting yourself into the market. I have taken my board to China a few times, not only to have internal discussions, but also to go out into the marketplace... We talk with Lenovo and TCL and you see how their young management teams have built their businesses with very low overhead and are very focused. Sometimes we make things too complex. We can be overly focused on process, but the Chinese are very focused on results. They are learning faster than you can imagine." (NYT 9/11)

## **VALUE - ENTERPRISE RISK AND REWARD**

Between 1995 and 2005, a review by Deloitte shows that companies in the FTSE 100 and FTSE 250 indexes that experienced the largest one-day drops in share price (80% of whom have not fully recovered) focused on short-term tactics and risk management, rather than long term value creation focused on unique business practices, strong brand and robust information flows. (CFO 9/9)

According to S& P, in 2nd qtr, 33% of S&P 500 companies significantly reduced their share count; and fewer companies (36%) significantly increased their share count. Lower share counts boost EPS but don't change a company's underlying value proposition. (CFO 9/20)

## **INTELLECTUAL PROPERTY**

An Australian court ruled that the managers of peer-to-peer software Kazaa had authorized users to infringe on music copyrights and Kazaa could remain in operation only if the software maker either included, "non-optional key-word filter technology" in current versions of the software received by new users, in future versions of the software and "maximum pressure" was exerted on existing users to upgrade to a new version containing the technology - or that the (US based) Altnet search software--called TopSearch--be restricted to providing lists of non-copyright-infringing works. (FT, NYT 9/5)

More law firms are taking patent cases on a contingency basis in which they are paid a percentage of any damages awarded. Acacia Technologies has acquired 120 patents in areas from credit-card fraud protection to hearing aids and has filed patent-infringement lawsuits against Intel, Cablevision and others. Nathan Myhrvold, Microsoft's former CTO has formed a company called Thinkfire, backed by high-tech firms and venture-capital investors that acquires patents and manages patent licensing for others. Freedom Wireless bought a "patent-enforcement" insurance policy through Lloyd's of London, which covered up to \$5 m of any litigation costs in exchange for a premium payment that was less than \$600k and stated if Freedom won its lawsuit or

settled, the insurer would get back its original outlay plus a 25% bonus. Freedom won a suit against Boston Communications for \$128m and is now going after other wireless service providers (WSJ 9/14)

A Beijing court ordered Baidu.com which holds a recent NASDAQ listing, is China's leading internet search engine, and directs users to pirated music to pay about \$10k to a unit of global music group EMI over downloads of pirated music offered through its website. Last month Netease, one of China's leading internet portals, suspended its similar online music search service over concerns about copyright piracy, (FT 9/17)

#### **M & A**

Massachusetts Secretary of State William Galvin is investigating the valuation as well as the process by which investment banks offered fairness opinions in the P & G acquisition of Gillette. (WSJ 9/9)

CNOOC's CFO and main negotiator with Unocal, said it was important for the world to grant both China and India, which have become major consumers of oil and gas, long-term energy security. "What is 'human rights'? I'll tell you what it means. It means having guaranteed access to energy. It means having petroleum to run your car." He said CNOOC might work with its parent company CNPC in making future acquisitions. "When [CNOOC] goes abroad, it is treated as an ordinary listed oil company. But if the state-owned parent goes out, it will be representing the Chinese government. And there are many countries where China is received with open arms, such as Africa," he said. (FT 9/17)

#### **IV. CUSTOMER, EMPLOYEE, SHAREHOLDER, and COMMUNITY RELATIONS**

##### **CUSTOMERS**

Alexa Bona, a Gartner analyst based in London, predicts that during the next 3 years, up to 60% of companies outsourcing customer-facing services will encounter customer defections and hidden costs that will either cancel or

outweigh any perceived savings in such arrangements. (CFO 9/15)

##### **EMPLOYEES**

Hiring - and making the decision to accept a job - can be more difficult when there has been a lot of turnover. "Pose tough questions to key players inside and outside your potential employer: For how long has this job experienced high turnover? Why? Does the top brass accept certain responsibility for the heavy exodus? What made past job holders a poor fit? What other problems plague the organization? Who will have the greatest impact on my success there?" "If there has been a lot of turnover, you'll want to understand the fit very well," says Greg Brenneman, who last year became Burger King's 9th CEO in 15 years. (WSJ 9/6)

Employees of the Levi Ski Resort in Finland are offered an extra \$31 a month not to smoke during work hours. The Dutch insurer VGZ gives both employees and policyholders a rebate worth up to about \$50 per year on a cholesterol-lowering product called Becel Proactive. At Weyco, if an employee fails one of the random nicotine tests they will be suspended for a month without pay and have to sign a three-year agreement not to use tobacco and if they fail another test they are dismissed. Michigan law bars firing employees for being fat, so Weyco has hired an eating disorder therapist, offers staff \$45 per month towards health club membership and lets them "earn" up to \$60 per month for doing physical activities. (FT 9/9)

ERISA "makes the corporate officials who run pension plans serve as fiduciaries, preserving assets for the exclusive benefit of employees and putting participant interests ahead of corporate interests." In their bankruptcy filings, Delta and Northwest both omitted pension obligations from the bills they sought court-approval to pay -- and warned they would weigh how to ease their multibillion-dollar commitments to tens of thousands of active and retired workers. "Northwest and Delta are required to make minimum pension contributions under ERISA and the IRS Code," stated PBGC's executive director. (NYT 9/15, CFO, WSJ 9/16)

" Corporate chiefs who want accurate information about how their companies are and are not succeeding should speak frankly with middle managers who deal daily with employees, suppliers and customers." (WSJ 9/19)

##### **SHAREHOLDERS**

Diversified mutual funds (in 100 stocks or more) are beating those concentrated in 30 or fewer - 14.9% per year (over the last 3 years since July) vs 10.1%. (NYT 9/4)

Jack Caffrey, equity strategist at J P Morgan Private Bank says stocks that miss earnings expectations or report bad news may lose 10 to 20% of their value in the short run. (NYT 9/4)

According to a report by CPA Australia, sustainability reports are not comparable enough to serve investors properly, but those who produce them have superior cash flow and earnings. <http://www.clear-profit.com/fw/cpa.htm>

If a pending shareholder lawsuit settlement involving alleged insider trading in the sale of Oracle stock by Larry Ellison "weeks before the company reported that it would not meet its sales goals, sending the stock down from levels it has not seen since" goes through, Oracle and its shareholders will end up paying \$24m to plaintiffs attorneys and \$100m to an unnamed charity which "could never have filed suit to get the money...and does not even have to pay the lawyers." (NYT 9/16)

A GMI review shows that the average 3-year total shareholder return for consistently poorly rated companies was 8.73% versus 15.93% for the well governed companies through September 1, 2005. During the same period the S&P500 had an average return of 11.91%. Companies that were consistently poorly rated were far more likely to have restated earnings, been subject to accounting investigations by regulatory authorities, found guilty of accounting fraud, had more related-party transactions involving senior officers or directors, were more likely to have multiple classes of voting stock and their boards had fewer independent directors than companies with consistently good

ratings. (WSJ 9/13, GlobalProxyWatch <http://www.davisglobal.com/9/16>)

More companies are negotiating with shareholders on proxy proposals. (Corporate Counsel Sept, <http://www.corpgov.net/>)

The trend of shifting costs from shareholders to the community by using the PBGC as an "option for private-capital funds and other investors who are seeking to spin investments in near-bankrupt industrial companies into gold" by shifting pension responsibility to the PBGC is increasingly popular. Examples and potential examples include Bethlehem Steel, Federal-Mogul, Polaroid, US Air, Cone Mills, and WestPoint Stevens - and perhaps in the future Delphi. (NYT 9/18)

## COMMUNITY

Huntingdon Life Sciences "moved its headquarters to the US after a long-running campaign by animal rights activists in the UK. The move was intended to offer greater protection to the company and its shareholders and directors; some of its executives had been attacked at their homes by activists. In the UK, market makers and stockbrokers, acting as nominee shareholders, withdrew share trading facilities after they were targeted by activists. The UK government was forced to step in to provide insurance and access to banking facilities at the Bank of England. The company eventually delisted from the LSE and became the sole subsidiary of LSR, which is currently traded on Nasdaq's over-the-counter market." (FT 9/7)

A GAO report released mid August outlines how some companies have transferred income-generating assets from ailing subsidiaries to healthy ones, leaving ailing subs with little else but money-losing assets, environmental liabilities, and the prospect of bankruptcy. These transfers are illegal if the intent is to hinder or defraud creditors. The GAO report says the EPA should do more to track and fine corporate polluters because of 231,630 businesses that filed for bankruptcy between 1998 and 2003. Information on unpaid environmental liabilities is available only for the 136 companies that

the DoJ has pursued. The Comprehensive Environmental Response, Compensation and Liability Act gives the EPA authority to compel businesses that handle hazardous substances to demonstrate their ability to pay for potential environmental cleanups and the GAO report urges the EPA to be more aggressive in demanding financial assurances such as letters of credit or guarantees from a parent company and to seek more tax offsets rather than allow tax refunds to flow, unhindered, to companies that have environmental claims outstanding. (CFO 9/8)

## VI. OTHER LEGAL/REGULATORY

SEC Chair Cox intends to continue to support the hedge fund registration rule. (WSJ 9/19)