

THE CORPORATE GOVERNANCE

ALLIANCE DIGEST

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Published 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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This edition of the DIGEST has 4 major sections:

- I. BOARD PRACTICES (AND INVESTIGATIONS)
- II. AUDIT COMMITTEE ALERTS
- III. COMPENSATION
- IV. INVESTOR CONFIDENCE

One EU official remarked: "If recommendations don't work, we can always come up with legislation." (FT 6/16)

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

I. BOARD PRACTICES INCLUDING D&O ALERT, PRIVATE FIRM ALERT, TRENDS IN SHAREHOLDER DEMOCRACY, DUTIES AND RESPONSIBILITIES, CROSS ATLANTIC OVERSIGHT,

CORPORATE GOVERNANCE CHANGES AND INVESTIGATIONS

A. D&O ALERT

Of the 10 securities firms that recently settled a \$1.4bn Wall Street case related to misleading investors with tainted research, 4 are planning to pursue insurance claims for a portion of the money the SEC ordered them to pay. Xerox Corp. said it would pay \$19m of the \$22m that 6 Xerox executives were ordered to pay. In future cases, the SEC is considering whether defendants should have to admit guilt and forcing defendants to pay all financial penalties out of their own pockets instead of being able to use insurance. (NYTimes 6/5, WSJ 6/16)

B. PRIVATE FIRMS ALERT

A Federal judge has ruled that officers and directors of private firms have a fiduciary duty to the corporation, similar to that in public firms. Although they did not benefit personally, directors may be liable for up to \$44m, with M. Cogan, because they allowed him to be paid more than comparable executives, arrange loans, and approve dividends while Trace Int'l was insolvent. The exact amounts per person are to be determined by the judge. (NYTimes 6/15)

C. SHAREHOLDER DEMOCRACY

Apria Healthcare will let one or more stockholders, owning at least 5% of its common shares for 2 years, propose 2 new directors every year. Their choices will be listed alongside the official slate in the proxy statement. R. Whitworth, Chair, won support for the proposal by arguing that a more open election process would improve the board's independence and effectiveness. (WSJ 6/11)

The SEC is considering revising rules allowing shareholders to more fully participate in nominating and electing directors. Changes could include

requiring companies to list shareholder nominees for the board of directors alongside the company's nominees. The Business Roundtable does not support changes. A report of findings is expected to be prepared by 7/15. (Business Week 6/9, WashPost 6/12, FT 6/13, WSJ 6/16)

The EU's internal market commissioner, made recommendations last month that include greater shareholder participation including shareholder ability to participate in meetings electronically, make it easier for them to ask questions and put issues on the agenda. "Economies only work if companies are run efficiently and transparently," he said. "We have seen vividly what happens if they are not: investment and jobs will be lost - and, in the worst cases, of which there are too many, shareholders, employees, creditors and the public are ripped off." (FT 6/16)

Shareholders at Dave & Buster's and El Paso Gas are looking to wrest control from the current board. At Dave & Buster's, investors are putting forth their own slate of three candidates. At El Paso Gas, shareholders propose shrinking the board from 12 to 9 and are offering 9 alternative candidates. (UPDATE FROM 6/18 - The El Paso resolution was defeated by a vote of 52% to 48%.) (WSJ 6/10, FT 6/11, FT 6/12)

D. DUTIES AND RESPONSIBILITIES

The reports on WorldCom fraud criticize top management but also cite failures by external and internal auditors, lawyers and board members. "Several multibillion dollar acquisitions were approved by the Board following discussions that lasted for 30 minutes or less and without the Directors receiving a single piece of paper regarding the terms or implications of the transactions," As a result of the reports, the general counsel, and the treasurer, resigned. AUDIT COMMITTEE NOTE: In 2000, regulators blocked the acquisition of Sprint, forcing a focus on operations, rather than acquisitions. The

company was unable to meet double-digit goals. Officials manipulated revenue, depreciation reserves and tax liabilities, in addition to improperly capitalizing line costs. Employees who cooperated were rewarded with \$10,000 checks; those who didn't were bullied.

(WSJ USAToday 6/5, FT WashPost 6/9, FT NYTimes WashPost WSJ 6/10, USAToday WashPost 6/11, WashPost 6/12, WashPost 6/15)

Several dozen academic studies on board independence have found that it has no correlation with company performance or that companies generally perform worse when they have more outsiders on their boards. Prof. Gompers, whose own study did not consider outside directors but did correlate good corporate governance with performance, explains it this way: "One of the most crucial factors in a company's long-term performance is its corporate culture: Is the firm responsive to shareholder concerns, or has it immunized itself from any such influence? Directors have had little effect on corporate performance because they largely have been unwilling to change that culture." (NYTimes 6/15)

Leslie Perlow: "It is time to take the gilt off silence. Our research shows that silence is not only ubiquitous and expected in organizations but extremely costly to both the firm and the individual." "The pressure for unanimity can prevent ...even top managers—from exploring their differences." (HBS Working Knowledge 5/27)

E. CROSS ATLANTIC REGULATORY OVERSIGHT

The EU is threatening to force US companies with banking and insurance operations in Europe to comply with a new law, that could include new methods to calculate capital adequacy and restrictions on intragroup transactions. The SEC argues that US financial conglomerates are regulated by domestic watchdogs and should not be subject to additional rules in Europe. The SEC has rejected a similar EU argument that European audit firms should be exempt from the requirement to register with the US PCAOB. (FT 6/16)

F. CORPORATE GOVERNANCE CHANGES

Aetna removed poison pill provisions (supported by shareholders in a non-binding vote last year, but not acted on by the company), implemented key board committees with fully independent members, "stronger audit committee practices," director training, a mandatory retirement age for directors, and disclosure of governance documents. Some of the changes were in the works and others were made to improve its ISS governance score. Aetna has received a D rating by The Corporate Library because of its pay practices and interlocking board composition. Other companies the Corporate Library gives low grades include American Express, Home Depot, Coca-Cola, Maytag, Verizon. Allstate, Citigroup, J.P. Morgan Chase, Honeywell, Walt Disney, Emerson Electric, Gemstar-TV Guide, Loews and SBC. (WSJ 6/5, WSJ 6/9)

The NYSE board agreed it will disclose compensation and governance guidelines and violations, ensure audit and compensation committee independence, and prohibit senior officers from serving on listed company Boards, among other reforms. (WSJ USAToday FT NYTimes WashPost 6/5, Newsday 6/6, BusinessWeek)

G. INVESTIGATIONS

The SEC has settled with WorldCom for \$500m. Tyco remains under investigation. The WorldCom investigation used outside counsel that was not nor will be counsel to them before or after the investigation. Under lessened threat from shareholder lawsuits, since it was in bankruptcy, counsel insisted on waiving attorney client privilege, allowed prosecutors and SEC lawyers to sit in on employee interviews, and published their complete findings. In contrast, Tyco's investigation used counsel that is continuing to assist them with shareholder lawsuits. In this case, counsel has maintained attorney client privilege. Other accounting problems have surfaced since the investigation and the SEC said Tyco will be required to restate its earnings over the last 5 years. (WSJ 6/12, FT NYTimes WSJ 6/17)

II. AUDIT COMMITTEE ALERTS INCLUDING REVENUES, TAX ACCOUNTING, OTHER ACCOUNTING ISSUES, TECHNOLOGY DISCLOSURE ALERT, AUDITOR ISSUES, NEW POLICIES, AND PATTERNS OF RESTATEMENTS.

A. REVENUES

IBM said the SEC was conducting a formal non-public investigation (under which the SEC has powers of subpoena) into their revenue accounting practices in 2000 and 2001. IBM shareholders criticized its lack of reporting transparency and its use of one-time gains from asset sales and pension fund profits to meet quarterly earnings targets. (FT WSJ USAToday WashPost 6/2, FT USAToday 6/3, FT 6/4)

Former executives of HBOC, the medical information group acquired by McKesson, were indicted on accounting fraud charges related to revenue overstatements, which included backdated sales. (FT WSJ NYTimes WashPost USAToday 6/5)

Two former officers of now defunct Interspeed were indicted on charges of fraud and falsifying records in a scheme to inflate revenues by about \$9m, or 60%, entering into side letters with customers that allowed them to return items at no cost, to meet bonus targets. (NYTimes 6/5)

Working with its auditor, KPMG, Qwest does not know when it will have audited books for 2000 to 2002. Qwest has disclosed that a year-long SEC inquiry has been expanded to include a review of how its adjustments to revenue from network capacity and equipment sales, as well as in its publishing unit was booked. Prosecutors and the SEC are also looking at deals in which Qwest officials got stock in companies that sold equipment to Qwest. One issue is whether Qwest wasted cash on equipment so individuals could benefit. (USAToday NYTimes 5/30)

Halliburton has agreed to pay \$6m to settle 20 shareholder suits that accused it of overstating revenue by \$445m from 1999-2001 by incorrectly counting revenue from cost overruns and change

orders on long-term fixed-price construction projects. The company began booking some of the unapproved amounts as revenue in 1998 and later disclosed the change in filings with the SEC. The SEC is investigating. (USAToday 6/2)

B. TAX ACCOUNTING

Apparel firms with foreign operations have seen an increase in tax disputes with the IRS. GAP took a \$131m tax charge in 2001 for "probable settlements of foreign and domestic tax audits" and Limited Brands recently won a victory over the IRS in a U.S. appeals court over how it treats foreign income. (WSJ 6/2)

The IRS is reviewing the timing of certain deductions, by Levi Strauss, for a Brazilian partnership that never made any jeans. After establishing the partnership in 1986 with \$100K, Levi Strauss Latin America took out a \$10m loan that generated huge interest payments due to Brazilian hyperinflation, helping Levi to claim \$138 million in interest deductions. Levi says the partnership was set up to repatriate \$10m from Brazil before an expected currency devaluation. The SEC has launched an informal inquiry into Levi's financial reporting. 2 execs, who were fired last year, raised concerns about the company's tax and accounting strategies. (WSJ 6/2, WSJ 6/17)

C. OTHER ACCOUNTING ISSUES

RESERVES: Freddie Mac's board asked its chair and CEO, L. Brendsel, to leave, fired the president and COO, D. Glenn, and pressured CFO V. Clarke to resign. The SEC is investigating whether Freddie Mac used cookie jar reserves to keep its revenue and earnings growth steady. Federal prosecutors in Northern Virginia are also investigating. Freddie Mac announced plans in January to restate past earnings due to its accounting for derivatives. (FT NYTimes USAToday WSJ 6/10, FT NYTimes USAToday WashPost 6/11, NYTimes USAToday WashPost WSJ 6/12, USAToday 6/13, WashPost 6/14)

SPECIAL PURPOSE VEHICLES: Justice and the FBI said PNC Financial agreed to pay \$115m in penalties and restitution and to co-operate with an

ongoing investigation to avoid prosecution for securities fraud over its efforts to hide \$762m in bad loans and investments in SPVs that did not have sufficient outside capital to be considered independent. PNC reached civil settlements with the SEC, the Fed and the OCC in July. (FT 6/3)

VENDOR ALLOWANCES: Kroger said that, earlier this year the SEC requested information on how it accounts for vendor allowances. Recently, Albertson's also received a letter from the SEC stating it was "conducting an informal inquiry concerning how certain retailers treat allowances they received from their vendors". (FT 6/5)

INFLATING SUBSIDIARY PROFITS: Chye Tae Won, chief of South Korea's third-largest business group, SK Group was sentenced to three years in prison on charges of falsifying account books by "window-dressing" the company's 2001 books to inflate profits of a subsidiary, SK Global, by \$1.25bn, and for reaping unlawful gains through stock trading. Son Kil-seung, chair of the parent group, had his three-year term suspended. (WSJ 6/13, FT 6/14)

UNDERSTATING EARNINGS: A Duke Power whistle-blower has filed a \$2.5m suit claiming the utility retaliated against him. He says he was demoted and subjected to a 5 hour "interrogation" by Duke attorneys because he informed regulators and Duke Management (using the ethics hotline) of accounting moves to avoid cutting power rates paid by consumers. He also alleges Duke broke a settlement agreement for \$2.5m (which Duke denies) to stop talking to the media. An independent audit, initiated by regulators, found Duke to have understated earnings by \$123m over 3 years and resulted in Duke paying a \$25m penalty to customers. The VP of Finance suddenly left the company without explanation. Duke has denied intentional wrongdoing. A federal grand jury is investigating. (CFO 5/27)

D. TECHNOLOGY DISCLOSURE ALERT

Interviews with Enron's broadband unit's former customers, suppliers, consultants, employees, partners and competitors suggest that the charges about the false

hopes surrounding the product development of technology reflect not criminal activity but the common claims that are made for a technology's abilities, long before it is commercially viable. "If they succeed in convicting the Enron developers anyone in Silicon Valley can be sent to jail." (NYTimes 6/8)

E. AUDITOR ISSUES

An E&Y executive was one of 13 people arrested by the ICAC after an investigation alleging that the chair of Hong Kong based Global Trend Intelligent offered bribes to help inflate the firm's revenue, smoothing the way for his company's listing on the Hong Kong Stock Exchange last year. E&Y served as auditors and "reporting accountants" for the firm. (WSJ 6/10)

SEC staff members have filed court papers to ban E&Y from accepting new audit clients for 6 months. SEC lawyers said E&Y's control systems for catching independence problems is "woefully inadequate, internally inconsistent, and under-publicized within the firm", that the firm keeps no central records that could easily be reviewed by regulators who want to track E&Y's joint ventures with clients and that E&Y failed to provide a clear way for employees to raise questions. (WSJ WashPost 5/30)

E&Y collected \$2.6m from HealthSouth for conducting janitorial inspections of the company's facilities in 2000 and 2001 and advised it to classify the payments as "audit-related fees," leading HealthSouth to make inaccurate public disclosures about E&Y's fees for non-audit services. (WSJ 6/11)

Another suit has been filed against KPMG related to a tax strategy that was sold to at least 186 clients in 1999 and 2000, according to documents the IRS filed in federal court last year; KPMG also sold similar strategies to at least 160 clients, according to the IRS who has identified the strategies as potentially "abusive" shelters, claiming the tax losses generated by the strategies were artificial. (WSJ 6/10)

F. POLICY

FASB Chair, R. Herz, denounced congressional efforts to block the board's

decision to require companies to treat stock options as expenses, saying such actions would establish "a potentially dangerous precedent." FASB has the support of SEC Chair W. Donaldson, who has said Congress should not meddle in the FASB's decision making. (WashPost 6/4)

The IASB is considering requiring "fair value" accounting for insurers that would require a rolling assessment of the adequacy of reserves against future policy claims. AIG and 15 other insurers are attempting to stop the IASB action saying it would increase earnings volatility and reduce the usefulness of financial statements to investors. The IASB has promised to give the insurers access and input to the 3-4 year process. (FT 6/4)

G. PATTERNS OF RESTATEMENTS (WSJ 4/17-5/29)

REVENUE: Qwest - revenue recognition. SEEC - revenue recognition policies for annual license sales. Cole National - shifting revenue recognition on the sale of warranties over the period of the agreements. Varco - revenue recognition when an order is shipped rather than when title is passed to the customer. Viad - open accounting matters related to recording residual cash flow interest of a collateralized debt obligation. CPI - requested by the SEC to delay the recording of revenue. Symbol Technologies - accounting fraud that inflated revenue. AFC - revised methods related to accounting for asset sales, cooperative advertising and other items.

TAXES: Triton PCS - deferred tax adjustments from adopting FAS 142. Rayonier - D&T changed its position on the accounting treatment and timing of recording certain tax benefits. First Southern Bancshares - revised the calculation of the tax benefit of alternative minimum tax operating loss carrybacks.

RESERVES: Brunswick - establish a reserve related to potential litigation resolution. GlobeTel - increased reserves related to re-valuation of IP World Ltd. stock held by GlobeTel.

ASSET IMPAIRMENT AND DEPRECIATION: Phelps Dodge - an SEC inquiry focused on asset impairment analysis and depreciation.

COSTS: Audiovox - accounting adjustments on certain costs. Applix - timing of acquisition related operating expenses.

VENDOR ALLOWANCES: Electronics Boutique - change in accounting for vendor allowances.

STRAIGHT-LINING RENT: Vornado Realty - revised its definition of funds from operations to include the effect of straight-lining rent as required by the SEC.

OTHER ERRORS: Mirant - overstated accounts receivable and accounts payable. Microtune - accounting errors. Value City - administrative error. U.S. Liquids - overstated operating income of an business unit. Restoration Hardware - accounting corrections. eUniverse - incorrect processing of accounting transactions. IXYS - accounting error overstated inventory. California Micro Devices - revised cost of sales, inventories, total loss and accumulated deficit because certain manufacturing variances had been expensed improperly.

III. COMPENSATION INCLUDING THE SNOWBALL EFFECT AND SHAREHOLDER PROPOSALS

A. THE SNOWBALL EFFECT

Maryland's insurance commissioner blocked the sale of CareFirst Blue Cross Blue Shield to WellPoint Health Networks for \$1.3bn and criticized the board for authorizing millions in bonuses that, he said, violated state law. State lawmakers then approved legislation requiring CareFirst to give state officials the power to review executives' compensation and select 10 of the insurer's 21 board members. Blue Cross Blue Shield then revoked CareFirst's license saying that the law stripped away the independence that Blue Cross licensees are required to have. S&P then placed CareFirst on "credit watch with negative implications" due to its loss of license which would likely result in over \$1bn in lost revenue. The firms are negotiating a resolution. (WashPost 6/4)

B. SHAREHOLDER PROPOSALS

Shareholders have won more than 24 majority votes on issues such as golden parachutes and expensing stock options. The pressure has been sufficient to cause some companies to give in without the need for a vote. Most resolutions are sponsored by union and public pension funds. (Business Week 5/26)

Despite Siebel's efforts to block it, a TIAA-CREF proposal that executive stock options be tied to the company's performance was voted on by shareholders. It received 38% of the vote. A similar proposal introduced by TIAA-CREF at SBC won 35% of the vote. (WSJ 6/11)

IV. INVESTOR CONFIDENCE AND OTHER VULNERABILITIES INCLUDING MUTUAL FUNDS, WALL STREET, JAPAN, TRACKING STOCK, CREDIT RATING AND STOCK SALES

A. MUTUAL FUNDS:

The SEC has recommended that mutual funds disclose more information about portfolio turnover and transaction costs in their literature. It also recommends that fund managers be forced to share more information about their compensation arrangements. US Rep. Baker, plans to introduce legislation based on the findings. (FT 6/10, FT 6/12)

An FT poll of the top 10 UK retail fund managers found that 8 are willing to disclose their voting on corporate issues to small investors who ask. Only 1, Fidelity International, the largest fund, confirmed it would refuse to tell retail customers how it votes despite routinely giving such information to large institutional investors. 1 fund declined to reveal its policy. There is rising pressure in the UK to disclose all voting. However, 1 manager said they had only had 1 request in 5 years. (FT 6/2)

B. WALL STREET

The 12 firms investigated by the SEC for the Wall Street Settlement have been asked to provide e-mails, minutes of meetings, employee evaluations and other records to show whether as many

as 50 executives, including current and former research heads and top-level CEOs properly supervised employees. (NYTimes 6/2, FT USAToday 6/4, USAToday 6/5)

Wall Street firms and public companies should disclose more about how they price and distribute IPO shares said an advisory committee convened by the NYSE and NASD in making 20 recommendations to the SEC to reform the IPO process. Some critics say the recommendations don't go far enough in addressing "preferential allocation". (NYTimes WashPost WSJ 5/30)

T. Jones, Citigroup's head of global investment management says he is not interested in shareholder activism. Mr Jones is a former vice-chair and director of TIAA-CREF and head of the audit committee at Freddie Mac. (FT 6/16)

Arbitration suits filed by investors against brokers were up 25% in the first four months of this year, versus the same period last year. In 2002, some 7,704 suits were filed, up 38% from 2000. (NYTimes 6/8)

The NASD is asking its member securities firms to comment on a rule-change proposal that would require Wall Street CEOs and chief compliance officers to certify annually the adequacy of their firms' compliance procedures for securities rules. Firms that don't already have a chief compliance officer would be required to name one. The rule needs approval from the SEC. (WSJ 6/5)

C. RESTORING INVESTOR CONFIDENCE IN JAPAN

36 listed Japanese companies will adopt US-style board changes by the end of this month. In the past 12 months there have been 3 times as many IPOs in Japan as in the US. (FT 6/16)

D. TRACKING STOCK LAWSUIT

Genzyme created Genzyme Biosurgery, a tracking stock, when it purchased Biomatrix in 2000. Two Genzyme Biosurgery shareholders are suing to block plans to absorb the tracking stocks into the main stock, saying they are being forced to sell stock at deflated prices. They say the company "engaged

in reverse insider trading" by withholding positive information about Genzyme Biosurgery in a bid to "lower the price, then get the shares on the cheap". Shareholders had agreed on a pricing formula if the tracking stock were acquired, but the suit alleges that plans to gain additional US market clearance for G-B products were withheld, causing the formula to be skewed. (FT 6/4)

E. CREDIT RATING AGENCIES

The SEC released the second of a series of reports raising concerns, but not reaching conclusions, about the credit ratings industry. (FT 6/7)

F. STOCK SALES

S. Ballmer, Microsoft CEO, wrote to employees expressing optimism over the long term but warning that disaffection with technology spending, questions about future innovation and issues in MS's customer relations posed "significant challenges" to MS's future, particularly in the short term. Two weeks prior to the warning, he sold around \$1bn worth of his own stock in the company. (FT NYTimes 6/5)

A QUESTION FOR YOU: WHAT DO YOU THINK IS THE MOST IMPORTANT ACTION COMPANIES SHOULD TAKE TO BUILD A BRIDGE OF TRUST WITH SHAREHOLDERS?

Please send responses to: ebloxham@thevaluealliance.com

Abbreviations:

AICPA – American Institute of Certified Public Accountants
AIMR – Association for Investment Management & Research
CGS – Cost of Goods Sold
CSFB – Credit Suisse First Boston
D&T - Deloitte & Touche
E&Y – Ernst & Young
FASB – Financial Accounting Standards Board
FERC – Federal Energy Regulatory Commission
IASB – International Accounting Standards Board
ICAC - Independent Commission Against Corruption

ICGN - International Corporate Governance Network
IRRC – Investor Responsibility Resource Center
ISS – Institutional Shareholder Services
NAPF – National Association of Pension Funds
NASD – National Association of Securities Dealers
OCC - Office of the Comptroller of the Currency
PBGC - Pension Benefit Guaranty Corporation
PCAOB – Public Company Accounting Oversight Board
PwC – Pricewaterhouse Coopers
SEC – Securities and Exchange Commission
SPV – Special Purpose Vehicles
SSB - Salomon Smith Barney
SV – Shareholder Value
TBD – To be determined