

THE CORPORATE GOVERNANCE

ALLIANCE DIGEST

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DIRECTOR ELECTIONS (WSJ, NY Times)

A recent article written by DELAWARE CHANCERY COURT Chancellor William B. Chandler III and Vice Chancellor Leo E. Strine Jr. is supportive of changes, describing the director election process as a "forgotten element to reform," calling for examination of the "management-biased corporate election system," and suggesting that policy makers take up the issue of requiring equal access to "the proxy machinery between incumbents and insurgents with significant nominating support."

In January, the CONFERENCE BOARD report noted "shareowners have no meaningful way to nominate or to elect candidates short of waging a costly proxy contest."

In response to the difficulties investors face electing alternative directors, RESOLUTIONS that would allow shareholders the right to place their own candidates on a proxy ballot are being proposed. (For example, at AOL Time Warner, Bank of New York, Citigroup, Kodak, Exxon Mobil and Sears.)

The AFL-CIO plans to PETITION THE SEC to create an absolute right to allow shareholders direct access to the proxy.

BOARD REPRESENTATION

To ensure proper representation of shareholders, India's Department of Company Affairs (DCA) Working Group on Corporate Governance will recommend that small shareholders be compulsorily represented on the boards of public companies. (Business Line - India)

COMPENSATION **COMMITTEES: ALERTS and TRENDS**

LIABILITIES

German prosecutors have CHARGED MEMBERS OF THE BOARD that approved severance payments and bonuses to executives at Mannesmann after they accepted Vodafone's purchase, saying they constituted a criminal breach of shareholders' trust. In addition, some of the executives themselves and the chief executive of Deutsche Bank were charged. (FT, NY Times)

THE STOCK OPTION DEBATES

Consultants say they expect the REPLACEMENT OF OPTIONS with restricted stock to continue. Some expect time periods for restricted stock, now often three years, to LENGTHEN to five or even seven years. (Wash Post)

The Merrill MIX of restricted stock to options rose to 70/30 from 50/50 the previous year. Supportive of the move, Jack Bogle, the founder and former chief executive of Vanguard mutual funds said RESTRICTED STOCK WOULD BE AN IMPROVEMENT over options, and Jeff Bezos, CEO of Amazon praised restricted stock as a "simpler" approach than options, where "the accounting and expensing of it is also much more straightforward." (Barrons)

AmEx recently agreed to REDUCE OPTIONS GRANTS to senior managers and substitute restricted stock for options given to middle managers. (Bus Wk)

The Canada Pension Plan will start OPPOSING STOCK OPTIONS under one of the toughest stands on corporate governance taken by an investment fund, saying it has concerns about options' effectiveness in aligning management and shareholder interests, its dilution of existing shareholders, its tendency to focus management on short-term results. (FT)

EXPENSING STOCK OPTIONS

Since last summer, more than 170 companies have said they will start treating options as an expense. (Bus Wk) Both Ernst and Young and the CEO of Yahoo came out in support of expensing stock options. (NY Times, FT)

NO BONUSES

Citigroup's Sandy Weill will accept no cash or stock bonus for 2002. (Wash Post)

Fleet's top executives will forgo their bonuses for 2002 and the company will institute rules requiring executive officers to hold at least 75% of the common stock given to them by the company, including shares received through the exercise of stock options, FOR THE ENTIRE TIME THEY ARE EMPLOYEES. (Dow Jones)

NO RETIREMENT PAY

The Pension Fund Association of Japan, with approximately 1,700 employee pension funds and assets of \$45.2bn, said that it would vote against the re-election of management or payment of their retirement allowances if a company suffered three straight years of losses with no dividend pay-outs. (FT)

PLANS ELIMINATED

Based on pressure from investors, General Electric and Coca-Cola have AGREED TO PHASE OUT a deferred salary plan at GE and an executive retirement plan at Coca-Cola. (FT, NY Times)

OTHER MEASURES

A report by the National Association for Female Executives (NAFE) shows that more companies are linking managers' salary and bonus to their promotion of women workers. (CFO)

UK: FOCUS ON PAY

The Trades Union Congress has launched a campaign to raise shareholder activism by pension funds to tackle such issues as excessive executive pay and other failings in corporate governance. (FT)

REPORTING

In a change from the past, this reporting season, companies listed on the Swiss Stock Exchange will be required to publish the aggregate salaries and compensation payments of their top executives and board members, board members' total holdings of shares and options, and the highest salary it pays to a single member. They also must publish the names of other companies on whose boards they sit. (WSJ)

EXECUTIVE COMPENSATION TOPS SHAREHOLDER RESOLUTIONS/CONCERNS

(FT, Bus Wk, NY Times, CFO, USA Today)

With average CEO pay "more than 400 times the average hourly worker's (up from 42 times in 1980)", a joint report released by the Investor Responsibility Research Center, the Social Investment Forum, and the Interfaith Center on Corporate Responsibility shows the number of resolutions addressing CORPORATE GOVERNANCE represented 75% of the total (UP 18% this year) and that 44% of the total resolutions address EXECUTIVE COMPENSATION.

Of these, two of the most popular concern EXPENSING OF STOCK OPTIONS (Caterpillar and Eastman Kodak both face such resolutions) and the SEPARATION OF THE CHIEF EXECUTIVE AND CHAIRMAN.

RE: SEPARATION, there are nearly 7 x more separation proposals than last year: 27 resolutions compared with just 4. For example, GE shareholders will vote on separating the top jobs. The SEC rejected GE's request to keep the proposal off the ballot.

INDEXING of stock options is also an issue being raised (for example at Coca

Cola) as well as proposals that ask companies to consider whether executive pay should be FROZEN when there are significant layoffs and whether a MAXIMUM RATIO should be set between the highest paid executive and the lowest-paid employee.

Shareholders are also pressing a return to US SHORE at companies that include Tyco, Carnival, Cooper Industries, Ingersoll-Rand, McDermott International, Schlumberger and Transocean, and resolutions requesting a board review of BUSINESS WITH TERRORIST-linked countries at G.E., Halliburton and ConocoPhillips.

Resolutions on DIRECTOR ELECTIONS are also being proposed: see above.

Related to SOCIAL ISSUES : the environment (particularly global warming), global labor standards, healthcare and drug development, equal employment opportunity (particularly in the area of sexual orientation anti-bias policies), and tobacco top the list.

AUDIT COMMITTEE: ALERTS AND ISSUES

VENDOR/PROMOTIONAL ALLOWANCES, SUPPLIER REBATES
(WSJ, FT, NY Times)

Ahold's CEO and chief financial officer resigned over accounting irregularities at the Dutch grocery giant's U.S. operations. Ahold said the accounting problems caused it to overstate operating earnings by \$500 million for 2001 and 2002.

The SEC is probing three companies related to vendor or promotional allowances: Fleming, Ahold and NashFinch. The accounting issues involve money that is given as an upfront bonus or as a discount on the product's wholesale purchase price, based on the distributor hitting certain sales targets. Distributors may be tempted to book the revenue from incentives upfront without knowing whether they would meet the sales target.

In a related issue, two former executives of Kmart, were indicted on criminal charges of FRAUD, The SEC said the two executives booked up-front payments from American Greetings of \$42.3m all in one quarter's accounts, instead of spreading it over the multi-year lifetime of the contract.

AUDITOR CERTIFICATION: CFO FIRED

(NY Times, CFO, USA Today)
KPMG who had taken over Universal Health's accounts from auditor Andersen, but had not changed the auditors doing the work, said it WOULD NOT CERTIFY the financial statements of Universal Health if Mr. Gorman, the CFO, remained. There were no disagreements with KPMG over any numbers or accounting issues. The dismissal of Mr. Gorman, the CFO of Universal Health angered a number of analysts, who said they had more confidence in the CFO than the auditor, and that the decision "was not in the best interest of shareholders."

Mr. Gorman had signed a letter that KPMG had asked him to sign, attesting to the financials, noting that he had in part relied on KPMG's expertise and that he had asked KPMG to provide a representation letter or certificate regarding KPMG's ongoing review of the financial statements and disclosures, which KPMG would not provide. Mr. Gorman said the logic had seemed a bit circular to him, with him certifying to KPMG that the company's accounting was correct when in fact he was relying on the auditors for that very assurance in some areas. The CEO, Mr. Miller said he fired Mr. Gorman because "he and the board were left with no choice" given the timing just before annual financial results were to be released. "We would have had no auditor."

THE CFO and THE AUDIT COMMITTEE

Almost 50% of the FUNDS think 'it would be useful to have a dotted line relationship between the CFO and the audit committee' while LESS THAN 20% do not think so, according to a SURVEY conducted by Corporate Governance Alliance of State Retirement Funds, including Teachers Funds.

Responses were a mixed bag when we raised the question of the CFO reporting to the audit committee in this publication in January. PAUL VOLCKER, who heads the International Accounting Standards Board, was asked the same question in late February by CFO Magazine: "Do you think CFOs should report to audit committees?" His response: "I think it's a good idea, and one that has to be explored."

AUDITOR CONFLICTS OF INTEREST, BOARD QUESTIONED: CEO AND PRESIDENT FIRED

(WSJ, NY Times, Bus Week, USA Today, Kansas City Star)

William T. Esrey, the departing Sprint chief executive, and Ronald T. LeMay, the company president, were fired after participation in a tax program recommended by the firm's auditors' Ernst and Young and now under scrutiny by the IRS. As a result, they could owe more than \$100 million in taxes.

Sprint's board has come under fire for requiring that its top executives use Ernst & Young to prepare their tax returns and, as a special perk, allowing the executives to consult the company's auditor for personal financial advice. (Some boards like Ryder Systems and Pfizer long ago stopped their previous practice of using auditors as tax advisers for executives.)

In addition to AUDITOR CONFLICTS OF INTEREST (in 2000, Sprint paid Ernst & Young more than \$65 million in accounting and consulting fees; less than 4% of the total was for audit work), the board is coming under fire for its COMPENSATION PRACTICES, which were designed to keep pay in line with that at Qwest, Global Crossing and WorldCom. According to Graef Crystal, in the nine years, through 2001, the CEO received a total of 83 options grants. The board gave out options to its executives and then accelerated their vesting schedule after shareholders approved a merger with WorldCom. (See another case of merger related compensation: Vodafone above.)

Now in the spotlight as a result of the conflicts, a preliminary analysis by the Corporate Library places the Sprint Board as the fourth-worst board in the

nation, receiving only 9 points out of a possible 100 (compared with an average rating of 56 in a study of 1,800 boards).

Furthering the charges of CONFLICTS, E&Y has drawn fire for its proposal, which Sprint chose not to adopt, that the company take back options the executives had converted into stock when the WorldCom merger appeared likely. That proposal while protecting the executives would have cost

Sprint

\$148 million in tax benefits it claimed from stock compensation in 2000.

TYCO

Tyco's former CEO and CFO transferred hundreds of millions of dollars of options to family partnerships before exercising them, in a tax-shelter maneuver similar to that used by Sprint Corp. executives. (WSJ)

CORPORATE TAX

A Senate Report will be released detailing Enron's Tax Avoidance and indicating that other U.S. companies followed many of Enron's tax maneuvers to various degrees. Issues raised by the report include: complex tax deals, tax deductible awards of stock options, and the lack of disclosure related to tax payments. (Wash Post)

NUMBER OF BOARD SEATS QUESTIONED

The number of board seats held by Henny de Ruiter, chairman of Ahold's supervisory board, who is running Ahold on an interim basis after the firing of its CEO, is being questioned. Ruiter who says he spends about 50 hours per week on board functions sits on the board of eight major multinational companies (including Aegon and Heineken). (WSJ)

JURISDICTION AND SUPERVISION ISSUES

Dutch authorities said they did not yet have the powers to supervise the reporting practices of companies such as Ahold, while European Union experts argued that the crisis at the company would bolster calls for PAN-EUROPEAN CORPORATE GOVERNANCE and accounting standards. Ahold's accounting issues

likely will bring pressure on the Securities and Exchange Commission to RESIST EXEMPTING FOREIGN ACCOUNTING FIRMS from supervision by the recently formed Public Company Accountability Oversight Board. Non-US accounting groups, including member firms of the Big Four based outside the US, have hoped to escape the reach of the regulator. (FT, WSJ)

EUROPEAN CORPORATE GOVERNANCE AND REPORTING

Euroshareholders, a group that represents shareholders in 23 European countries, presented a 10-point CORPORATE GOVERNANCE ACTION PLAN to the European Union. In a separate initiative, European regulators are pressing ahead with plans to force all listed companies in the European Union to report their RESULTS in 2005 QUARTERLY but are expected to demand far less information than is currently provided in US companies' quarterly statements. (FT, WSJ)

TOUGHER STANDARDS

Self-imposed, Cendant has made changes that go beyond requirements of Sarbanes-Oxley legislation and the New York Stock Exchange listing rules, including requiring two-thirds of the company's board be independent, the elimination of stock options as compensation for directors, and the requirement that members of the company's audit, compensation and corporate governance committees receive no compensation other than directors' fees from the company. Like GE and Walt Disney, the company also appointed a "presiding director" to lead regular executive sessions of nonmanagement directors. (WSJ)

CRIMINAL AND CIVIL LIABILITY FOR EXECUTIVES AND SUPERVISORY BOARD MEMBERS "MISLEADING"

Germany introduced proposals to take effect January 2005 that would make executives take personal responsibility for misleading shareholders. Executives would be subject to longer prison

sentences for financial crimes and shareholders will be able to launch joint-action civil cases against individual executives and supervisory board members if they are suspected of spreading misleading information. Auditors, financial analysts and credit rating agencies will be subject to tighter rules under the proposals and laws may also be introduced to require disclosures of individual executives' salaries and benefits.(FT, NY Times)

CHANGES TO CORPORATE GOVERNANCE IN JAPAN

Revisions in the Commercial Code take effect in April enabling Japanese companies to use independent oversight committees to help guide corporate governance. The new system uses three separate committees, made up of a majority of directors recruited from outside the company, responsible for auditing, remuneration for directors, and selection of qualified candidates for the board. Sony Corp., Hitachi Ltd., Toshiba Corp. and Orix have already embraced this new regime of giving outside directors broad executive authority. They expect the new approach to the boardroom will encourage fresh ideas and more openness of management, thus making it easier to implement dramatic management changes in policy and strategy (The Asahi Shimbun, WSJ)

WHAT'S NOT IN THE NEWS

Discussions about SEPARATION of the CEO and CHAIR roles continue. There is little experience with this structure in the US according to a study by the Corporate Library: only 15 of the S & P 500 have separate and independent CEO and Chairs. A common argument raised against separation is skepticism that companies would not perform as well under this structure. Based on analyses performed in early February, from a shareholders perspective, a review of the 15 versus the 500 shows no clear evidence of underperformance. Related to the 15, 1/2 beat the returns of the index and 1/2 did not, for the one year period and YTD. (For the 3 month period, 2/3 of the 15 beat the index.)

VULNERABILITIES

LOW CONFIDENCE IN REPORTING

A Hackett Group survey found that despite pressure from government and Regulatory agencies to improve accountability, just 9 percent of average companies believed they had confidence in their forecasting and reporting outputs. Just one-third of the respondents at so-called world-class companies said they think forecasts and reports are reliable and accurate. (CFO)

BOARD UNDERSTANDING GRADED

150 international executives surveyed by the Economist rated the level of "understanding of the business" by non executive board members at C+ (where A is excellent, B good, C satisfactory, D unsatisfactory and F poor).

CONFIDENCE IN DETECTION OF FINANCIAL IRREGULARITIES

Where 1 means complete confidence that they would detect and 5 means no confidence at all: the CFO received a 2.1; senior management and external auditors: 2.3; the audit committee and internal auditors: 2.5 and the board: 2.7.

CONFIDENCE IN RECTIFYING FINANCIAL REPORTING ISSUES ONCE DISCOVERED

Using the same scale, where 1 means complete confidence that they would rectify the financials: senior management and the CFO received 1.9; the board received 2; the audit committee 2.3; and both internal and external auditors received 2.5.

MAIN REMEDIES TO CORPORATE GOVERNANCE ISSUES

Asked to identify the main remedies to corporate governance issues: 57% said full disclosure of off balance sheet transactions; 48% greater powers for the audit committee; and 46% regular rotation of external auditors.

CORPORATE TRANSPARENCY RATINGS OF DISCLOSURE BY COUNTRY

The Economist sampled disclosures by country (with 0 being information not there; 1 information there but hidden; 2 information easily found but hard to understand/incomplete; 3 information

easily found, understandable and complete).

Japan scored the worst with .4, the US was next at .5, UK 1.1, France 1.2 and Germany 1.3.

A QUESTION FOR YOU:

GIVEN RECENT AUDITOR ISSUES AND THE EXPECTATION OF POTENTIAL CONFLICTS IF THEY ARE NOT ADDRESSED, WHAT SHOULD BOARDS DO TO ENSURE THAT THEIR RELATIONSHIPS WITH AUDITORS PROMOTE THE BEST INTERESTS OF LONG TERM SHAREHOLDERS? We'd like to hear your views. Please email ebloxham@thevaluealliance.com with your views. We will share them (anonymously) in future editions of the digest.

As a director, do you have 10 questions to ask - and only time to ask 2? We help boards put in place straightforward processes to get the answers to the other 8, efficiently, so the remaining 2, which are also critical can be answered in committee and board sessions. Implementing strong processes can help prevent liability issues and concerns. For more information, please call, email or visit

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John M. Nash is the founder of the corporate governance movement for independent directors, as founder, in 1977, and President emeritus of the National Association of Corporate Directors. Eleanor Bloxham is a pioneer in the area of economic value management and its application in good corporate governance, founder and President of The Value Alliance, and author of the book "Economic Value Management", published by John Wiley and Sons. Both Eleanor and John are Principals of the Corporate Governance Alliance.