JULY 2005
VOLUME 9 NO 7

BOARD ALERT

YOUR NEWS FROM OTHER BOARDROOMS

INSIDE

Boards Cutting Tax Work Performed by Auditors

Concerns about investor perception drive change, though some boards resist

BRINKER INTERNATIONAL cut back the amount of tax work it is giving its accounting firm relative to audit work by 41% this year compared with 2004. According to former Dallas mayor **Ronald Kirk**, an audit committee member on the board of the $3.9 billion restaurant company, concern about shareholder reaction was behind the change.

"For me, in my case, because I have spent much of my life in public service, I am much more attuned to the appearance of issues—the appearance of conflict rather than actual conflict," says Kirk, who also serves on the boards of **Dean Foods** and **Petsmart**. "I would say in the area of conflict avoidance, why raise the issue?"

This view reflects a broader trend. Fortune 1000 companies have been significantly cutting down on the amount of tax-related work they are giving their accounting firms. In a 2004 survey conducted by **The Corporate Library**, 183 firms, or 19.7%, of the 931 polled reported that tax fees made up 35% or more of total fees. The same survey taken this year, however, shows that number has dropped. Of the 920 firms polled, only 76, or 8.3%, reported tax fees at that level.

Aulana Peters, a director on the boards of **Deere & Co**, **Merrill Lynch**, **Northrop Grumman** and **3M**, says the trend she sees of giving independent auditors work related strictly to the audit is not likely to go away anytime soon. While many directors don't see a problem with having the same

TAX WORK *(continued on page 8)*

More Companies Turn to Premium Options

FEDERAL SIGNAL, **Computer Associates International** and **Polaris Industries** have taken the unusual but increasingly popular step of granting top executives premium options.

Premium options, which have an exercise price higher than the stock price on the day the option is issued, haven't traditionally been very popular. But they're being used now at companies in transition stages as part of a comp plan that includes different equity awards.

"There's a little more interest in premium options. It's a reaction to institutional shareholder pressure to create more shareholder-friendly

PREMIUM OPTIONS *(continued on page 9)*

Directors More Willing to Bend on Shareholder Demands

DIRECTORS ARE TAKING shareholder demands much more seriously. **The United Brotherhood of Carpenters and Joiners of America**, for instance, withdrew proposals seeking a majority standard in board elections from 12 of 13 companies, including **Intel** and **Time Warner**. The reason? The companies agreed to join a union-corporate task force on the issue. The union also withdrew proposals from **Dillard's** and **Lowe's** after the companies agreed to implement majority elections outright, according to **Ed Durkin**, the union's corporate affairs director.

The same trend of cooperation with shareholders is being seen on the environmental front. At **Ford**, **Christian Brothers**

SHAREHOLDER DEMANDS *(continued on page 10)*

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Shareholder Activism
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Audit Committees Adding Exec Sessions with General Counsel

MORE AUDIT COMMITTEES have, or are planning to have, regularly scheduled executive sessions with the general counsel. That includes the likes of **Aetna**, **Barnes & Noble**, **Comcast**, **Consolidated Edison**, **Dow**, **Eli Lilly** and **Footlocker**.

"Having regularly scheduled executive sessions with the general counsel is not a general practice among most boards, but it is a good practice that is becoming a common practice," says **Mike Cook**, chair of the audit committees at Comcast, **International Flavors & Fragrances** and **Rockwell Automation** and a member of the audit committees at Dow and Eli Lilly. "And for my boards that don't do this, I'm going to be looking at doing it this year."

"Having regularly scheduled executive sessions with the general counsel is not a general practice among most boards, but it is a good practice that is becoming a common practice."

MIKE COOK, Audit Committee Chaiman, International Flavors & Fragrances, Rockwell Automation

Regularly scheduled meetings with the general counsel provide the audit committee with key insight to the company. They also convey a strong message to senior management.

"It is helpful in terms of putting your cards on the table," says **Purdy Crawford**, chairman of the audit committee at **Footlocker**. "The general counsel has unique insight into tone at the top and the concerns of people who use the ethics-complaint hotline. These meetings underline to the complete management team how strongly the board and its audit committee feel about the ethic of integrity and the spreading of that tone throughout the organization."

The momentum for the trend started with Sarbanes-Oxley, says **Michael Del Giudice**, a member of the audit committees at Barnes & Noble and Consolidated Edison. About a year later, the **American Bar Association** recommended that the general counsel meet regularly and in executive session with a committee of independent directors to communicate concerns about legal compliance or material violations of law.

A lack of oversight on the part of corporate attorneys likely prompted the ABA's response, says **Barbara Hackman Franklin**, a member of the audit committees at Aetna and Dow and a board member at **Milacron.**

"The ABA was probably responding to the **Enron** situation, in which the lawyers should have been a watchdog regarding ethical behavior on the part of management but were not," she says.

The current environment in which directors find themselves has also served to increase the practice. Corporate scandals, lawsuits and heavy publicity are the norm for many boards. Having a private session with the general counsel is a good way to check the pulse of a company.

The audit committees that already have regularly scheduled executive sessions with the general counsel vary greatly in the number of times they meet.

"At one board I'm on, we do it every meeting and another we might do it once or twice a year," notes Franklin "There is no one size fits all."

The time spent in these meetings also varies greatly, depending on how much ground the general counsel needs to cover. The topics can run the gamut from litigation, legal and regulatory compliance, disclosure and financial risk management to the whistle-blower process and the ethical tone of the company. Because many of the issues that might arise are of a delicate nature, an executive session is often the best format for discussion.

Not all directors think having these scheduled executive sessions is necessary, however.

"It is a nice idea, but I really am concerned about the degree of formality we are building into the process," says **Rod Hills**, chairman of the audit committee at **Chiquita**, which does not have these meetings on a regularly scheduled basis. "The key issue here is the establishment of a relationship with the general counsel and elements of the board so that you are comfortable there won't be any problems with the company that the general counsel is aware of but which the board is not aware of."

Indeed, at audit committees where there are not regularly scheduled executive meetings with the general counsel, directors—usually the chair of the audit committee—rely on a strong relationship with the general counsel to keep tabs on sensitive or significant issues. That way, if issues do develop, the general counsel will notify that director immediately.

"As an audit committee chair, I often talk offline with the general counsel throughout the year on different issues that come up," says **James Boland**, chair of the audit committee at **Goodyear Tire & Rubber**, and a member of the audit committees at **Invacare** and **Sherwin-Williams**. "It could be environmental issues, or things that could impact the financial statements, such as disclosure, accounting issues for highly judgmental areas or judgments on reserves that might have legal ramifications." His audit committees do not have regular executive sessions with the general counsel. ■

Lead Directors Get Extra Pay for Added Workload

FOR THE FIRST TIME since it adopted a lead director in July 2003, the $12.9 billion homebuilder **Centex** has awarded the board's lead director, **Frederic Poses**, an extra $25,000 in recognition of his increased workload.

Poses will receive the annual stipend—on top of the $300,000 per year the company will pay regular directors in equal parts cash, stock options and restricted stock—following Centex's 2005 annual stockholders meeting.

"There's a fairly wide range of things [Poses] is responsible for, any one of which you would say, 'Well, that's not that huge a deal,'" says **Barbara Alexander**, the chair of Centex's audit committee and a director at **Harrah's Entertainment**, **Burlington Resources** and **Freddie Mac**. "But when you put them all together it is an extremely time-consuming effort."

Centex's governance and nominating committee's decision to give Poses extra remuneration is in line with the actions of several other boards. The lead directors on the boards of 22 of the 185 largest public U.S. industrial and service corporations are given an average of 24% more in compensation than their fellow board members. That's according to a 2004 **Pearl Meyer & Partners** survey of director compensation.

Greg Loehmann, a researcher at the compensation consulting firm, says a growing number of boards have added lead directors since 2003, when Pearl Meyer barely tracked statistics about lead director pay because the position was so rare.

In fact, the number of S&P 1500 companies with lead directors in 2004 jumped to 42%, up from 25% the prior year, the **Investor Responsibility Research Center** reports.

"Basically, I think the time has come for this," says **Scott Newquist**, president and CEO of **Board Governance Services**. "There is no doubt that lead directors will have to spend considerably more time and effort to do a better job and manage the board."

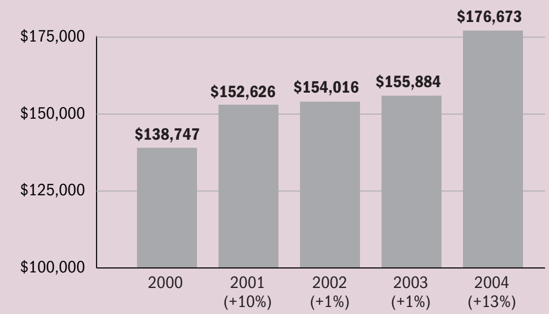
Indeed, lead directors do "a great deal" more than their fellow board members, says **Warren Rudman**, lead director of the $20.2 billion aerospace and defense company **Raytheon**.

The number and breadth of the extra duties assigned to lead directors differs from company to company, however. At a minimum, the role entails overseeing executive sessions of the board, the Pearl Meyer study reports.

But it usually goes far beyond that.

"I coordinate board meetings, work out the agendas, act [as] a conduit for all the directors on issues they wish to be presented to the board and the company, speak to the CEO on at least a weekly basis, set agendas for all the committees and set the agenda for the board meeting itself," says Rudman. Coincidentally, he is also the chair of the board's management development and compensation committee, which is responsible for establishing director pay. Rudman recuses himself from all discussions related to his lead director compensation, says Raytheon vice president and corporate secretary **John Kapples**.

Average Director Total Renumeration



Source: Pearl Meyer & Partners 2004 Director Compenation Study of the Top 200 Corporations.

The amounts and forms of lead directors' extra compensation also vary.

For his duties as Centex's lead director, Poses will collect only 12% over what a regular Centex director receives. That's half of the average extra compensation lead directors get, according to Pearl Meyer.

Rudman, on the other hand, collects 60% more than his fellow board members. On May 4 Raytheon granted him 931 shares of restricted stock "in partial payment for his service as lead director." The shares comprise the $36,000 in restricted stock per year that he's entitled to as lead director. (On the day he received the stock award, Raytheon shares were trading at $38.90.) The position also pays him $24,000 in cash annually.

Regular board membership entitles Raytheon's directors to just over $100,000 in cash and restricted stock.

While he thinks that extra pay for lead directors is a good idea if it is commensurate with the directors' responsibilities, Board Governance Services' Newquist points out a possible downside to the trend: Regular directors may feel they don't have to work as hard or be as well informed because the lead director bears all of the responsibility.

Making sure their fellow board members don't lapse into that false sense of security may deserve a place on lead directors' already lengthy "to do" lists. ■

Board Alert is an independent general circulation monthly newsletter published by Money-Media Inc. Subscriptions are available to corporations. This provides delivery to each board member and to those who work closely with them. Please contact Lewis J. Leonardi at 212-542-1255 for subscription information.

Please send correspondence to *Board Alert* at Money-Media Inc., 1430 Broadway, 12th floor, New York, NY 10018. Phone 212-542-1200. Fax 212-616.3882 E-mail: editor@boardalert.net. Website: www.boardalert.net.

Changes at SEC, Corporate Pressure Slow Reform Efforts

The nomination of Representative **Chris Cox** (R-Calif.) as the new head of the **SEC** is the latest indicator that the pace of governance reform is slowing. While Cox is likely to take mainstream positions on 404 and options expensing, directors should not expect an easing of existing governance standards.

In recent months the pace of reform has slowed considerably compared to that of the last three years. Galvanized by the **Enron** and **WorldCom** scandals, former SEC chair **William Donaldson** surprised many by being a strong advocate of governance reforms such as proxy access and stock options expensing. But under tremendous pressure from corporate interests, Donaldson had already either backed away from or slowed the pace of many reforms he once championed.

Under Cox, that more business-friendly approach is likely to continue. That will mean issues like proxy access will continue to languish and may disappear all together.

At the same time, Cox won't turn back the clock. Business groups are hopeful that because Cox opposed options expensing and was a strong pro-business conservative during his tenure as a California representative, he will repeal some onerous regulations. But this is not likely to happen, in part because of public pressure, media scrutiny and the investor protection mission of his new office, and in part because Cox has strong ties to the accounting industry as well as to corporate interests.

"My guess is that Cox will continue on the same course," says **Charles Elson**, director of the **John L. Weinberg Center for Corporate Governance** at the **University of Delaware**. "There may be some changes on the margins that are necessary, but I expect the same fundamental notions of supporting governance reform… Cox originally voted for Sarbanes-Oxley."

Business interests have already been accommodated on a range of issues. Take director elections: Donaldson had to retreat from the controversial proxy access proposal calling for shareholders to be able to include nominees in proxy materials under certain limited conditions.

"Proxy access was already dead," says **Pat McGurn**, executive vice president of **Institutional Shareholder Services**. "Shareholders already were taking their battles to the states and to individual company proposals [for majority director elections]. Cox merely provides an exclamation point to that death." Majority election proposals urge companies to require majority votes for directors.

On 404, business concerns have also been addressed through the accounting oversight board created by Sarbanes-Oxley, the **PCAOB**, blunting many director complaints. The implementation of 404 has been delayed and more guidance was recently provided by PCAOB in a way that gives directors more discretion over how they tackle internal controls.

"We participated back in April in the section 404 roundtable, and basically PCAOB made clear that there will be modifications," says **Roger Raber**, president and CEO of the **National Association of Corporate Directors.** "They committed to having internal controls be more risk-based rather than one size fits all, and to give more discretion to directors."

The more risk-based approach means that if an internal controls issue doesn't present that much of a risk, directors can use their discretion to not spend as much time on it or look at it during a following year. "The consequence is that compliance will be less expensive," says Raber.

Cox is not likely to support further attacks on 404. That's because his loyalties are split. "It's a regulatory issue that sometimes pits accounting versus corporate interests," says McGurn. "Section 404 is a punch list for corporate interests, but his career shows a strong ear for [both] accounting and corporate interests. The middle might be an attractive place for him to be on that issue."

Accountants are among the top three industries that have contributed to Cox's campaigns since 1989, according to federal election reports analyzed by the **Center for Responsive Politics.** The accountants have given him more than $209,000 in that period.

"This overall level of giving from the accounting industry shows a substantial level of support by accountants for Christopher Cox," says **Steven Weiss**, communications director and editor of the *Capital Eye* newsletter for the Center for Responsive Politics.

On stock expensing, Cox was a strong opponent of the new rule as a representative of California, a state where many of the technology businesses that will be hardest hit are located. Cox can be expected to be more business friendly as a result—but again, not to extremes.

"Cox will probably push to provide wider latitude to issuers with regard to option valuation methodologies, but won't seek to cancel or delay the rule," says McGurn.

This approach would continue the slowing pace of reform under Donaldson. The SEC has already granted a six-month delay and great latitude in calculating the costs of options.

Cox is not likely to go so far as to roll back expensing, because public and investor sentiment for stock options expensing is so strong. According to McGurn, this issue could "make or break" Cox's chairmanship.

If Cox tries to roll back the expensing rule, McGurn argues that he risks becoming another **Harvey Pitt**, who resigned under fire after numerous public relation flaps.

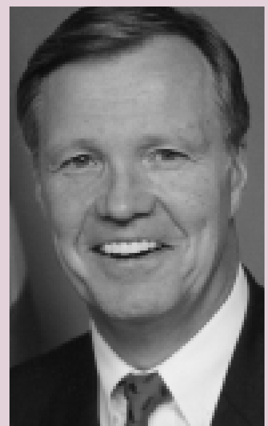
In a recent luncheon address at the Pacific Growth Equities Life Sciences Growth Conference, Pitt himself reportedly said not to expect a "sea change" at the SEC. "Don't make the mistake of expecting significant repeal," he was quoted as saying, calling the "grousing and whining" over new regulations "useless and counterproductive."

Still, particularly in the area of liability, business groups can expect more friendly measures from Cox.

Cox was instrumental in the Securities Reform Act, 1995 legislation he co-authored that curtailed investor lawsuits. Professor Elson notes that this is the one area where he sees Cox most likely to take a different tack. ■

NEW SEC LEADERSHIP

Will Directors Breathe Easier Under Cox?



CHRISTOPHER COX, Congressman (R-Calif.), SEC Chairman-Elect

WILL BOARD MEMBERS be less likely to face liability for alleged failures to fulfill their duties under **Christopher Cox's** watch as head of the SEC? Probably, according to some people who follow the chairman-elect's politics.

"The general thinking is that [Cox] would be looking to be a little less expansive in terms of the SEC's regulatory reach," says **Aegis Frumento**, a partner in the New York office of **Duane Morris**, where he heads the firm's securities litigation practice.

Donald Langevoort, a law professor at **Georgetown University**, is generally in accord.

"While we can't know for sure what kind of agenda he's going to come in with," he says, "I think there will be more of a reluctance to bring cases where the officer or director fell asleep at the switch, [and] should have known that something amiss was going on, but didn't intervene."

That would afford directors and officers some of the freedom from worry they enjoyed in the days before the **Enron** and **WorldCom** scandals—or at least something closer to it.

"In those days, a court would say, if the directors considered the transaction and there was discussion, it was presented and documented, that was it," says **Sarah Wolff**, chairman of litigation at **Sachnoff & Weaver** in Chicago. "Unless they breached their duty of loyalty or engaged in self-dealing, they exercised their duty of care."

Frumento says his opinion is based on Cox's history as defender of securities professionals during his days as an attorney at **Latham & Watkins**, a law firm that once represented **Arthur Andersen**. He also points to Cox's record in Congress, where he sponsored the 1995 Securities Litigation Reform Act, legislation designed to cut back shareholder suits against corporations.

The SEC's stance on directors' responsibilities is likely to have a big impact on the number and outcome of suits board members will face in the next few years.

The federal agency can bring civil cases against any claim it feels is actionable under the federal securities laws, says **Dennis Villavicencio**, a founding member of **Akins & Villavicencio**, a law firm that primarily represents clients in securities disputes. "That includes claims based on fraud, failures to disclose and potential conflicts of interests," he says.

SEC investigations often spark an onslaught of private litigation.

"Because the SEC generally does a good amount of investigation prior to filing charges, civil lawyers do certainly think of [SEC charges filed against a company] as a pretty good lead," explains Villavicencio.

But while experts are optimistic that Cox will ease the fears of directors worried about liability based on ambiguous standards, their predictions for directors who commit or condone fraud are dour.

"Chris has always been in favor of being very tough on the fraudsters," says veteran securities lawyer **John Olson**, a Democrat who has known Cox since the SEC commissioner-elect was a young lawyer working for former White House counsel **Peter Wallison** during the second **Reagan** administration. "He has supported tough penalties for individual violations of the securities laws."

That would be in line with the thinking of two of the four other SEC commissioners. Republicans **Paul Atkins** and **Cynthia Glassman** have both gone on record expressing their skepticism about the utility of assessing fines against corporations as opposed to individuals. Many expect that Cox will share these views. "The thinking is that those commissioners are going to find an ally," says Frumento. ■

EXECUTIVE COMPENSATION

Boards Revise Compensation Plans to Fit New Tax Code

SEVERAL FORTUNE 1000 companies, including **Veritas Software**, **ExxonMobil** and **Washington Post Co.**, are taking advantage of transition relief the **IRS** provided in January for boards and executive compensation professionals struggling with updates to the Internal Revenue Code.

The challenge has been interpreting the notoriously nebulous Section 409A, added to the Internal Revenue Code as part of the American Jobs Creation Act. One of hundreds of tax code changes included in the act, Section 409A will have far-reaching effects on deferred compensation plans.

The section provides deadlines for filing deferral elections, and requires executives to agree up front on a fixed date for the payment of their deferred compensation. Section 409A allows accelerations of those specified payment dates only if the company undergoes a change in control, or if the executive dies, is terminated from the company or becomes disabled.

"What people are really concerned about now is keeping the elections that have been filed from being fouled up under 409A."

MARY HEVENER, Partner
Baker & McKensie

Compensation that an executive elected to defer or to receive payment of in violation of these requirements—which they did not have a legally binding right to as of Dec 31, 2004—will be taxed at a 20% rate.

To help executives avoid this penalty, companies are amending their deferred compensation plans to prevent unnecessary taxation of compensation that executives made decisions about before the new rules went into effect.

"What people are really concerned about now is keeping the elections that have been filed from being fouled up under 409A," says **Mary Hevener**, a tax attorney at **Baker & McKensie** in Washington.

ExxonMobil's compensation committee dealt with the problem on June 3, according to one of the company's recent SEC filings. The committee made all outstanding deferred incentive awards payable together with accumulated interest or dividend equivalents in a single installment on August 1.

They did it "in light of recent tax law changes and for the purpose of achieving consistent treatment of all grantees," says ExxonMobil spokesman **Russ Roberts**.

Other companies and executives are terminating plans because they don't want to be subject to the statute's strict limitations on future changes in payment dates or the new limitations on how and where funds can be invested, explains Hevener.

The $2 billion Veritas took a different tack. On May 23 the company amended its management deferred compensation plan to "allow existing participants to make certain changes to their deferral elections."

ExxonMobile and Veritas made the changes pursuant to Notice 2005-1, which the IRS issued in December 2004 and corrected in January. The notice allows deferred compensation plan participants to change offending deferred compensation payment schedules by locking in changes to them by Dec. 31.

So why amend the deferred compensation plans now?

"We didn't want to get down to the wire," says the general counsel of a Fortune 1000 company that amended its deferred compensation plan to allow its participants the option of cashing in deferred compensation or changing deferral decisions to bring them in accordance with the new law. "We wanted to give people a reasonable amount of time to make the decision and, frankly, a lot of stuff happens at the end of the year and we just didn't want to get backed up."

One thing's for sure: The companies that have made the changes have done so only because the IRS has issued guidance on the issue.

"Most companies are not making changes to plans until they see regulations that provide specific guidance as to the specific types of changes that are either required or permitted," says Hevener, who adds that few companies have moved to otherwise bring their plans in compliance with 409A.

That's because 409A is so cryptic.

"The statute is relatively short in length and has been interpreted in a manner that applies to an enormous range of types of plans and types of transactions," says **Brick Susko**, a compensation attorney at **Cleary Gottlieb**. "That means there's going to be an enormous need for a lot of guidance."

Companies are waiting for the second round of regulatory guidance, which may be out by August 2005 and is expected to cover drafting and operational concerns, a **Treasury** official said at a recent conference sponsored by the **American Law Institute–American Bar Association**. ■

SOX Best Practices: Tighten Audit Committee Oversight

TO ENSURE COMPLIANCE with Sarbanes-Oxley, audit committees have developed some key best practices in their oversight of management. That's according to a new study by **Financial Executives International's** research arm, **Financial Executives Research Foundation**.

The study, titled *Sarbanes-Oxley Section 404 Implementation—Practices of Leading Companies*, is based on discussions with senior officers from 27 Fortune 500 companies and details their experiences with SOX compliance during 2004.

As part of that, management at some companies is sending the audit committee a formal report about significant deficiencies at least a week before the audit committee meeting. The report describes each significant deficiency, the person responsible for remediation, what steps have been taken, when it will be done, and if it could become a material weakness.

Pre-SOX, a lot of companies just had oral presentations to the audit committee and any report was thin and simply provided a basic overview. Companies that furnish a formal report to the audit committee find that it increases the efficiency of meetings.

"The discussion is much more focused if it is based on a formal report rather than an open-ended discussion or presentation," says **William Sinnett**, manager of research at FERF and co-author of the report.

Boards at some companies, such as **Legg Mason** and **MCI**, are going even further than the best practices laid out in the report.

"In the cases I've been involved in, we have insisted that even those relatively minor deficiencies be brought to the attention of the audit committee," says **Denny Beresford**, chair of the audit committees at Legg Mason and MCI and a director at **Kimberly-Clark**. He is also chairman of the **Financial Accounting Standards Board**.

But some directors are concerned that an audit committee might get bogged down in the details of a company and cross the line from oversight to micromanagement by getting involved in every type of control deficiency.

"You don't want the audit committee to have to spend a whole day discussing deficiencies," says **John Hall**, a director at **Bank One**, **Humana** and **USEC**, a $1.4 billion Fortune 1000 energy company. "You have to draw a balance. If it is a major problem, then the audit committee needs to get involved." Hall is also the former chairman of the board and CEO of **Ashland**.

Boards are also having those responsible for oversight of a significant deficiency, known as the process owners, formally meet with the audit committee and explain the deficiency they are responsible for, as well as what needs to be done and when it will be resolved.

But the concern is that bringing in the process owner every time there is a significant deficiency might be overkill. Instead, some directors prefer to draw the line at a material weakness or a significant weakness that has a good chance of turning into a material weakness.

Audit committees are also conducting separate executive sessions with the external auditors (which is already required by SOX), the internal auditors and financial management, according to the report.

These sessions are very helpful, because they allow the audit committee to have a detailed and candid discussion about how the others are performing.

"During one executive session, we had an external auditor—a Big Four firm—tell us that they didn't think the internal auditor had the required level of technical competency," says **Marilyn Seymann**, a director at **Beverly Enterprises** and two other public companies. "In that situation, you fire the internal auditor or find someone strong enough to be on top of them. Then you take a hard look at your internal audit function." Seymann is also associate dean at **The College of Law at Arizona State University** and a founding partner of the **The Directors' Council.**

Some audit committees are having management and the external auditors meet at the end of the compliance process to identify lessons learned. They then jointly present their findings to the committee.

But there is concern among some directors. For one, audit committees are spending too much time on compliance and need to get back to accounting, some directors argue. Further, they say audit committees need to focus less on rules and procedure and more on principles.

"We are up to our eyeballs in rules," notes **Frank Popoff**, former CEO and chair at **Dow** and a director at **American Express**, **Qwest** and **United Technologies**. "But let's be candid. The underling issue is compliance. It's the exercise of judgment at the committee level. It's not going through a checklist and saying, 'I've done my job.' The Holy Grail should be adherence to principles." ■

"In the cases I've been involved in, we have insisted that even those relatively minor deficiencies be brought to the attention of the audit committee."

DENNY BERESFORD, Audit Committee Chairman, Legg Mason, MCI

TAX WORK *(continued from page 1)*

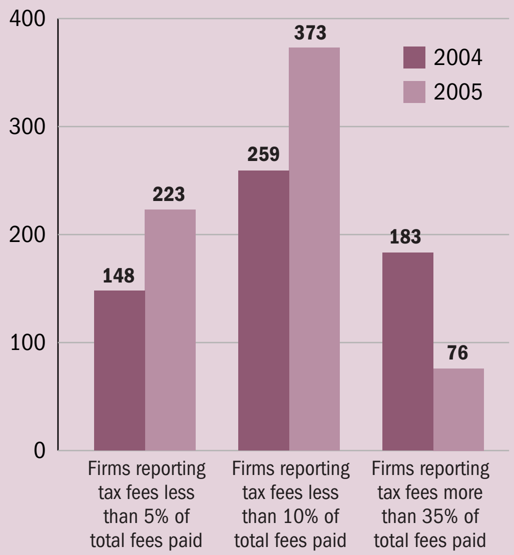
firm do audit and tax work, it's a question of perception, she says.

"Hiring the independent auditor to perform services other than the audit or audit-related work is an easy issue for activist shareholders to point to," she says. "Audit committees have a lot of work to do and they take that work seriously. They don't want to be second-guessed; therefore, some committees may take the issue of tax services off the table."

Still, Peters and many other directors argue that while they can see why firms are concerned about shareholders' perceptions, there is a benefit to having a single firm handle both audit and tax services.

In fact, of the three companies Peters serves as a board member, only Merrill Lynch decreased the amount of money it paid to its auditor for tax services. It paid $8.9 million to its auditor last year, down from $9.5 million the prior year. In the same period, Northrop and Deere paid a respective $600,000 and $100,000 more to their auditors for tax services rendered.

Tax Related Audit Fees Drop Sharply in Fortune 1000



Note: A total of 920 firms reported fees for 2005 compared to 931 in 2004. All companies are in the Fortune 1000 and exclude private companies.

Source: The Corporate Library

Mike Cook, a former CEO for **Deloitte and Touche** who serves on the boards of **Comcast**, **Dow**, **HCA**, **Rockwell** and **International Flavors**, agrees that it's best to have the same firm perform tax services and the audit. "I see no conflict. It's not in the company's best interest [to separate the jobs], and it does not lead to a better-quality audit," he argues.

Cook notes that a lot of knowledge of tax compliance, federal and state regulations and international returns is enhanced in preparing tax returns. All the boards Cook serves use the same firm for audit and tax services.

Those benefits notwithstanding, Kirk believes it's a battle not worth fighting.

"I think you could reach a conclusion that there was a very valid reason to not separate the two," he says. "Having said that, you still run the risk... of shareholders or independent groups having to get as comfortable with your reasoning behind that as you are and devoting the extra time and energy to explain that."

Last year many large institutional investors, such as **CalPERS**, pressured companies not to allow their auditors to perform any non-audit services. CalPERS had a bright line test and was withholding votes for directors on audit committees of companies where the same audit firm was performing any tax service.

Rather than land on shareholder groups' blacklists and face the negative PR associated with shareholders' withholding votes, a growing number of boards are electing to acquiesce on splitting audit and tax services.

Efforts to split the two functions will be further helped by new rules due out in a few months from the **Public Company Accounting Oversight Board** (PCAOB). The rules proposed by the PCAOB in December—which Cook says are likely to be adopted—ask that the audit committee provide detailed disclosure of proposed tax services, and that it consider potential effects on the firm's independence. Certain specific tax services, such as tax planning for executives would be prohibited by the PCAOB.

The change comes as the debate over this issue has shifted. CalPERS has backed off from its demands for a complete separation of the two functions. "We wanted to be consistent with what the marketplace is looking at and the rules set forth by the PCAOB," says **Brad Pacheco**, a spokesman for CalPERS. "We still have concerns with the amounts of non-audit services and will be talking about it with companies behind closed doors, so that's not off our radar screen."

Cook agrees that boards should be aware of the issue and have limits on the amount of non-audit fees paid. "We should be sensitive to the amount of fees in relation to the amount paid for the audit, he says" If more is spent for tax work than on the audit, he says, there's an optics issue. This is in line with the view of **The Corporate Library's** senior analyst **Paul Hodgson.** "It's not necessarily a problem unless they are paying the auditor for other services that cost more than audit services," he says. "As long as the work is not that valuable to them that they can afford to lose it, it's not a problem." ■

PREMIUM OPTIONS *(continued from page 1)*

plans," says **Ira Kay**, national director of compensation consulting at **Watson Wyatt**.

Big institutional investors like **CalPERS** have been increasing pressure by conducting campaigns against targeted comp committee members of companies with the worst compensation practices, as well as advocating greater transparency and disclosure.

Premium plans are also more attractive for top executives now because of the new expensing rules. "In the new accounting environment, premium-priced options will have an advantage because you will get a lower Black-Scholes value than fair value options," says **Jan Koors**, managing director of compensation consultancy **Pearl Meyer & Partners**, referring to the model used to value options.

"At the same time," she notes, "the accounting advantage may be offset because companies will have to grant more of the premium options to make executives feel whole. The trick is to issue enough to satisfy executives while at the same time not increasing dilution so much that it becomes an issue with shareholders."

Federal Signal, Computer Associates and Polaris join the ranks of a handful of companies that already use premium options, such as **Colgate-Palmolive**, **Chubb**, **Tyco International** and **IBM**.

A total of 5.6% of the S&P 500 either applied some form of performance condition to options in the latest fiscal year or plan to in the current one in 2005, according to independent governance research firm **The Corporate Library**. That's a jump from the 1% of companies awarding stock options with a performance condition in 2001.

There are three different contexts for the recent round of premium option grants—a need for retention at Computer Associates during some rocky times; a new CEO at Polaris to whom the board wanted to provide incentives; and a turnaround at Federal Signal.

Computer Associates granted options on April 11 to 10 executives at a stock price that is 20% higher than the stock price on the date of grant. Computer Associates' stock price has already recovered and its worst days are behind it after years of lawsuits and investigations, according to fund data and analysis firm **Morningstar**. The shareholder and Erisa class action suits were over accounting issues. Observers familiar with the company's thinking say that the options were granted to retain key executives.

While it will use the premium options for fiscal 2005, Computer Associates will no longer use them for fiscal 2006. The company will instead implement a long-term incentive program made up of restricted stock, restricted stock units and performance shares tied to performance targets related to billings growth and revenue growth.

Polaris, the $1.8 billion snowmobile company, granted stock options to its newly promoted president and COO, **Bennett Morgan**, on April 11 with a 15% premium over the stock price on the date of grant. "It incentivizes the management, so it's a shareholder-friendly practice," says **Tom Goetzinger**, associate director of Equity Research at Morningstar.

Federal Signal on April 27 granted options to its chief executive at an exercise price 12% higher than the stock price on the date of grant. The company is in the midst of a turnaround after restructuring and management changes, and recently suffered a hit to its stock price.

"Premium options [for top executives] are a very effective incentive in a turnaround," says **Paul Hodgson**, senior research associate at The Corporate Library.

However, Federal Signal CFO **Stephanie Kushner** cautions against "over-interpreting" the reason for the grant, saying it was prompted by a "mechanical" issue rather than the turnaround. "The practice was unique to that particular grant, and the company is not planning on changing its normal practice of issuing grants at market value," she says.

All three companies are using the premium options to supplement other stock grants. This creates a situation where there's a kicker for superior performance. While a top executive cannot control a company's stock price, it is an incentive for getting the most shareholder value, since if the stock outperforms they get extra compensation.

Why not issue premium options alone? That might create retention or recruitment obstacles. Historically most pay packages do not include premium options, so it's harder to make the pay package competitive for recruiting purposes, according to comp consultants. It's not first on the list for most companies, but rather on the list of alternatives, they say. By using a mix of premium and other types of options, companies can improve retention.

But comp consultant Kay notes that as part of an overall portfolio, premium options send a bullish signal about the stock. Kay advises $58 billion multi-industry **Tyco International**, which for the second year in a row offered premium stocks to the CEO. *(continued on next page)*

> **"The accounting advantage may be offset because companies will have to grant more of the premium options to make executives feel whole."**
>
> JAN KOORS, Managing Director, Pearl Meyers & Partners

(continued from previous page) The compensation consists of restricted stock and three tranches of premium stocks at three rising stock prices.

Premium options are not likely to be extended to executives beyond the very top tiers. That's because the rank and file hate them, according to **Yale Tauber**, principal of **Independent Compensation Committee Adviser**. Lower-level employees have little impact on the stock price and discount the options' value in their minds.

The new expensing rules create an additional disincentive to go beyond the top brass. "In the new accounting environment you would not ideally want to have a fixed expense for something that may deliver little or no value. And to the extent that the option already is underwater, you are increasing that likelihood," says **Dan Ryterband**, managing director of **Frederic W. Cook & Co.** ■

▶ Special Section

Shareholder Activism

SHAREHOLDER DEMANDS *(continued from page 1)*

Investment Services, a shareholder activist group, recently withdrew a greenhouse gas resolution after Ford agreed to issue a first-of-its-kind environmental report.

At the $14.3 billion energy company **American Electric**, a shareholder activist group submitted a proposal asking the company to make certain disclosures related to environmental issues. The directors not only agreed with the proposal, they told the group it would be done in six months.

"Well, they were astounded," says **Les Hudson**, who is on the board at **American Electric** and **American National Bankshares**. "But in the end, it served the company well, served shareholders well, and we got a lot of positive press over it."

So what is behind the détente?

One reason, boards are being more careful about picking their battles. Some directors see this trend as simply a matter of keeping their powder dry and ready for the issues that really matter. Anything that would negatively affect a board's ability to recruit a new CEO, for instance, will be fought tooth and nail.

But at least regarding election issues, many directors reason that majority elections, annual elections and poison pills are not as important as other issues. Almost all directors win by a majority of the votes, and there are other ways besides poison pills to defend against hostile takeovers.

"I have talked to lots of directors who feel they want to save their ammunition for things they think are going to be crucial for the company," says **Karen Horn**, a director at **Eli Lilly**, **Georgia-Pacific** and **Simon Property Group**.

Meanwhile, directors who do not heed the will of shareholders, or at least hear them out, are playing a dangerous game. If resolutions continually receive a majority vote and directors fail to address them, they will start to rack up withhold votes. Eventually, they are risking a proxy fight that they could lose.

"Dissident slates can win," says **Pat McGurn**, executive vice president of **Institutional Shareholder Services**. "You better co-opt their core issues, because if you don't they are going to get a lot of voting support. These days it is literally settle, co-opt or die."

Other directors also see this as a slowly evolving change in attitude. "Some shareholders in the past who have proposed changes in corporate governance were viewed as gadflies, and their changes didn't make much sense," says **Tom Everhart**, a director at **Agilent**, **Hughes Electronics** and **Raytheon**. "While there are arguments for and against any proposal to change corporate governance, corporations are trying to weigh legitimate shareholder proposals more objectively." Everhart previously served on the boards at **General Motors** and **Hewlett-Packard**.

Dissident groups say they've noticed a change in attitude, too.

"There are more companies showing a greater willingness to consider, and having less hostility toward, our resolutions," says **Bruce Freed**, co-director of the **Center for Political Accountability**, which advocates increased corporate transparency, among other issues. "We are very pleasantly surprised."

Another factor has been a general shift in how many board members see their role. More board members take shareholders into consideration, says **Warren Batts**, chairman at **Methode Electronics** and retired chairman and CEO of **Tupperware** and **Premark**.

"Reality is setting in that directors are supposed to be the shareholders' representative, and that we cannot ignore them just to favor management all the time," says Batts. Batts also served on the boards at **Allstate**, **Sears** and **Sprint** and is a director with the **National Association of Corporate Directors**. ■

SHAREHOLDER ISSUES

Directors Reach Out to Investors on Climate Change

IN JANUARY, **Unocal**'s vice chairman of the board, **Jack Creighton**, met with **Christian Brothers Investment Services** and other nonprofit advocacy groups in New York City to discuss greenhouse emissions.

The meeting marked the first time a board member was involved in discussions on this issue. Christian Brothers asked for board-level or CEO engagement, and got it. A shareholder resolution asking for a comprehensive report on the business risks of climate change has since been withdrawn.

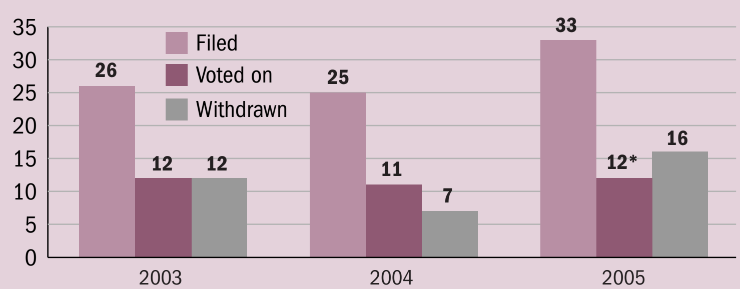
"We need to make sure that nonprofits and public interest groups are aware that the issues that they are concerned about are from time to time discussed at board and committee meetings, and that the company takes these issues seriously even if our positions are sometimes not totally positions that they advocate," says Creighton, who heads Unocal's social responsibility committee and is former CEO of **Weyerhaeuser** and interim chairman and CEO of **United Airlines**.

The result of growing shareholder pressure, this is part of a larger trend toward conciliation and dialogue at the board level with investor groups on climate change. In fact, a record number of resolutions were filed this year on climate change. A record number were also withdrawn—16 this year, compared to seven in 2004—according to the **Investor Responsibility Research Center**.

Mindy Lubber, head of the **Coalition for Environmentally Responsible Economies (Ceres)**, a coalition of investors and environmental groups, says she has met with about two dozen board members of Fortune 500 companies in the past 18 months. All of them agree that it's their job to assess the financial risk of climate change for their companies. That's double the number of directors that she met with in the previous 18 month timeframe, she says.

U.S. Global Warming Shareholder Resolutions

A record number of shareholder resolutions were filed this year on climate change, and a record number withdrawn.



Average Support: **14.3%** **17.1%**

**Number expected to come to a vote this year. Five resolutions were omitted by the SEC or were not in the proxy.*

Source: Investor Responsibility Research Center

"They are definitely more interested... We have been working very closely with independent board members at a number of companies to educate them on the climate risk issues and questions," says Lubber.

Several factors are motivating this new responsiveness. More companies are accepting the science of global warming and the eventuality of controls of carbon emissions; the Kyoto Protocol was put in effect, which includes all the major industrial countries except for the U.S. and Australia; and there is increasing domestic pressure for regulations on a state and regional level, in the absence of federal action, according to **Douglas Cogan**, deputy director of social issues service at IRRC.

Against this backdrop, the catalyst for companies to address this issue has been shareholder pressure.

Just in the last few months, a resolution was withdrawn at **Ford Motor** by Christian Brothers Investment Service and Ford agreed to issue a comprehensive report on climate change. Leading the discussions is a Ford vice president who will bring the board in at an appropriate time and involve them in the process, according to **Irv Hockaday**, who serves on the board of Ford.

"The concept of the report, as I recall, originated with management, but the board was made aware and supported the idea," says Hockaday. While the shareholder resolution asked for a report with certain features, its contours are being worked out by management in dialogue with shareholders. Hockaday is former CEO of **Hallmark** and also serves on the boards of **Crown Media Holdings, Dow Jones, Sprint, Aquila** and **Estée Lauder.**

▶ Special Section

Shareholder Activism

On its most recent proxy, Ford had a shareholder resolution to get it to lower its greenhouse emissions. The board recommended that shareholders vote against the resolution and said it is currently taking measures to work with shareholders on lowering the emissions.

Meanwhile, **JPMorgan Chase** in April agreed to shareholder demands and announced it would "work with clients to develop new financial products that facilitate emissions reduction, conduct research into the financial implications of the rising cost of carbon, and deploy investment capital to businesses that reduce or mitigate greenhouse gases." **Citigroup** and **Bank of America** have already announced similar policies.

And in May, General Electric's **Jeff Immelt** announced a new strategy to identify carbon-reducing technologies as a new opportunity for the company. Wilson says that is creating new momentum on cutting back greenhouse emissions.

The pressure from investors continues to grow. In a recent meeting at the United Nations, 29 leading institutional investors joined to push companies, Wall Street and regulators, such as the SEC, to take specific actions to spur more disclosure and analysis about climate risk. That included **CalPERS** and **CalSTRS** which represented \$3.2 trillion in assets, according to Ceres. ■

■ BOARD STRUCTURE

Johnson & Johnson Agrees to Talks on CEO-Chair Split

▶ Special Section

Shareholder Activism

JOHNSON & JOHNSON, the $47.3 billion pharmaceuticals company, has agreed to enter negotiations with shareholders over their proposal to separate the chairman and CEO positions.

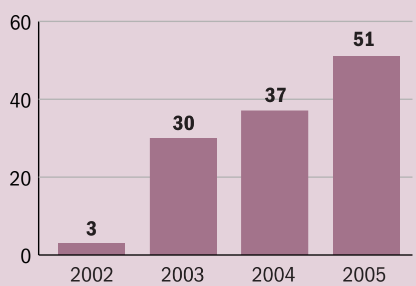
After receiving the proposal, **Bill Weldon**, Johnson & Johnson's CEO and chairman, agreed to sit down with the **Interfaith Center on Corporate Responsibility**, the shareholder group that filed the proposal. The small, informal meeting took place at Johnson & Johnson's headquarters, according to **Dan Rosan**, a director at ICCR.

While the issue has yet to be resolved, ICCR has withdrawn its proposal as an act of good faith.

"What we really need is somebody in the company who will look five years or seven years down the road and say, 'Where do we want the company and the health system to be?' rather than someone who will look at the quarterly or weekly sales and earnings forecast," says Rosan. "[The latter is] what CEOs do."

Johnson & Johnson's decision to sit down with ICCR may prove to be a smart move. Recent proxy votes at other companies show that proposals to split the chairman and CEO roles are gaining support among shareholders.

Shareholder Proposals Requesting a Change in Board Leadership



Source: Investor Responsibility Research Center

"Investors still are not satisfied that independent board leadership is realistic if the chair and CEO is the same individual," says **Carol Bowie**, a director in charge of governance research with the **Investor Responsibility Research Center**. "Investors are demanding accountability, of both executives and directors. Separating the positions is another aspect of attaining that in many people's minds."

And it's getting to be much more common. According to Investor Responsibility Research Center data, 35% of S&P 1,500 companies had separate chairs and CEOs in 2004, up from 30% in 2003. Eleven percent had an independent chairman, up 9% from 2003.

A variety of companies have faced shareholder efforts to split the roles, and the issue is gaining strong shareholder support. At **Boeing**, a shareholder proposal to separate the functions of chairman and CEO garnered 25% approval. At **Textron** shareholders approved the same proposal by 51.4%.

The measure has appeared on a number of proxies for pharmaceutical companies including such firms as **Wyeth, Pfizer and Merck.** Shareholder proposals at those companies received 39%, 41% and 50% approval, respectively. Shortly after its annual meeting, Merck handed over the chairman job to three independent directors who sit on the executive committee.

But while the ranks of companies with a separate chair and CEO are growing, some directors say the change is being made largely to appease shareholder groups, not to address a substantive conflict of interest.

Sometimes that means sitting down to hear a shareholder group. The directors at Johnson & Johnson, for instance, disagree with ICCR's position that a CEO is overly focused on the short term.

"It is an incorrect understanding of what happens in the real world," says **Jim Cullen**, the presiding director at Johnson & Johnson. "It is incorrect to assume that the CEO is so focused on tomorrow's stock price and next quarter's earnings and all the day-to-day matters that he or she is unable to focus on long-term strategy." Cullen is also the non-executive chair at **Agilent Technologies** and a director at **Prudential**.

Another point of contention between shareholders and directors is some activist groups' belief that it is inappropriate for the board—whose main function is to oversee the CEO—to be chaired by that very individual.

"A combined chair and CEO who winds up in such a powerful position that he or she will dominate the board is not today's reality," says Cullen. "If you turn back the clock 10 years, that was closer to the way things might have worked then. Today, no responsible public company board that is earning its compensation and representing its shareowners will ever allow that to happen."■

Hedge Funds Flex Corporate Governance Muscle

DUE TO A TREMENDOUS rise in assets and influence, hedge funds have become the new kid with a big stick on the governance block. The lightly regulated investments have been flexing their muscles and making their power felt all the way up to the boardroom.

▶ Special Section

Shareholder Activism

Hedge funds helped **Carl Icahn** win his proxy fight at **Blockbuster**, and **OfficeMax** recently prevented a proxy contest after agreeing to **K Capital**'s demands to appoint an independent director. The **Kmart/Sears** merger was driven by **ESL Investment.** Conversely, **Deephaven Capital Management** is trying to defeat the **Verizon-MCI** merger via a proxy fight. And **BKF Capital Group**'s shareholders just voted to support the dissident slate put forth by **Steel Partners II** by a two-to-one margin.

"When they want something done, have a large position and don't get it, they go in and say, 'We are going to put some of our friends on the board,'" says **Dan Dalton**, a founding director of the **Institute for Corporate Governance** at **Indiana University's** business school and a director at **First Financial Bancorp**. "You now see four or five of them getting together and making $8 billion, $10 billion, $14 billion deals and spreading their risk. That is unheard of."

Hedge funds have an estimated $1 trillion to invest, and many of their strategies are based on arbitrage and short-term price fluctuations. Those tactics are often at odds with the long-term health of a company.

Not surprisingly, that raises some concerns among board members.

"Private equity is behaving the way merchant banks did in the '20s," says **Joseph Bower**, a director at **Brown Shoe** and **Loews**. "They have large blocks of capital and are using it to pursue profitable opportunities. Some of it looks like rape and pillage, and most people don't like being vulnerable to this type of active capital market. It is terrifying."

This puts directors in a bind. Hedge funds are investors with the power to vote and are willing to use this power to their advantage. Many hedge funds, however, will move on once they turn a quick buck, leaving the long-term shareholders holding the bag.

"It does concern me when the goal of activism is to try and make transactions and acquisitions very easy to happen," says **Karen Horn**, a director at **Eli Lilly**, **Georgia-Pacific** and **Simon Property Group**. "Directors already have a lot of pressure with having to consider the long-term versus short-term interests of the company. It does worry me if some hedge funds have a disproportionate voice when their interests might not coincide with those of other shareholders."

Yet some directors are not overly concerned about this dilemma and do not distinguish between investor groups.

"I personally do not feel their impact on the boards or companies I serve," says **Reg Brack**, a director at **Interpublic Group** and **Quebecor** and former chairman and CEO of **Time Warner**. "I know they are there, but shareholders are shareholders, whoever they may be, Aunt Minnie or **Long Term Capital**."

While not all hedge funds are in it for the short term, not taking a hard look at who owns the shares and what their interest might be can be dangerous.

"Saying 'I don't care who owns my shares' is a somewhat outdated approach to how the markets are working," says **Kevin Cameron**, president of the influential proxy advisor service **Glass Lewis & Co**. "The market dynamic has changed significantly. It is not like there is **Warren Buffett** and a bunch of happy retirees. It is Warren Buffett and some guy who is going to be out of your stock in two days and is just trying to play some small convertible arbitrage event."

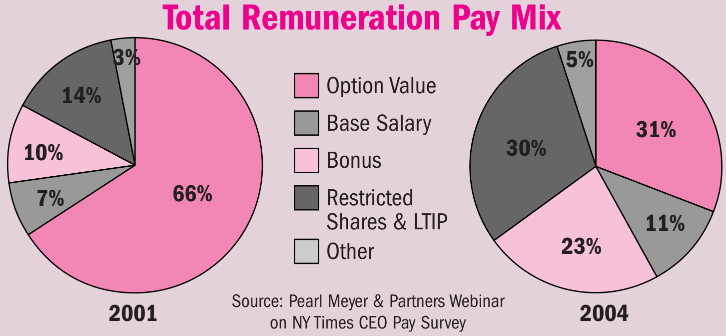
To protect themselves, some directors are planning their strategy very carefully, keeping a close eye on who owns shares and avoiding making the company an easy target for a predatory hedge fund.

"I've been in situations where the board was planning an event that might have attracted the hedge funds had they known about [it]," says Bower. "But we had two, three years of board discussion about what we were trying to do and planned very carefully so as to keep things quiet. It's like sailing and bad weather. You plan for it, you get forecasts and then sail so that you can avoid it. If you get caught, you can try to run before the storm." ■

Options Expensing Forces Shift in Compensation

EXECUTIVE COMPENSATION is changing as companies seek alternatives to granting stock options. Increasingly, compensation consultants say, companies are relying more on supplemental retirement benefits and less on stock options.

"We've been hearing a number of reports on the increased use of pension funds to augment salaries," says **Alyssa Mchold Ellsworth**, a spokeswoman for the **Council of Institutional Investors**, an organization of large public, labor and corporate pension funds.



Source: Pearl Meyer & Partners Webinar on NY Times CEO Pay Survey

A greater reliance on retirement benefits to compensate top executives has several benefits. For one, supplemental executive retirement plans and other forms of retirement benefits are invaluable in retaining top talent. "It's a good idea if the executive owns a significant part of the company, say 3% or 4%—and therefore can retire whenever he or she wants—and the company wants the CEO to stick around," says **Pat Haggerty**, a compensation consultant at **James F. Reda & Associates**.

Companies are unlikely to disclose their reasons for increasing an executive's SERP, so the companies that have employed the retention tactic is hard to determine. But Haggerty says it's been a topic at several compensation committee meetings. He knows of at least one Fortune 1000 company that's restructured compensation to offer a better retirement payout.

Another factor behind the shift in compensation is the impending deadline that will require companies to expense stock options by Jan. 1. Despite the requirement, options still represent an average of 31% of a CEO's total remuneration, according to a **Pearl Meyer** study of 200 companies with median revenues of $11 billion. Options remain the largest portion of their compensation, although their use appear to be on the decline.

"The changes in how we are required to expense stock options have led many organizations, including ours, to look at their overall executive compensation plans," says **Patricia Langotti**, a member of the **National Penn Bancshares** board. "I don't know that it has specifically driven retirement plan changes or enhancements, but I definitely agree that changes in how options are required to be expensed have led us to rethink our whole executive compensation plans."

That's welcome news to some executives, who are eager to diversify out of option-heavy plans.

"I'm working with a client at a very hot company who, on paper, has a $12 million gain in his stock option plan," says **Mark Lipis** of **Lipis Consulting**. "He's saying that this is such an overwhelming component of his personal portfolio that he'd be willing to give up some of that gain and swap it for something else that would allow him to put eggs in more baskets."

Such an exchange would offer the company some benefits, too. Putting more options back into the pool makes shareholders happy, since it reduces dilution. Plus, lowering the number of shares outstanding can be helpful if a company is planning acquisitions.

Of course, the exchanges would also result in income statements with fewer stock options, which, as of Jan. 1, will count against earnings calculations. Many board members are likely to find that compelling.

There's a huge downside to awarding greater retirement benefits over options, though. Unlike stock options, retirement payouts usually aren't performance-based and therefore don't align the CEO's interests with shareholders'. In fact, pension benefits have become the latest target of shareholder groups for that very reason.

Lipis also cautions that allowing executives to exchange options for retirement benefits may do more harm than good. The financial benefits of awarding fewer stock options may not be worth what it costs to issue extra pay in the form of SERPs.

"For the most part, a dollar into a deferred compensation arrangement is going to cost the company a dollar," he says. "A dollar of a stock option may only cost the company 30 cents because of the way the option valuation models work."

Moreover, the company will have to account for the additional expense when it reissues the forfeited options to someone else, Lipis says. ■

More Boards Formalizing CEO Evaluation Process

A MORE FORMALIZED CEO evaluation process is catching on with many boards. It's called the "dashboard," and consists of a graphic distillation of a metrics-based approach that can be represented on a single screen or page.

Those metrics consist of soft criteria such as "How well established is your management succession plan?" and "How much are you learning about new markets?" Some directors think there's a danger of too much emphasis on softer criteria and improvement rather than on firm performance and returns.

Nevertheless, somewhere around 40% of boards are now using soft metrics in the form of dashboards, estimates **Mason Carpenter**, professor of management and human resources at the **University of Wisconsin-Madison School of Business**. Carpenter is currently conducting research on the CEO evaluation process, which has included speaking with 25 directors so far.

"It's moving towards a hybrid from the standpoint that boards are including more of the softer criteria [in addition to firm or stock performance]," says Carpenter. "To do that you have to understand the company better. Boards are more hands-on and more knowledgeable about the organization now."

One reason dashboards are becoming more popular is that there's greater scrutiny of the link between pay and performance. Dashboards allow boards to benchmark performance with ratings year to year that provide evidence of performance beyond stock price, such as strategic planning.

Indeed, nearly three quarters of directors and senior managers say they are under greater pressure to measure non-financial information to judge their companies' performance, according to a recent Deloitte consulting survey.

Another reason is that more CEOs are walking out the door—or being kicked out—so directors want another avenue to provide CEOs with feedback. CEO turnover rose to 120 announced departures in May, more than double the 57 CEO changes announced in the same month a year ago, according to outplacement firm **Challenger, Gray & Christmas**. May marks the fourth consecutive month of 100 or more changes.

Of those that favor the dashboard approach, Carpenter singles out **Mercury Marine**, a division of $5.4 billion boating products company **Brunswick**, as implementing it particularly well.

At that company, the directors grade the CEO on a scale of one to five on 12 criteria, such as managing external relations and the CEO succession process, according to director **Manuel Fernandez.** The questionnaire goes out in the November to December time frame. A median score of all the grades is then calcu-lated.

Then all nine directors receive a spreadsheet of all 108 scores—the ratings that each of the nine members assigns the CEO in the 12 categories—and a chart of the spread. The names of the directors are kept blind, with the governance chair collecting the questionnaires.

"We try to manage the spread on any one question," says Fernandez, who is also the lead director at **Black & Decker** and serves on the boards of **Flowers Foods**, **OpenNetwork Technologies**, **Relay Health** and **RealVue Technologies**. "If there's a low spread, everyone thinks the same, while if there's a large spread there are outliers. Where there are disparities among members of the board, the chair of the governance and human resources meet to deal with the feedback of the process and focus on the disparity [in discussions] with the CEO."

Andrew Policano, who serves on the board of $210 million industrial materials company **Badger Meter**, agrees on the importance of softer criteria. "We do a survey of the key executives in the organization, we do a survey of the board and we do a careful evaluation," says Policano. "'Is he communicating well internal and externally?' is one question we ask… It's a way to give feedback to the CEO."

Feedback to the CEO is one reason why one of **Dennis Beresford**'s boards recently adopted more formal written evaluations that incorporate softer criteria such as succession planning. "The whole process is more one where CEOs want to get feedback and the board wants to provide something beyond 'You're doing a great job' or 'You haven't been fired so everything must be good," says Beresford. He sits on the boards of **MCI** and **Kimberly-Clark**.

While an important advantage of the dashboard is its use of complex indicators, the disadvantage is that it is more open to politics and internal influence, according to Carpenter.

And some directors favor an approach that is more quantitative in its overall emphasis. "There should be enough quantitative data so that a third party can look at that, enough to discern whether the CEO is doing well," says former **National City** governance committee chair and current **Stryker** chairman **John Brown.**

Brown also worries about a potential check-the-box mentality. ■

A CLOSER LOOK

Colgate Aims to Be at Forefront, Adopts Peer Reviews

THE BOARD AT $10.5 BILLION household products manufacturer **Colgate-Palmolive** has joined the rising number of boards conducting peer reviews of its directors.

"We made the decision to have peer reviews because we saw this as a best practice," says **Ellen Hancock**, a director at Colgate. "We knew this was something that some companies were tackling, and we wanted to be at the forefront." Hancock is also on the boards of **Aetna** and **Electronic Data Systems**.

The number of boards conducting individual director evaluations, or peer reviews, is on the rise. According to a **Korn/Ferry International** survey of directors, 37% of boards it surveyed conducted peer reviews last year. That's up from 29% in 2003, and experts expect this number to continue its climb.

"We made the decision to have peer reviews because we saw this as a best practice."

ELLEN HANCOCK, Director, Colgate-Palmolive

What's driving the increase? Judging from the survey's results, it is a combination of factors. Although most boards don't conduct individual director evaluations, most directors feel they should. The same study showed that 79% of directors feel their board ought to regularly review individual director performance.

At Colgate, the board—under the direction of the nominating and governance committee—hired an external facilitator from a well-known consulting firm to assist with individual director evaluations. Participation was voluntary.

The facilitator interviewed each of the directors about their performance and that of their peers who participated in the evaluation. Questions included: "Is the director prepared for the meetings? Does he/she contribute in a meaningful way? Do they fulfill their responsibilities of appropriate review?" The respon-ses were then analyzed by the facilitator and discussed with each board member individually.

Other board members were not privy to the results, because Colgate wanted the evaluations to be purely for self-improvement and not a means of scoring or rating each director.

"We made it clear," says Hancock. "This is not whether you should stay on the board. It can be a problem if, in fact, that information gets socialized."

As boards become more accustomed to Sarbanes-Oxley, they will find more time to conduct reviews, some believe.

"As Sarbanes-Oxley becomes more routine, board self-evaluations are going to be the next big thing," says **Laurence J. Stybel** of **Stybel Peabody Lincolnshire**, a firm that specializes in assisting with board evaluations. "The train can only move in one direction."

Currently, the majority of boards grade their board or committee performance as a whole. Indeed, 81% of boards did group evaluations in 2004, up from 65% in 2003, according to the Korn/Ferry study. This type of group evaluation is required by the New York Stock Exchange and is considered by **Morningstar** and **CalPERS** when examining a board's fidelity to corporate governance.

As peer evaluations grow in popularity, boards are tailoring the reviews to fit their specific needs. Unlike Colgate, not all boards keep the results of their peer reviews confidential.

For instance, at **Hillenbrand**, a $2.1 billion medical products and equipment manufacturer, one of the purposes of the peer-review process is to help determine when a director should leave the board, according to **Ray Hillenbrand**, chairman of the board and governance committee. The directors fill out a questionnaire and send the results to **Towers Perrin**. Eventually, the evaluations are reviewed by the governance committee, and then the chair of the governance committee meets with the individual directors to discuss both their evaluation and strategies for improvement.

The chair of the governance committee at **Chiquita**, a $3 billion food company, interviews all of the directors and the CEO about the other directors, says **Rod Hills**, a member of the governance committee at Chiquita. He then decides if there is a need to share the information with a particular director.

PerkinElmer, a $1.6 billion scientific, photo and control equipment producer, has a similar process. There the lead director provides constructive criticism and coaching to individual directors when the peer evaluations turn up concerns or areas for improvement.

A major worry among directors is that a potentially damaging peer review could wind up in the hands of an attorney representing a disgruntled shareholder. At Colgate, the third-party facilitator generated all the written materials relevant to the evaluations and destroyed them when he was done. Since these materials were produced by a third party, they were not subject to Colgate's document retention policy. Thus, their speedy destruction did not pose a problem.

Overall, Hancock says the peer review process was an invaluable asset for improving the efficiency of the board. She notes that she is studying the benefits of the program with an eye on sharing her experience with others.

"What I learned at Colgate, hopefully, I'll bring to my other three boards," she says. "If you are on multiple boards, you can take this experience and bring it to others." ■