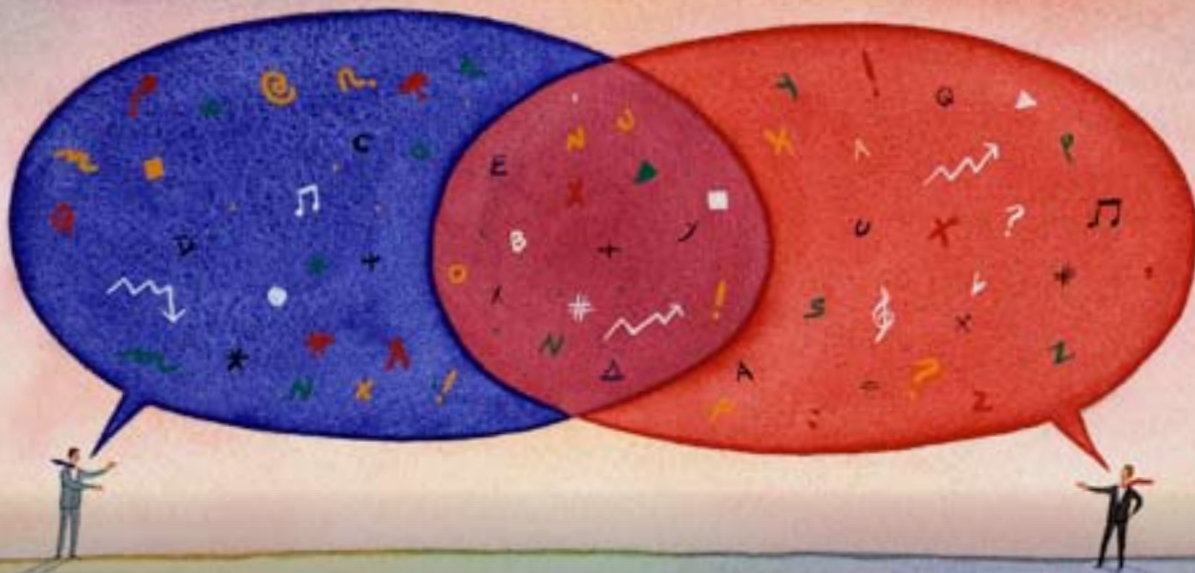


Boardroom Briefing

A publication of Directors & Boards magazine

Board/Shareholder Communications



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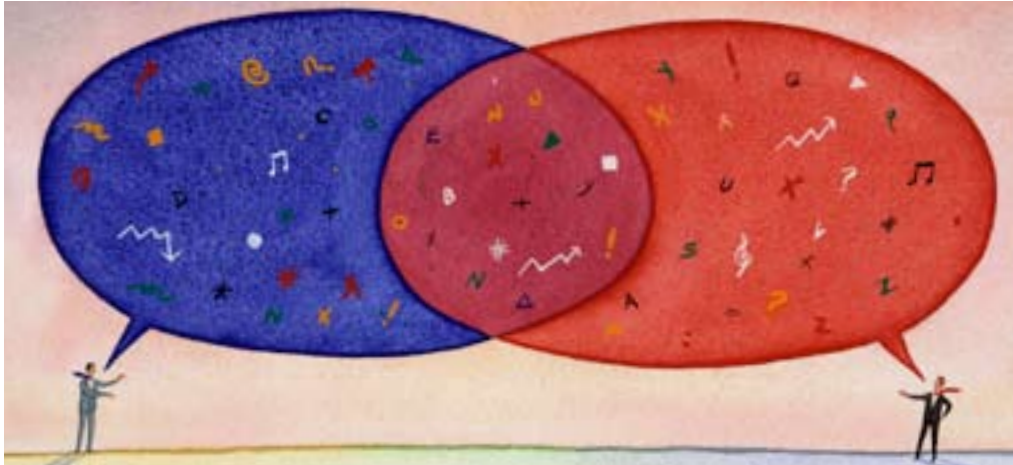
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Boardroom Briefing: Board/Shareholder Communications

By James Kristie

A time for rethinking tradition and best practices for how boards 'meet' with shareholders.



James Kristie

I got cornered not long ago by a reporter for a major news service agency, who demanded to know, “Why don’t directors speak to the press?” If the board is supposedly representing and

looking out for the shareholders, he reasoned, and shareholders want to know what’s going on with their investments—what’s happening in the company—then why don’t directors make themselves available to the media as a proxy for speaking to their shareholders?

This would be particularly true, he further argued, in a crisis situation or other fast moving scenario when directors could play a vital role in reaching out to their investor base with some counsel from on high.

I had an answer for him, but it wasn’t one that he wanted to hear. The traditional position is that a corporation should speak with one voice—that voice being management’s, not the board’s or any individual director’s. I suggested that it might be counterproductive to have eight or 10 or 12 individuals sounding off on vital corporate matters. And what if certain individuals on the board had their own agenda to promote? “Loose cannons,” anyone? No, I countered to my media colleague, rather than greater clarity for shareholders, confusion could reign.

Directors & Boards has been on top of the board/shareholder relations issue throughout its 29 year publishing

history. In one of our most direct explorations of the topic, 10 years ago we published a classic advisory, “Should Directors Meet with Shareholders?” (Winter 1996). The author was Michael Miles, former chairman of Philip Morris Cos. Inc., who was sitting on several Fortune 500 boards. (One of those boards was Dean Witter, Discover & Co., which subsequently became Morgan Stanley—a board seat that has been a hot one for Miles and his fellow board members this year as they dealt with a bitterly fueled succession crisis.)

“Shareholders,” Miles advised at the time, “have the right to meet with whomever they have a legitimate reason to meet with—be it the CEO, other members of senior management, or the directors of the company.” But, he noted, there is an important caveat to that sweeping assertion:

- “The first condition is that there be a specific, significant reason for the meeting, such as a major question, or complaint, relating to overall corporate strategy, performance, or corporate governance.”
- “The second condition for a director/shareholder meeting is that it should take place only when more traditional channels of communication have been tried and deemed to have failed.”

A not-unreasonable position, and one that Miles soundly defended in a rare view by a sitting board member on such a sensitive issue.

But we’re 10 years on now from that conservative rationale. The landscape for board/shareholder “meetings”—

actual toe-to-toe interaction or multichannel communications—has changed in startling ways. Think conference calling, Web access and delivery of information, a recent array of regulatory and legal guideposts (such as Reg FD), the much wider and deeper pool of share ownership among Main Streeters, the growing assertiveness of Wall Streeters (including hedge funds) to say, “Hey... what are you doing?”

Perhaps it’s time for a new model of board/shareholder relations. Maybe the Miles approach is too timid for the times. Maybe the Kristie answer to the reporter’s query is in need of rethinking.

In that spirit, we welcome you to this Boardroom Briefing on “Board/Shareholder Communications.” This is the fourth in **D&B’s** continuing series of single-focused reports on matters of utmost concern to enlightened board decision making. And look for our final 2005 Boardroom Briefing, on the controversial topic of executive compensation, in December.

We’re pleased to present this report to you in collaboration with the National Investor Relations Institute—whose president and CEO, Louis Thompson, has authored several articles for **D&B** over the years that have kept the board/shareholder relations topic front and center. We trust the advisories in the following pages will further advance the best practices for boards in their role as the shareholders’ advocate.

James Kristie is editor and associate publisher of **Directors & Boards**. He can be contacted at jkristie@directorsandboards.com.

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The IRO: The Board's Key Communications Ally

By Louis M. Thompson, Jr.

Boards have an ally who in years past has only played a marginal role with the board and was rarely in the boardroom.



Louis M. Thompson, Jr.

Corporate boards of directors have always had a duty to represent the interests of the company's shareholders.

Until the corporate accounting scandals that began with Enron and resulted in

Congress passing the Sarbanes-Oxley Act in 2003, boards were for the most part "management's board"—not asking the tough questions and compensating senior executives with large bonuses and stock options even when shareholder value declined significantly.

Boards today recognize the need for independence in order to better represent the interests of the company's owners. Independent directors also recognize the need for unfettered information if they are going to perform their roles properly. To that extent, boards have an ally who in years past has only played a marginal role with the board and was rarely in the boardroom. The ally is the corporate investor relations officer (IRO).

IROs are on the front line when it comes to shareholder relations. No one in the company spends more time tending the interests of shareholders—institutional and individual—than the IRO. From their meetings with analysts and institutional investors, they have a strong sense of what these individuals are thinking and saying about the company. They hear

firsthand the issues and concerns that investors have over the future of the company as well as over current performance. As such, they can be the board's intelligence link with the investment community.

Four Investor Relations Roles

Investor relations officers can play four key roles in the board/shareholder communications process. The first is as a conduit between directors and shareholders. As Roger Raber, CEO and president of the National Association of Corporate Directors (NACD) says, the perspective of the IRO is key to effective board-shareowner relations in two fundamental ways:

- As fiduciaries, who serve the corporation and all of its constituencies on behalf of all shareholders, directors need to understand the goals of their company's shareholders.
- Directors need their company's shareholders to understand their goals as fiduciaries.

The second role for the IRO is board education. This starts with participation in formalized educational programs for independent directors new to the board. But, more importantly, it means providing continuing education for all directors in terms explaining macro events in the market as well as those in the company's industry sector, industry and peer stock performance, insight on why the company's stock performs

the way it does, earnings expectations, analyst activities, and institutional holdings—who is buying, who is selling and perhaps why.

The third role is serving as the corporate conscience—asking the question: what's in the best interest of the shareholders? The corporate secretary may join the IRO in performing this role. An example would be where the company has a board-approved "poison pill" or shareholder rights plan that has been an irritant to some of the larger investors year after year. Over the past two proxy seasons, several hundred companies have terminated their poison pills. We see the same trend with boards moving to annual director elections from classified or staggered boards.

The fourth role is that of communicating with investors to gain support for board/management positions on proxy issues. As the shareholder democracy movement gains momentum, this role becomes even more crucial. However, there are certain barriers to effective communication with the individual investors that need to be overcome.

What the IRO Should Provide the Board

What kind of information can a board expect from the investor relations officer? The following is what Matthew Stroud, vice president for investor relations with Darden Restaurants, Inc., provides in his written presentation:

Market Performance

- Market overview
- Economic commentary
- Industry stock performance
- Darden stock performance
- 3- and 12-month broader market indices of performance

Analyst activities/action

- Research reports
- Initiations/discontinuations of coverage
- Upgrades/downgrades
- Public announcements (quarterly/monthly)

IR activities

- Conferences
- Institutional shareholder activities
- Individual investor shareholder activities

Earnings expectations

- Quarterly
- Annual
- Changes

Institutional holdings

- Holders
- Buyers
- Sellers
- Contacts

Addendum

- Graphs: Stock price of company vs. peer group and broader market indices
- Charts: Competitive stock price performance and market value for 3- and 12-month periods, price/earnings ratios
- Analyst research reports

In Matthew's oral presentation to the board, he provides:

- A partial financial update
- A summary of the written presentation (5-7 minutes)
- Responses to board questions

Key Board/Shareholder Communications Issues

In 1985, Congress passed the Shareholder Communications Act, creating the Non-Objecting Beneficial Owner (NOBO) and Objecting Beneficial Owner (OBO) classification for individuals who owned stock in brokerage accounts—or “street-name” accounts, as they are often called. When individuals open a brokerage account, they have the option of designating themselves as OBOs. The identity of OBOs cannot be revealed to the companies in which they own shares. If a company is willing to pay for it, it can obtain a list of NOBOs, normally through the intermediary Automatic Data Processing (ADP).

This gives the company the ability to communicate directly with their registered shareholders and the non-objecting shareholders who hold stock in street-name accounts. However, companies are prevented from communicating directly with the objecting beneficial owners. We have learned that some 70 percent of individuals who hold stock in brokerage accounts are designated as objecting beneficial owners. Many of these investors have no idea that the company does not know their identity because their brokers may have already checked the OBO box without their knowledge.

The brokerage firms are supposed to request sufficient copies of proxies and annual reports to cover their NOBOs and OBOs and distribute them to these individuals. It is an annual article of faith that the numbers being requested are accurate and that they are being distributed to all of the street-name holders. Absent the ability to communicate directly with these investors, companies are left to communicate the company's position on proxy issues indirectly through their Web site, which of course,

assumes these investors are accessing the company's site for information. A shareholder identification coalition has been formed consisting of the National Investor Relations Institute, the Society of Corporate Secretaries and Governance Professionals, The Business Roundtable and the Securities Transfer Association, for the purpose of getting the Securities and Exchange Commission to change the rules to allow direct communication between companies and their street-name shareholders and to urge the intermediaries to lower their rates for obtaining lists of these investors. Most companies, particularly those with large numbers of individual investors, find the costs prohibitive.

So, why is it so important for companies to communicate with their individual investors when most of the companies' shares are predominantly held by institutional owners? Over the past three proxy seasons, where shareholder proxy proposals have received a majority vote, in most cases the swing vote came from the individual investors!

Enlightened boards of directors recognize that the risks and liabilities that come with being a board member can be mitigated by having quality, unfettered information to use in the performance of their oversight and fiduciary duties. Having direct access to the company's investor relations officer is vital in understanding what is on the minds of the company's shareholders. It is also important that communication is a two-way street and transparency in this process benefits the important board/shareholder relations process.

Louis M. Thompson, Jr. is president and CEO of the National Investor Relations Institute (NIRI). He is an occasional contributor to **Directors & Boards**, is serving his second term on the NYSE Individual Investor Advisory Committee, and also was a member of the Corporate Governance Working Group conducted under the auspices of Harvard University.

Malice in Wonderland

By Norman R. Augustine

A journey through the looking glass of board/shareholder communications.



Norman R. Augustine

“I have never felt better about the prospects for the company,” speaketh Ken Lay, chairman of the board of directors for Enron, a few months before the implosion. And then there were the little surprises offered to shareholders by Rite-Air, Waste Management, Sunbeam, WorldCom, ImClone, Xerox, Tyco, Adelphia, Global Crossing, Computer Associates, Cendant, Homestore and MicroStrategy—for starters. All in all, it has not been a particularly good patch for board’s and management’s candid communication with shareholders. The boards of these companies—not to mention their shareholders—must have felt like the Red Queen in Alice in Wonderland: “...I have believed as many as six impossible things before breakfast.”

The foundation of the free-market system, the system that along with our democratic form of government has made America such a great nation, is that investors should have equal access to accurate information about firms in which they are considering investing, or have already invested, their money. Shareholders place their trust in boards to oversee these firms—so, is it not reasonable that

those same boards should be expected to communicate frequently and fully with the shareholders they have been elected to represent?

Communication: Who’s Responsible?

Unfortunately, it’s not that easy. First of all, the role of the board is to govern, not to manage. It is *management’s* job to manage. In the normal course of business (that is when management itself is not the *subject* of the communication), it should generally be the responsibility of *management*, not the board, to communicate with shareholders. The reason for this is the same reason that ships (at least those still on the surface) do not have two captains. Or worse yet, a dozen captains, as becomes the case if individual members of a board take it upon themselves to speak to shareholders on behalf of the board.

Nonetheless, shareholders should periodically, particularly in time of crisis, hear directly from the board itself. This can best be accomplished by providing a joint letter from the chairman of the board and the CEO in the annual report or as a special report, as circumstances may warrant. It would be a good idea to also routinely include a brief letter from management in quarterly reports, patterned after the letter already included in annual

reports. In those cases where the CEO also serves as chairman, the board most assuredly should identify one of its independent members as a lead or presiding director who could speak on behalf of the board in circumstances where management is conflicted or otherwise compromised. This individual should also be available to handle direct communications to the board from shareholders. Every such communication should be forwarded unopened to the lead director and *every* such signed letter deserves an answer from the lead director or whomever he or she may designate as being appropriate.

But, again, it’s not easy. Consider just four complicating factors:

Shareholders are not the only people who read corporate communications.

So do competitors. Thus, while shareholders have sound reasons to desire a deep understanding of a firm’s strategic plans, it may not be in their best interest for a board to share certain aspects of those plans. The solution to this dilemma is of course for a board to disclose general strategic direction, but to protect the specifics.

That bastion of shareholder communications, the annual meeting, has become a theater of the absurd.

Although in principle such meetings should be the essence of democracy, only a small fraction of shareholders even attend annual meetings. And for good reason. Because of proxy voting, the outcomes of such meetings are all but ordained before they are ever called to order. Further, too many such meetings are dominated by individuals with

“The practice which has evolved in recent decades of having management publicly predict its revenues and earnings has become an invitation to disaster.”

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questions that have little or nothing to do with the firm's affairs. Thus, the shareholders who do attend become the captives of rebels with a cause, unions seeking a fresh venue for negotiating labor agreements, disgruntled employees, and gadflies basking in their moment in the sun.

A far more constructive model would be to have these anachronistic gatherings make the giant leap from the nineteenth century to the twenty-first century all in one bound and invite shareholders to submit by email (snail-mail, if they must) their questions and concerns to the corporation's outside auditor, from which the latter would compile and filter the submittals received and provide a list of questions and concerns to be addressed by management or the board, as appropriate. Management, together with the board, would then post on the Internet (or *via* snail-mail) *considered* answers to each item raised.

Spouting whales get harpooned.

The practice which has evolved in recent decades of having management publicly predict its revenues and earnings has become an invitation to disaster. First of all, there are so many external factors affecting the performance of a complex organization that in most cases management itself does not know with any great precision what the firm's performance will be a year hence. Secondly, such predictions are in essence an engraved invitation for strike-suit lawyers to fund that new yacht they have been coveting.

Ask, for example, Carly Fiorina, late of Hewlett-Packard. Shortly after taking over as CEO she predicted revenue growth for the then-current year of 12 to 15 percent...and earnings growth "faster than that." Buoyed by early results, she changed the prediction to a straight 15%...with "faster" earnings growth. Next was

a prediction for the following year of 15 to 17 percent revenue growth. But when results for one early quarter fell a few cents short of the by-then highly elevated expectations—still not bad performance—the company shed \$24 billion in market cap in just three days.

Then there is the more recent case of Best Buy. The company reported an increase in second quarter earnings of 48%. The only problem was that it was a penny below what the market had been led to expect. The result was an 11% drop in market cap in one day—the largest drop in three years.

Much better to let actual results actually speak for themselves.

The regulatory pendulum has, as often is the case, swung too far in virtually precluding the use of "pro forma" results in communicating with shareholders. Prior to the dot-com-bomb there were few greater sources of abuse than the use of *pro forma* accounting. One quarter Cisco reported earning of \$230 million on a *pro forma* basis, only to disclose a few weeks later for the same quarter a *loss* of \$2.7 billion using standard GAAP accounting. For Amazon, it was a *pro forma* loss of \$76 million, followed a few weeks later by a GAAP loss of \$234 million. As Warren Buffett described it, ". . . the CEO tells his owners, don't count *this* and don't count *that*—just count what makes earnings *fat!*" Unlike the canonical description of Wagner's music—"It's better than it sounds"—most *pro forma* reports were a lot worse than they sounded.

During my service as a member of the Public Oversight Board I was a critic of *pro forma* accounting as it was then being practiced. However, if properly applied it can in fact be a very useful tool in helping a board and a management team communicate to shareholders the true status of their firm's health.

"Properly applied" in this instance includes releasing *pro forma* and GAAP results simultaneously, providing a trace between the two, and adhering to defensible reasoning (e.g., including all costs of sales as an expense item, which was not the case in some past abuses).

The bottom line is that boards have a clear fiduciary responsibility to assure that appropriate information is provided to shareholders—although in most cases it should be the role of management and not the board to actually *provide* that information. Further, fundamental fairness—not to mention the law—requires that *all* shareholders should be provided equal access to information. Finally, that information which is provided should be forthright, accurate and balanced. How refreshing it would be occasionally to find in an annual report, as was actually the case in Berkshire Hathaway's 2002 report, that someone's *pro forma*, after careful consideration, presented an earnings outlook that was *more pessimistic* than the GAAP results (which were also presented). Warren Buffett concluded that the year had been unusual—unusually *good!*

Whatever the case, the days are long gone when a few boards thought they could get away with a communication policy of "Tell 'em *nothin'*...", and tell it *slow!*"

Norman R. Augustine served as President of Lockheed Martin Corporation upon the formation of that company in 1995, and became its chief executive officer, and later chairman. He is currently a member of the board of directors of ConocoPhillips, Black & Decker, and Procter & Gamble and a member of the Board of Trustees of Colonial Williamsburg and Johns Hopkins and a former member of the board of trustees of Princeton and MIT. He is a member of the President's Council of Advisors on Science and Technology and the Department of Homeland Security Advisory Board and was a member of the Hart/Rudman Commission on National Security. He serves as a director of the National Association of Corporate Directors.



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Boardroom Briefing Interview: Theodore Dysart, Jr. and Rob Sharpe

A director and an executive search professional discuss the key internal and external communications skills required by today's board member.



Theodore Dysart, Jr.



Rob Sharpe

What are the key communications skills you look for in a director or director candidate during the selection process?

Theodore Dysart, Jr.:

The real key is that you have someone who understands how to effectively deliver a message. Directors need to be careful listeners and have the ability to express their viewpoint in a concise and coherent manner. One of the most compelling

reasons to participate on a board is to help influence and direct debate. But this does not mean command and control—it is about listening to diverse viewpoints and then helping bring people together toward a common mission.

Rob Sharpe: It's always an art form to strive for consensus while advocating a viewpoint that you strongly embrace. People prone to issuing ultimatums or speaking only in conclusions are seldom going to be part of the solution. And while healthy debate is invaluable in a boardroom, open dissension is seldom helpful. Directors need to be clear in the rationale for their position while at the same time engaging in active listening to make sure they understand the views of all directors. In the end, a strongly held minority view is often a red flag that

“You never want to see something that you said accidentally, printed in *The Wall Street Journal*.”

the issue on the table merits further discussion.

And if we take those skills and apply them to board-shareholder communications, which implies an external inquiry directed by a shareholder to a specific director, what are the implications?

RS: First of all, it's a rare circumstance that would necessitate a director to discuss their company publicly. Absent an agreement among the full board, no individual director should presume to speak on behalf of the board or the business. In addition, taking a public position that doesn't represent the clear consensus of the board risks creating an untenable environment within the boardroom.

That said, in today's environment, it has become more common, and is often actually helpful, for directors to hear directly from investors concerning the company. In such a conversation, it is important to understand and appreciate the position of the shareholder and demonstrate your interest in not just listening, but in actually discussing the issues. It is also important to make sure that you convey an openness to do what's appropriate vs. what's popular. Often

it is easy for investors to conclude that a director is only interested in following the party line. That perception is not helpful to the company or the board. So I think communicating a sincere willingness to listen to shareholders and be their advocate is important. Never forget that, at the end of the day, you ultimately serve at their pleasure, not at the pleasure of management.

TD: I would add that it is important that when directors speak, they speak with a unified voice. Debate is healthy and should be encouraged but that should really only occur internally, within the boardroom. When speaking externally, either one-on-one with a shareholder or in some public format, a common voice and consistent message must be presented. Otherwise you risk having different factions of the boards warring back and forth as well as potential damage to the company.

Lack of what communications skills, especially as they relate to that public presentation, would cripple the effectiveness of a board member?

TD: Knowing when to keep one's mouth shut is a key skill. As one of my mentors once said to me, “You are the master of what you don't say and the slave of what you do.”

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RS: Absolutely agree. Have the discretion and the judgment to take the heat, regardless of whether you feel that your personal position would be better served by replying. You must realize that your public comment will seldom be helpful to resolving a debate or an argument within the board. Also, by letting your fellow board members know that you recognize that you're all in this together, you will often be better positioned to take whatever future action is necessary.

Do different board members require different skill sets? Does the chair of the audit committee have more pressure than, say, the head of the compensation committee?

RS: There is no doubt that—assuming you are talking to an investor—the chairperson of the audit committee is going to receive questions much different from those posed to the chair of the compensation committee. So the skills we are talking about may be less about communication and more about being sophisticated enough to respond effectively to complex questions in your specific area of responsibility.

TD: Directors have to be specialists. You never want to say to a shareholder, “Let me check into the details and get back to you.”

How have developments such as Sarbanes-Oxley and various whistleblower requirements changed the communications landscape for directors and board members?

TD: After the big blow-ups of the various Worldcoms and Enrons, we've seen a notable increase in the frequency of direct board-shareholder interaction as opposed to inquiries routed through management. This necessitates a heightened sensitivity to, and need for, enhanced communications skills on the part of directors.

RS: When an action is taken that is in the best interest of the company, directors have to be prepared to communicate with shareholders. However, it is important to recognize that not all shareholders are necessarily at the same level of sophistication. So directors have to make certain that they can communicate ideas in precise and simple terms, demonstrate that they understand the subject matter, that they care about the individual investor's point of view, and that they can carry that message into the boardroom. What this really boils down to is that the skills of diplomacy have become more important than ever.

Often it is
easy for investors
to conclude that
a director is
only interested
in following the
party line.

So let's say a director gets a letter from a shareholder or institutional investor concerning something that is going on at a company. What's the general sequence of events that such a direct inquiry precipitates?

RS: Clearly it's going to depend on the subject matter. There may be a unique circumstance where the most appropriate action is to discuss the inquiry with your other outside directors as a first step. This might be a situation where, for instance, a letter from a credible source raises issues with respect to the integrity of the CEO. The external directors would then have to make a decision on whether it was appropriate for

them to retain their own counsel. This would be an exceedingly rare, though not unprecedented, situation.

On most matters, my bias would be to inform the chairman and the CEO of the inquiry, make sure that you, as the addressed director, understand all that the company knows about this particular issue and shareholder, and then agree on an appropriate response. This response might come from a lead director, or it may come from the CEO or general counsel's office. The important thing is to make sure that your fellow independent directors know what you're doing and that there's consensus on the appropriate response.

More importantly, since these inquiries will no doubt occur, directors need to have a pre-established procedure on how to handle these matters. It's very healthy that more and more companies have transparent procedures for shareholders to communicate with the outside board members so that these directors can understand the concerns and pressures acting on investors.

How would that apply to more direct, face-to-face interaction, such as when a director is intercepted and quizzed at a public event or other meeting?

RS: This is really a question of discretion and confidentiality, regardless of the setting. Unfortunately, this may mean that you have to make the choice of looking like you are not fully informed so that you don't disclose information that shouldn't be disclosed.

TD: The reality is that, at this level, somebody with the right skills knows how to manage or even dodge questions to which there can be no immediate response. This goes back to the skill of diplomacy. Certainly there are ways to engage on a topic without providing a direct answer.



There are also ways to communicate that the time, venue or environment is inappropriate for having the specific discussion.

What are the principal risks for a director associated with direct dialog with a shareholder?

TD: You never want to see something that you said accidentally, printed in *The Wall Street Journal*. You've got to be sure that you're on message and clearly understand that you do not represent simply yourself but all directors on the board and—by extension—all shareholders and investors in that particular company.

Every person has his or her own moral line that he or she won't cross, and I respect those directors who aren't willing to cross that line. There are occasionally times when directors have to take a stand, and there have been several recent high-profile instances in which directors resigned and then, after the fact, expressed the reasons and concerns behind their decisions. However, if you serve on a board, you have a greater responsibility than your own personal viewpoint.

RS: To me, the primary risk is that you unwittingly do damage to the company by speculating on future actions by the company or your fellow directors. Unless you have a consensus with other directors on

both the substance and advisability of a public discussion of an issue, keep your mouth shut.

Should boards consider installing a lead director for shareholder communications?

RS: If there is an issue around compensation, then the appropriate director to speak is the chairman of the compensation committee. Similarly, if the question is about financial control, the answer more than likely would come from the audit committee chair. I would not advocate that the concept of a lead director be driven by the prospect of shareholder communications.

By the same token, shareholders in this post-Enron world believe they are empowered to ask questions of directors and board members and expect immediate replies. So, if for some reason a board knows that it will have a series of conversations with investors on a contentious issue, it may in fact be useful for the board to have a designated spokesperson. Once established, this spokesperson not only helps assure control of public statements, it gives other directors a logical way to deflect questions.

TD: All you can do is control within your group how you are going to field questions. So, whether it's a phone call, letter or direct one-on-one question, having a pre-defined

structure in place for how you are going to manage the response is the best way to mitigate the risks we've described. A director can always say, "I don't have time to discuss this with you right now. When can I get back to you?" That's always going to be a reasonable way to buy some time and construct a strong answer.

Rob Sharpe is a director of Ameriprise Financial, Inc., a spin off from American Express. Since late 2002, Sharpe has been a partner in the New York office of Brunswick Group, a financial communications firm with offices in seven international locations. From 1998 to 2002, he was senior vice president public affairs and general counsel of PepsiCo, Inc. In 1996 and 1997 he was senior vice president and general counsel of RJR Nabisco, Inc. In 1994 and 1995 he was head of business development for Tyco International and during most of the prior 12 years held a variety of legal positions with RJR Nabisco. He is a graduate of Wake Forest Law School, DePauw University and the Purdue University Engineering School. He has prior board experience on two NYSE listed boards.

Theodore L. Dysart is managing partner of the Americas for Heidrick & Struggles' Board of Directors Practice. Dysart, who joined Heidrick & Struggles in 2001, works exclusively on board engagements. In 2004, Hunt-Scanlon's Executive Search Review named him one of six "executive recruiters to watch." Dysart is a regular commentator on the subject of corporate governance; his comments have appeared in *The New York Times*, *USA Today*, *The Wall Street Journal*, on CNN and CNNfn, as well as in other local and regional publications. In addition to his corporate activities, Dysart serves on the board of the Greenwich Council of the Boy Scouts of America.

The Directors & Boards Survey: Board/Shareholder Communications

Methodology

This Directors & Boards survey was conducted in July 2005 via the web, with an email invitation to participate. The invitation was emailed to the recipients of **Directors & Boards'** monthly e-Briefing, and to the membership of the National Investor Relations Institute (NIRI). A total of 727 usable surveys were completed.

About the respondents

(Multiple responses allowed)

A director of a publicly held company	12.0%
A senior level executive (CEO, CFO, CxO) of a publicly held company	6.0%
An investor relations professional/officer	62.6%
A director of a privately held company	12.6%
A senior level executive (CEO, CFO, CxO) of a privately held company	7.2%
A director of a non-profit entity	13.2%
Institutional shareholder	2.4%
Other shareholder	9.7%
Academic	3.5%
Auditor, consultant, board advisor	7.9%
Attorney	6.6%
Other	6.0%

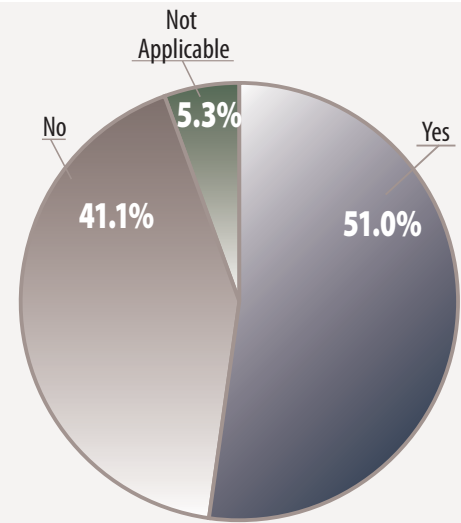
Revenues

(For the primary company of the respondent)

Average Revenues:	\$3.587 billion
Less than \$250 million	31.4%
\$250 million-\$500 million	9.0%
\$500 million to \$1 billion	13.1%
\$1 billion to \$10 billion	35.5%
More than \$10 billion	10.9%

Board/Shareholder Communications Policies and Effectiveness

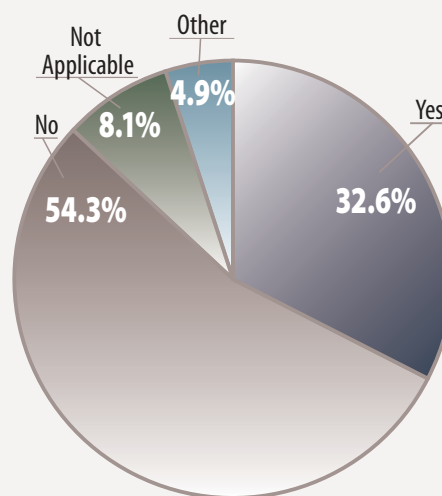
Does your company have a publicly disclosed policy for board/shareholder communications?



Who in your company's management team is primarily responsible for responding to shareholder questions?

Investor Relations Officer/Department	58.9%
CEO	14.4%
CFO	8.8%
Corporate Secretary	4.7%
General Counsel	2.4%
COO	0.5%
Not Applicable	6.3%
Other	4.1%

Other responses included: CGO (Chief Governance Officer), chair of the board, shareholder relations officer (routine SH questions) or investor relations officer (questions re: earnings, stock price, etc.), treasurer



Has your company designated at least one independent director whom shareholders can contact?

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N I R I

National Investor Relations Institute



8020 Towers Crescent Drive, Suite 250
Vienna, Virginia 22182
703-506-3570 FAX: 703-506-3571
www.niri.org

Is there a process in your company for shareholders to contact individual directors?

Yes, via the corporate secretary	38.8%
No Process	31.1%
Yes, a designated director	7.9%
Yes, via other management personnel	6.6%
Not Applicable	7.7%
Other	8%

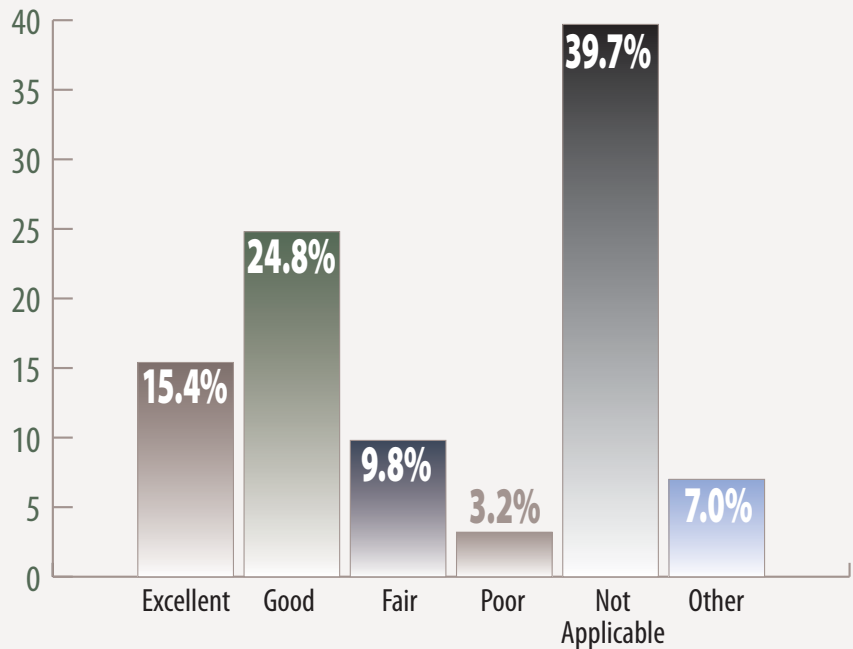
Other responses included: "Yes, at the annual meeting." "Shareholders can contact the board as a group via our web site home page." "Directly via e-mail." "Through VP of Investor Relations." "Via the company's hotline provider. Responses are screened by Compliance before being forwarded to the directors." "They can send messages to individual directors at our website." "Only via the Whistler Blower outlet." "A lead director that anyone may contact."

In your opinion, what types of shareholder questions should be handled by the board/directors rather than management?

Board policies and procedures	61.5%
Whistleblower issues	60.3%
Director nominations	54.4%
Board structure, size and tenure changes	52.8%
Executive and director compensation	52.3%
Shareholder proposals regarding corporate governance and corporate responsibility	50.9%
Accounting and audit policy issues	19.1%
Disclosure issues	13.8%
Corporate strategy	10.6%
Company performance	10.0%
Other (please specify)	9.6%

Other responses included: "Any other matter that does not have to do with the day-to-day running of the company." "There is room for management to participate in most of these item responses." "Management should handle stockholder questions." "All of these should be addressed

Rate your company's board (not management or the investor relations team) on its followup and communication with shareholders.



first by management and if not resolved to the shareholder's liking, a board member can handle." "I think most of these issues should be handled by management and when necessary, communicated to the board. Management would then communicate the company's response to investors." "Audit policy issues (but not accounting at an operational level); broad level policy re: whistleblower issues; company performance in terms of results achievement (not operational detail)."

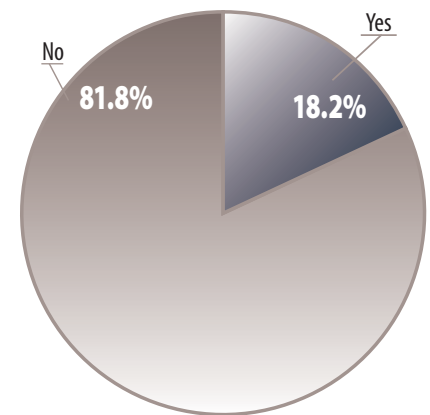
Board Questions

(Answered only by directors of publicly held companies)

Have you spoken personally with a shareholder of your company in the past three months?

Yes, about business issues or questions	28.6%
No, no opportunity	26.0%
No, as a matter of policy, I do not speak with shareholders personally	26.0%
Yes, socially, not about business issues or questions	22.1%
Other	3.9%

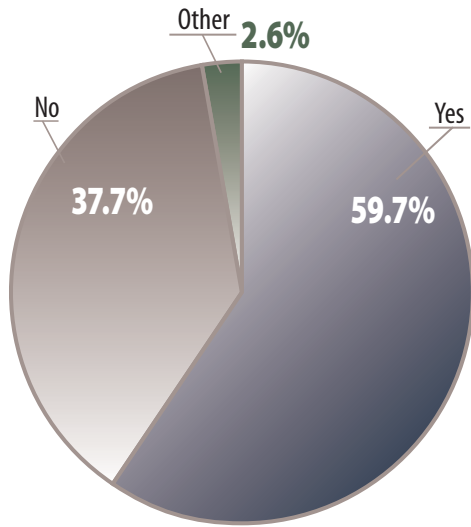
Have you written to or otherwise communicated with a shareholder of your company (other than verbally) in the past three months?



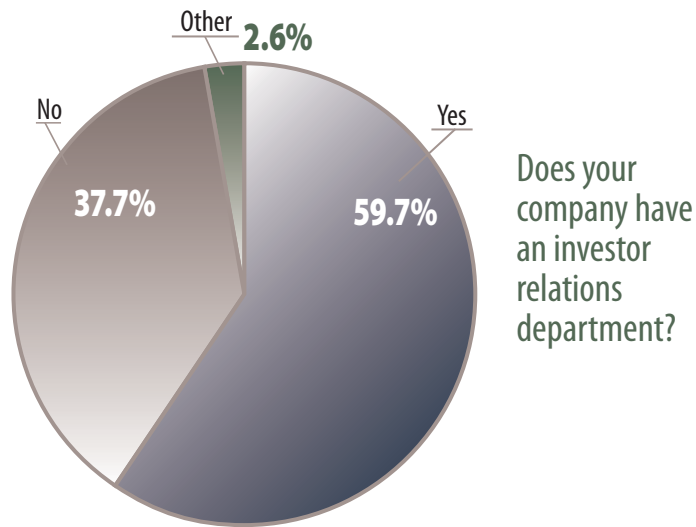
Rate your comfort level in speaking directly with shareholders.

I'm comfortable in limited discussions with shareholders	50.6%
I'm uncomfortable speaking with or communicating with shareholders directly	28.6%
I'm comfortable discussing anything with shareholders	18.2%
Other	2.6%

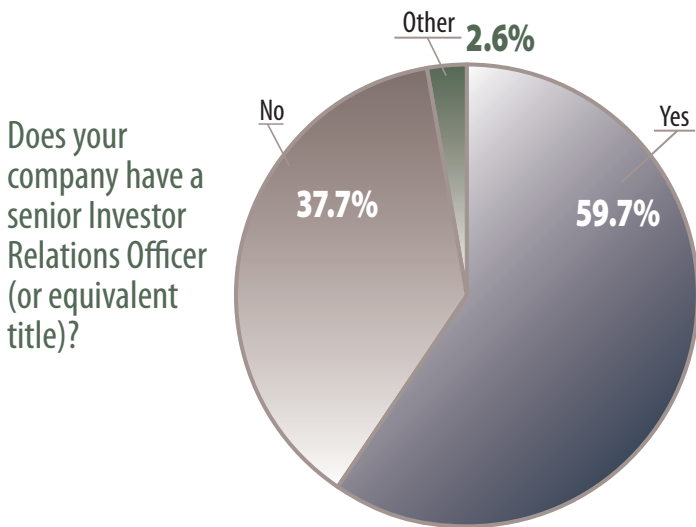
Do you feel your company has provided clear guidance to you as a board member on what's appropriate for direct board/shareholder communications?



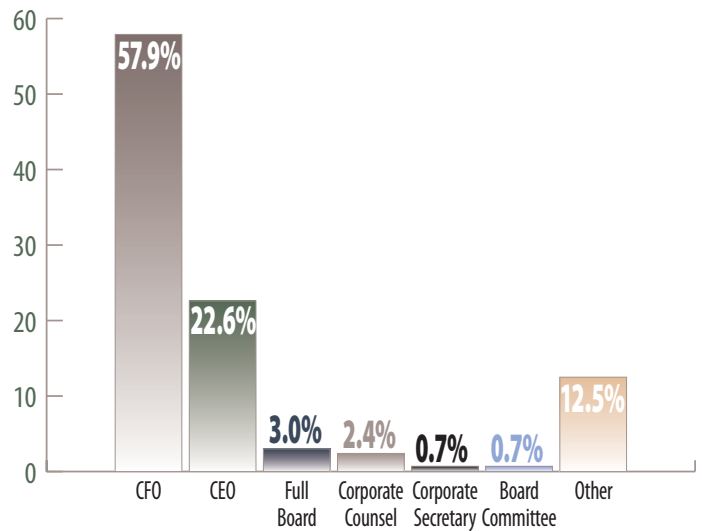
Investor Relations



The following questions applied only to those companies with an IR Department

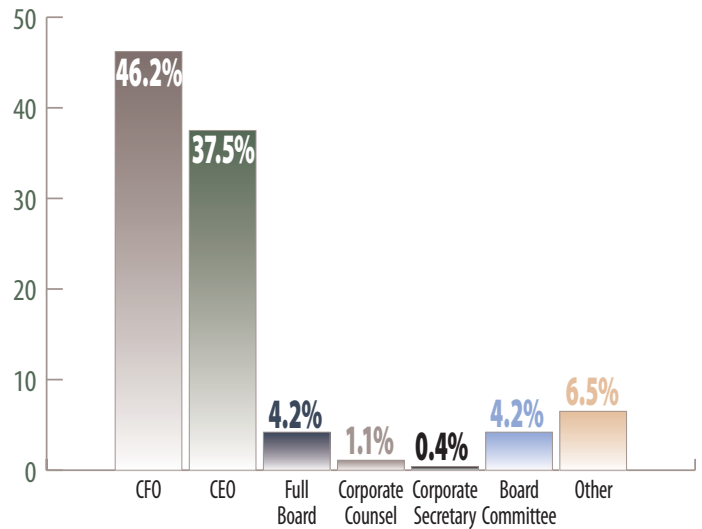


To whom does your investor relations team report?



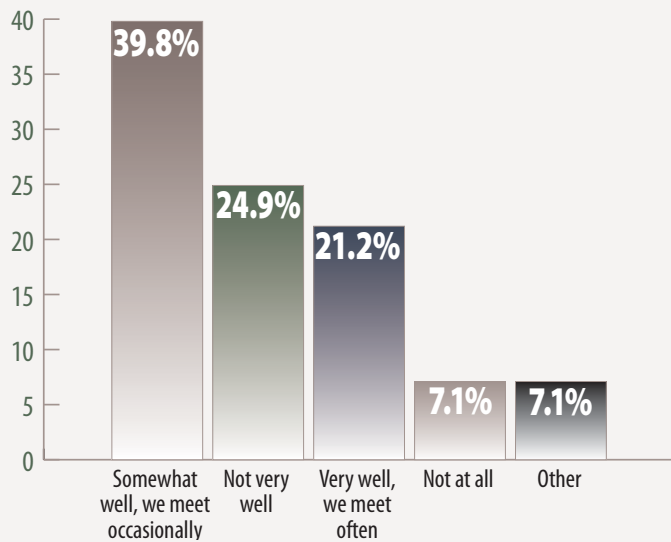
Other responses included: Head of corporate communications, corporate development, CAO, treasurer, COO.

To whom *should* the investor relations team report?

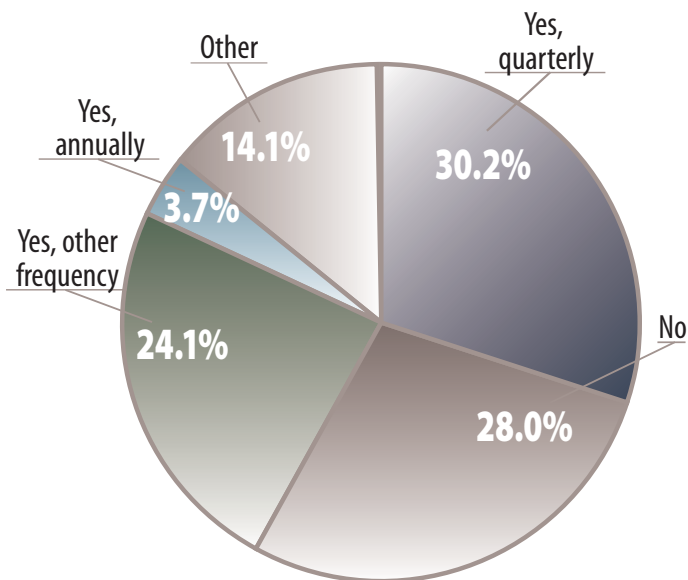


Other responses included: "Either the CEO or CFO with a dotted line to chairman of the board." "Probably the CFO, but needs to have strong relationship with Corporate Counsel/ Secretary to understand disclosure issues." "The Executive Office (typically CEO, CFO, COO)." "Dual reporting to CEO and Board."

How well does your company's board know the company's investor relations officer or team?

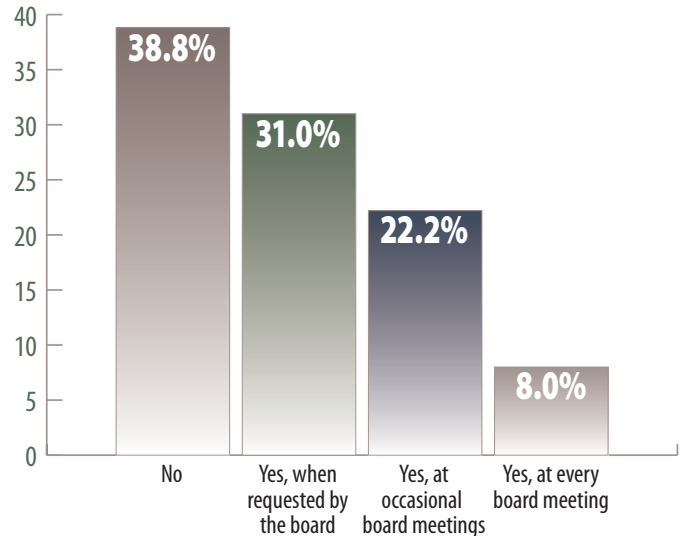


Does your investor relations team provide written reports to the board?



Other responses included: "Detailed report quarterly, market activity report daily." "PowerPoint presentation one time a year. No written report." "Indirectly as part of the board packet." "Weekly updates on the stock and the market in general; semi-annual in-depth reports on investor relations activities and issues." "Reports are provided at each board meeting, usually 6 times per year, and when ever an event occurs that warrants communication outside the regular board meeting schedule." "As updated analyst reports are issued they are shared with board within a week; brief update at each board meeting." "We include information in quarterly board books and send out other reports, but there is not formal written communication." "Generally not formal written reports, but verbal interaction twice a quarter at a minimum."

Does your investor relations team make presentations to the board?



What type of information should a board expect to receive from the company's investor relations team?

What analysts are saying about the company	88.5%
What shareholders are thinking or saying about the company	87.4%
Types of investors in the company	80.4%
List of top shareholders	79.5%
What the composition of investors means about the company	67.5%
Other	9.0%

Other responses included: "Significant movement in stock price, key competitive activity, performance vs. indices, IR outreach activity." "Benchmark best practices." "Significant trades." "IR strategic plan; IR goals vs. results." "Likely investment community reaction to strategic initiatives." "Comments by owners as to critical board issues, such as capital deployment." "Market sentiment; comparative peer information relative to company; investment characteristics of company; perceptions of management's performance." "Shareholder and analyst comments on management." "What employees are saying about the company." "Plans for communications with investors." "Activists in the shareholder base." "Strategy for attracting long-term investors to company."

Are shareholders more likely to contact board members directly today? Should board members reach out to and communicate directly with shareholders?

"Board members are typically busy people who have other jobs and commitments to attend to. Typically they do not have time to research, compose and proof responses to shareholder questions. They usually do not have direct access to the information needed to research questions,

even if they did have the time. Board members should use the IR department to send whatever messages are needed. That way, the IR group can ensure consistency and accuracy.”

“I think shareholders are more inclined to contact board members because of corporate governance-related issues. In many instances, however, management is intercepting those questions and responding on behalf of the directors.”

“Shareholders are likely to reach out to board members if the company is underperforming or not achieving its previously communicated commitments, or if the stock price is falling relative to the market.”

“Shareholders may be more likely to contact board members today given the less positive developments at certain companies in recent years. I think the board should be available to respond to shareholder inquiries, but not necessarily proactively reach out to shareholders.”

“We believe that our independent directors should not act as a spokesperson for the company. We have a whistleblower policy that allows a concerned person to report activities that would be sent directly to the board. Having direct shareholder contact with a board member may increase the company’s exposure to Reg FD issues. Current activities/status about the company are best handled by the designated communications channels.”

“I believe that shareholders are more likely to contact the board only if they perceive a problem with management. I do not believe board members should communicate directly with shareholders unless it is in response to an inquiry and the director has had a chance to discuss the matter with management.”

“Board members have a right and need to hear unfiltered what shareholders are saying. However, the process needs

to be in a way that the directors are not stepping on management’s toes (and perhaps overstepping their bounds as directors).”

“Shareholders may not have access to board members when communications are funneled through a member of Company management. Shareholders should have access to directors; however, many directors are on multiple boards and unable/unwilling to look at/answer shareholder correspondence.”

“There are circumstances that encourage direct communication between shareholders and the board; however the practical mechanism for conducting communications on a daily basis is through the corporate communications/IR department. Ad hoc communications between shareholders and board members provides many of the same challenges encountered in CEO/CFO communications with shareholders—without the safeguards that have arisen in recent years. Boards that speak clearly in the proper forum serve shareholders’ need to know best.”

“Board members have an obligation to the shareholders to provide oversight of management. Interaction with investors is not part of this responsibility unless the investor wants to blow a whistle.”

“In any case, whatever level of communication is allowed or permitted or promoted must be structured and buffered. The potential for damage is very high. However, I believe that if communication is structured and methodologies or policies and procedures are adhered to, the communications can be rich with ideas and perspectives.”

Shareholders do contact directors more frequently today. They understand they have gained additional power and need to be aware of decisions or provide input. I do not believe directors should reach out other than to be available. A single director or committee should be

appointed as the owner of shareholder relationship issues.”

“Most board members are ill-trained and ill-equipped to communicate directly with shareholders. I think only a designated board member should directly communicate with shareholders, but only after significant training on the issues, potential pitfalls and previous disclosures.”

“Board/shareholder communications are in a state of disarray. I expect that shareholders are more likely to contact board members today because so many issues are being argued in the press. As to direct communications, it occurs to me that this should be addressed on a case-by-case basis. However, I believe the norm should be a unified public position with clear accountability, and who better to hear the news from than the person responsible for the result.”

“Directors at the annual meeting are faced with a host of individual shareowners who ask trivial questions that directors feel is wasting their time. I think board members can participate in conferences and discussions that would help them understand the viewpoints of institutional shareholders. This may be a more effective way of keeping abreast of the issues. Another way is by bringing the investor relations officer into the board meetings and discussing the state of the company’s progress with Wall Street. This should be a regular part of the CEO assessment process when the board is determining compensation for the following year.”

“The only time a board member should communicate directly with shareholders is when there is a senior management issue that needs to be addressed—otherwise, management should be responsible for communicating with shareholders.”

“As a major shareholder, I find it very difficult to obtain access to directors to discuss issues such as compensation.”

Investor Perception Studies

By Alan Oshiki

In the past, a gap between a company's perceived value and its actual share price may not have required the intervention of board members.



Alan Oshiki

Here's a situation that may sound familiar: you and your fellow board members believe that your company is undervalued by the capital markets and, despite efforts to attain

an appropriate value, investors remain unenthusiastic and the stock price continues to languish. As the meaning of "fiduciary duty" broadens to include individual director accountability, this circumstance may be more than just a detail left to management—it may be a situation that requires the board to act directly.

Many companies faced with lagging stock prices conduct an investor perception study, involving a series of in-depth interviews with a representative number of current and former shareholders, securities analysts and other market participants. Armed with these interview results, the market's views can be directly compared to the perceptions of the company's management team thereby framing the extent of, and uncovering the reasons for, any gap in perceptions.

In the past, company management (typically the CFO or the investor

relations officer) initiated the study and in certain cases may have presented the findings to the board. However, given the significant emphasis on director independence, it may now be incumbent on boards, rather than management alone, to be the primary motivating force behind this effort.

Perceptions and Valuation

An early lesson learned in business school is the concept of "information asymmetry," the notion that differences in management's and market participants' perceptions of a company create a value disparity that is reflected in the stock price. In an ideal world, the only difference between the two sets of perceptions—and views on appropriate stock price valuation—would result from management's possession of insider information (for instance, knowledge of a pending merger announcement). But in reality, management and the capital markets often see a company's situation quite differently. For obvious reasons, a clear understanding of that divergence can be extremely useful to board members.

Investor perception studies gather the market's views about a number of issues, ranging from management credibility to the effectiveness of business strategy and the quality

of communications and forward-looking guidance. Many companies don't wait until a significant valuation disparity arises—some perform an initial, "baseline" study and then conduct updates every year or two thereafter.

Using the Results

A key goal for any board is to achieve an appropriate market value for the company, often by closing a perception gap with the company's shareholders. The findings of a perception study therefore guide a company's actions toward closing the gap between actual stock price and management's perceived value.

How would this work? A simple example would be a company's anticipated earnings growth rate. If management believes its earnings growth rate should be 10 percent per year but the market says that eight percent is more likely, there's going to be an adverse difference in stock price. The company would then use this knowledge of the difference in views to take some form of corrective action—for example, providing more information through company disclosures that explains why the higher growth rate is appropriate and how it will be reached and maintained.

(continued on page 34)

"A key goal for any board is to achieve an appropriate market value for the company, often by closing a perception gap with the company's shareholders."

Non-Financial Reporting Gains Momentum

By Mark Hynes

Traditional accounting standards such as GAAP financial statements have no means of recognizing the worth of non-material assets.



Mark Hynes

“Adding real shareholder value” has long been a key focus for the directors of public companies. It has come to encapsulate all the measures of success, from free cash flow to

non-material assets of the business. Non-material assets traditionally have been harder to define, report and measure and have thus not been a substantive part of a company’s overall valuation. But pressure from investors will change this.

Traditional accounting standards such as GAAP financial statements (or equivalents around the world) have no means of recognizing the worth of non-material assets such as experienced employees, customer loyalty, corporate strategy, market growth, product innovation and demographic change. Yet GAAP is what many companies think of as ‘corporate reporting.’

National Australia Bank (NAB) finance director Michael Ullmer said recently, “I think you’d probably find around the world at the moment that boards are probably spending more time on looking at those regulatory and compliance issues than they would be looking at growing shareholder value.”

The Absence of Tools

Further, many boards of directors and senior managers have a

difficult time identifying non-material performance measures and monitoring their impact. A survey conducted on behalf of Deloitte Touche Tohmatsu by the Economist Intelligence Unit (EIU) in October 2004, supports this. Of 249 board members and top executives polled, only about one third (34 percent) said their companies are proficient at monitoring critical non-financial indicators of corporate performance. Those surveyed blamed this on “the absence of developed tools for analyzing non-financial measures,

and skepticism that such measures directly impact the bottom line.”

Research shows that regulatory financial reporting alone is failing to meet the needs of investors. For example, in interviews with over 1,800 managers and investment professionals across 16 industries, PricewaterhouseCoopers’ Value Reporting consistently has found that only 25% of the measures cited as critical for understanding a company in a given industry are covered by the regulatory reporting model—75% lie outside the regulatory reporting framework.

Chief investment officers increasingly are looking for metrics beyond typical financial indicators to provide a more robust view of a

company upon which to base their valuations, giving rise to a number of initiatives aimed at addressing this issue. In Europe, the Enhanced Analytics Initiative comes from a group of asset managers and asset owners with AUM (Assets Under Management) totalling over 380 billion Euros, who actively support better sell-side research on “extra-financial” issues. Putting their money where their mouths are, these fund managers are dedicating brokerage commissions to analysts who author research on “fundamentals that have

“Research shows that regulatory financial reporting alone is failing to meet the needs of investors.”

the potential to impact companies’ financial performance or reputation in a material way, yet are generally not part of traditional fundamental analysis.” This has already led to new, fundamental research.

XBRL and Usability

However, creating the research and analysis of the ‘extra-financial’ issues solves only one part of the problem; the format in which it is delivered is crucial. In financial reporting, a new standard, eXtensible Business Reporting Language (XBRL), is expected to change the usability of data. XBRL is a language for the electronic communication of business and financial data. By providing a computer readable

(continued on page 34)

Can We Talk?

By John F. Budd, Jr.

How an innocuous SEC rule challenges director credibility



John F. Budd, Jr.

There's a Quixotic element in promising shareholders that they can personally communicate with directors—an offer that is usually carefully hedged by a process that often reads like the small print in a warranty statement. Directors, struggling for credibility with shareholders, are done no favors by incautious offers of their accessibility which pander to an SEC rider that “suggests” opening dialogue with individual investors.

Shareholders who are patient and willing to run the communications obstacle course—perusing the turgid language in proxy statements or negotiating the tangles of websites—will not be impressed by the bureaucratic process. To offer communications circumscribed by in-house ground rules makes mockery of the objectives.

Given its minimal role among more weighty regulatory matters, it is understandable that communicating with shareholders is largely dismissed as a low priority—an irritating intrusion on management's time—even though it is, paradoxically, a factor that could be the linchpin in the long-term success of Sarbanes-Oxley.

In the idiom of sports, sincere, open and honest communications between independent directors and shareholders could be the

“closer” that saves the trust game for directors. Conversely, treating the communications process indifferently could sacrifice public confidence in the integrity of the entire corporate governance reform campaign.

Hyperbole? Consider this: what seems to have been lost in the cacophony of retroactive retribution against fraudsters, present and future, is the fundamental goal of Sarbanes-Oxley, which is to restore the trust and confidence of shareholders and the public in corporate America's good name. Initially, this goal was explicit; later as the Salem witch-hunt mentality took over, it was reduced to an implicit objective, honored largely in rhetoric, but ignored in rule-making and compliance mechanics.

The Spirit of Communications

Rules on paper are impersonal. How these rules are implemented, either with panache and empathy with shareholder expectations, or with indifference and offhandedness, signals whether there has been a real change in attitude or just more of the same patronizing lip service. Unlike other regulatory mandates that are procedural and anonymous in practice (absent violations), communications is highly visible and engages shareholders in their satisfaction or dissatisfaction. Unintentionally, this relatively minor requirement—ambiguously defined—becomes the standard by which all the governance reforms are measured. The observable conduct and comportment of directors

addressing the communication process—their demonstrable *attitude*—thus has more opinion-making clout than all the criteria for independence setdown.

It frames what governance guru Charles Elson, director of the Center for Corporate Governance at the University of Delaware, characterizes as the sensitivity to the spirit of the new rules over and beyond the technical letter of law compliance.

It's not easy to counter and cope with the subjective views, biases, perceptions and other individual factors that root opinions. The *governistas*, entrapped by orthodox thinking and naively confident that the public will reward their toughness against executive malfeasors, are oblivious to the reality that rules alone won't cut it. Punishing the bad guys does little to reassure the public that the average CEO and board are on their side.

The hypothesis that prevention plus punishment equals responsibility isn't one that the public buys. As Cadbury-Schweppes' CEO Todd Sitzler succinctly put it, anyone with a concerted desire to commit fraud will not be deterred by restrictions in the process.

Communication by Proxy

Scrutinizing 22 proxy reports (it takes a dedicated masochist to read these corporate Dead Sea Scrolls!) reveals that about half mention the issue of communicating with directors, but avoid at all costs the notion of reciprocity. Generally, these

proxies contain a bland, matter-of-fact directive to write to the corporate secretary, who'll somehow orchestrate the communications process. But is the corporate secretary, the exemplar of caution and ambiguity, the ideal individual to create new paradigms of open board-shareholder communications? Or will traditional orthodoxy serve up pabulum rather than upset the equanimity of already-overburdened directors with reading matter that literally demands legal vetting?

Occasionally in these proxies, a company will promise no screening (Gentex) while others (Process Energy, for example) acknowledge that mail will be screened for unspecified criteria—this despite the Council of Institutional Investors and the National Association of Corporate Directors specific recommendation that “no intermediary should impede the communications between a shareholder and director...and place no obstacles in the way of that communication.”

Measured against the truly onerous requirements of the reform agenda (Section 404, for example), it is understandable why communications gets low-balled. It's no big deal—just set up a process and move on to bigger issues.

But it is a big deal! Bernard Shaw once observed that the difficulty in communications “is the illusion that it has been achieved.”

On the Defensive

Self-consciously assuming that shareholders only complain, companies tend to treat the subject of board-shareholder communications defensively. Witness Amgen's approach: “anyone who has concern about the Company's conduct... accounting controls, etc...may

communicate directly with non-employee directors.” By way of the corporate secretary, of course!

Creating an ombudsman's role, as some companies have done, has a sense of openness about it, but at least in one instance (GE), the incumbent is a cheerful gatekeeper who deftly shields directors from toilsome (possibly incriminating) letter writing by reviewing questions and drafting responses, then briefing involved directors quarterly. Such censorship is not lost on shareholders.

Or try phoning, as I did, one Fortune 50 company's IR department. I was enmeshed in voice mail and electronic options, mechanically asking me for my Social Security number, but never asking me if I was a shareholder—which I was, with 2,000 shares.

Condescending to shareholders with promises of a level of transparency that can't realistically be fulfilled only reinforces shareholder skepticism. Any director who has tried to change a spouse's mind will realize the enormity of modifying a shareholder's opinion. Rules and laws are palpable but puny weapons against subjective judgment, bias, perceptions or peer opinion. What therefore seems to be an afterthought to the SEC's larger goals on disclosure elevates to a priority in a practical context.

Making Communications a Real Partnership

The CEO and the board that recognizes this and grasps its significance will cast aside the perfunctory handling of board-shareholder communication in favor of establishing a real partnership. That's what will earn the trust and confidence we all so earnestly seek.

Governance is an abstract to most shareholders, measured primarily in a satisfactory return on investment (or lack thereof). Good governance, bad governance, mediocre governance—it's largely immaterial. To the public, governance is largely preventive, a promise of punishment rather than performance.

But attitude is subtle, and sends many signals. Directors and CEOs can't fake it, delegate it to staff or assign it to surrogates. Any independent director nowadays worth his options will assure himself that this communications upgrade is carefully thought through. How deep should transparency go? Who is monitoring to catch orchestrated advocacy probes? How do we unknowingly prevent Reg FD violations? What role and visibility should legal counsel have? How do we offset any sense of censorship?

Don't offer what can't be delivered, such as one-on-ones with individual directors—and be up front about that. Don't bury contact instructions in nine point type deep within the proxy statement. Will responses be timely and, in Arthur Levitt's dictum, put in plain English?

Ask for a dedicated phone line for shareholders (featuring a human being and no electronic safety zones). Insist on seeing and answering any questions or comments directed your way. And don't let yourself be offered up for coffee klatches with individual shareholders.

John H. Budd, Jr., is a director of the New York chapter of the National Association of Corporate Directors, and is author of a white paper on director-shareholder communications called “Perils in the Process.” He is founder and chairman of a boutique public policy council, The Omega Group, in New York.

The Art of the Shareholder Letter

By Larry Robbins

One reason that shareholder letters tend to be vague is the specter of litigation.



Larry Robbins

Letters introducing annual or quarterly reports have achieved a bad reputation. Too often these perfunctory communications contain platitudes or vagaries that do not convey useful information. And the result could be a loss of confidence in the company. Many years ago, a student submitted a paper with the following monumental Freudian slip:

The social concerns of the firms are tapped from the annual report and are measured as the number of lines discussing such issues divided by the *total lies* [italics added!] of the report.

Although this statement is either an honest error or bad joke, it underscores a perception that companies lie by misstating, hiding or omitting important information.

A company can use its reports and the letters to shareholders to demonstrate financial and managerial savvy. When viewed as part of a system of communication,

the chairperson's letter not only records activity, it gains the confidence of the shareholder by demonstrating that the company and its board understands the process of running its business.

To communicate the what and the how—results and process—the CEO or the board chairperson should consider at least some of the following information for the introductory letter:

- General results and comparisons with the last reporting period
- Adherence to applicable laws and regulations
- Audit procedures
- Key management issues: successes and how they were achieved; failures and how they were addressed.
- Future plans (not predictions)

These topics do not have to be contained in one letter. In fact, if they are presented as part of a series, more shareholders might actually look forward to reading all of the letters, using them to help interpret the data contained in the remainder of the report. If the letter creates a connection with the reader, the result is increased confidence in the way the company operates.

What Shareholders Need to Know

To bolster shareholder approval, think about what today's investor, jaded by countless scandals and regulations, needs to know. In addition to wanting to see quartile performance, shareholders are also interested in governance and the role of the board. Therefore, in one of the letters, the chairperson might describe briefly how the board operates. A list of committees and their functions will demonstrate the scope of the board's responsibilities and how it accomplishes the "due diligence" necessary to protect the shareholders. It is also extremely important to discuss the procedures for evaluation—self-evaluation or evaluation by outside agencies.

Much in the news today is the issue of the independence of directors. In the mutual fund industry, for example, the debate is literally raging between the SEC and the U.S. Chamber of Commerce about the need for independent directors. The percentage of independent trustees directly reflects governance policies. Both sides of the argument—for or against independent directors—have merit, but when a board makes a decision about independence issues, it should tell the shareholders its rationale.

One reason that shareholder letters tend to be vague is the specter of litigation. But that's what compliance officers are for: to protect the company and the shareholder. Turning a negative—how can we write the letter so that we won't get

"The chairperson's letter not only records activity, it gains the confidence of the shareholder by demonstrating that the company and its board understands the process of running its business."

sued?—into a positive—what can we say that honestly deals with the most important issues?—will increase a company’s reputation for integrity.

What the Letter Should Say

Here is a brief list of the kind of information and analysis a letter to shareholders should and should not contain:

State facts, not opinions. Since the report itself will show the results of the reporting period, the introductory letter should summarize honestly and straightforwardly how the results were achieved. Above all, make sure that the financial information in the summary corresponds to the facts contained in the report itself.

Don’t say too much. Too many details in the chairperson’s letter duplicate what is in the report. Moreover, if something good or bad happened but it only resulted in a minor variance, it is not necessary to call attention to the event in the letter. The introductory letter should summarize activities and trends and not bore the reader with information contained in the report.

Don’t leave out important information. It is possible that a firm matched its competitors’ results but only by an extraordinary event, such as a one-time write-off or windfall. Shareholders are entitled to know not only what a company did in a reporting period but how it did its business.

Be clear, not ambiguous. Fact spinners often try to cover up problems. That is the nature of propaganda. “We are pleased to say that our results across all divisions have been consistent.” Sounds reassuring, but what if the next sentence should read, “Our results have been consistent; we have consistently underperformed all the



benchmarks”? If underperformance is a fact, then state the reasons and what the company is doing to correct the problem. Do not underestimate the analytical skills of shareholders—they are not easily fooled.

Set the right tone. Letters to shareholders should be formal but not pompous. As in any letter, avoid the passive voice because the reader doesn’t know who is doing what to whom and because there is no real connection between the writer and the reader. Use straightforward, concrete language that sends the reader forward and not backward.

After the Draft

Once a draft of a letter is completed, many eyes will see it. In a world of laws and regulations, every word is subject to scrutiny. Compliance departments need to verify the facts and anticipate various responses—from shareholders as well as from the SEC and other regulatory agencies. The key role of compliance is to provide oversight by a trained professional analyst whose job is to verify reported performance.

It is no secret that the chairperson usually does not write the first or even succeeding drafts of the letter to shareholders. However, the chairperson’s signature acknowledges that he or she accepts the responsibility not only for the content of the letter but for the entire report. Before signing this letter, then, the chairperson should become the reader, asking: “Does this letter make sense? Does it accurately portray the state of the company? Is it hiding anything?”

With good reason, regulatory agencies and shareholders are demanding transparency and accountability. An honest, sensible, personalized letter can help meet these demands, opening rather than closing communication. A clear and honest letter will demonstrate that the company is going in the right direction and that the reader—the current or prospective shareholder—can invest with confidence.

Dr. Larry M. Robbins is the former founding director of the Wharton Communication Program at the University of Pennsylvania and the current director of Penn’s Center for Teaching and Learning. He is also Chairman of the Board of the HSBC Investor Funds.

Full Value Requires a Full Story: Don't Ignore the Intangibles

By Scott Chaikin

Discussion of intangible assets gives a company's numbers much-needed context.



Scott Chaikin

Since the implementation of Regulation FD in 2000 and the passage of the Sarbanes-Oxley Act in 2002, public companies have been reshaping their disclosure policies. Directors and

executives have found themselves in the middle of an increasingly heated debate over proper presentation of company financials. Unfortunately, that debate has prompted many companies to pull back from following reasonable, appropriate best-practices in communicating financials.

Worse yet, the debate has also dampened discussion of intangible assets, which can make up 50 percent or more of a company's value. Discussion of these assets gives a company's numbers much-needed context, and also encourages richer understanding and a longer-term perspective of the company's prospects. This is exactly the kind of information that investors have been demanding.

As *The Economist* magazine once noted, intangible assets are "anything in a firm that generates value that you can't drop on your foot." By definition, intangibles are non-physical and non-financial, which means they are difficult to capture in income statements and balance sheets. Intangibles can include brands, trademarks, reputation, customer loyalty, quality of management, strategic execution,

product innovation, human capital, intellectual capital, networks and alliances, market share, quality of corporate governance, and the perceived independence of a company's board of directors. One particularly startling illustration of intangible value is General Electric: when Jack Welch was CEO, some investors said his reputation alone added 10 percent to that company's stock price.

Leading authorities agree that intangibles affect investment decisions and market valuations. Baruch Lev, professor of accounting and finance at New York University and a pioneer in this area of study, estimates that intangibles generate one-half to two-thirds of a public corporation's market value. Jonathan Low and Pam Cohen Kalafut at Predictiv, a leading research firm focusing on measurement and analysis of non-financial assets, believe at least 50 percent of a traditional company's value is based on nine critical intangible drivers. They also report that portfolio managers claim 35 percent of their

investment decision is based on evaluation of non-financial data.

More Information Brings Greater Confidence

Though intangibles may be hard to define and quantify, they represent real value, and some firms are finding increasingly sophisticated means of measuring that value. The fact that these assets are not concrete makes it that much more important for firms to find effective ways to communicate their value to investors.

Imagine, as a director or executive, you are considering two acquisition candidates. You have adequate financial reports on both, but on one you also have a far more thorough analysis of management strength, market reputation, intellectual capital, product development pipeline, customer perceptions and other non-financial information. Having a more complete picture of the latter, you're likely to have greater confidence in your analysis of that deal, perceive



“There is no one-size-fits-all template for making sure investors understand a company’s intangible assets, but there are some guiding principles.”

less risk, and be more willing to pay full value. Equity investors are no different—and they have thousands of investments to choose from.

The “full financial disclosure” measures that have been adopted to restore confidence in financial reporting were also intended to improve transparency. Transparency means more than just accurate and complete reporting of the financials. It also requires a company to provide sufficient information to help investors and analysts develop meaningful conclusions and make appropriate investment decisions or recommendations. At the end of the day, the *quality* of a company’s disclosures is much more important than the *quantity* of its disclosures.

Identify, Measure, Communicate

There is no one-size-fits-all template for making sure investors understand a company’s intangible assets, but there are some guiding principles.

Some categories of intangibles are common to practically all companies, and investors look at them regularly to help them make their decisions. These include management quality and depth, long-term vision and strategy, governance and marketshare. Additionally, each company has its own unique set of key drivers of its vision. These could be its product development pipeline, acquisition philosophy and track record, marketing strategy, focus on innovation, or any combination of other factors that might contribute to the value of the company.

Investors should be fully aware of the breadth and depth of all of these underlying assets. Companies, in their communications, should not only define their major intangibles, but also should track their progress by measuring and reporting on them, when possible. Employee engagement, customer loyalty, and the pace of new product introductions are just a few of the measurable non-financial assets that can help provide investors a broader picture of your company.

Finally, the communications need to be constant and consistent. Keep talking about these assets and keep updating. You’re trying to give investors a context for better understanding and fully valuing your company—don’t expect them to remember the key elements of that context from previous communications.

Provide a Complete, Compelling Story

While insight on non-financial assets should clearly be featured in the quarterly earnings release, which is typically the first place that investors dig for timely information, such information should also be an ingrained element of the full investor dialogue. The corporate website, conference calls, analyst meetings, shareholder meetings and annual reports all can and should contribute to the overall information package—consisting of both financial and non-financial information—on which an investor can base his or her decision. Executives and directors have a responsibility—to their companies as well as shareholders—to ensure that the full story is being told

through all those channels on which investors rely.

While compliance with evolving regulations is the baseline goal, companies should also guard against developing a “checklist” mentality of releasing only the information that is required by law. Those that follow this checklist approach will be missing an important opportunity to communicate their full story and to let the public know what it is that makes their company unique.

Investor relations, the function through which a company manages its Wall Street relationships, is essentially a marketing function. Depending on numbers to market a company to investors is akin to marketing a car based solely on miles per gallon, horsepower, and zero-to-sixty speed, without also considering such factors as safety, reliability, technological advancements, customer service and resale value. Marketing works best when it has a compelling, authentic story to work with, and every company’s dialogue with its investors requires the same.

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Board/Investor Communications: Making it Work

By Constance Dierickx

The first step in developing a strong investor communications platform is for directors to re-examine their definition of “investors.”



Constance Dierickx

Increased investor scrutiny on companies and boards is a blessing as well as a curse. As individual and institutional investors become more vigilant, directors have a unique

opportunity to reach out to them in a meaningful way. Bringing investors “into the tent” raises their psychological ownership, beyond their literal financial relationship. When investors feel left out, they tend to be more critical and more vociferous. Even brief communiqués that engage their thinking about the company can spur enthusiasm.

Of course, there are potential pitfalls to navigate when it comes to investor communications. Most basic is the need to guard information that should be guarded without putting too many items into that category. Outside of that, no news is not good news. When the flow of timely information is reliable, it needn’t be frequent to build trust with investors. In turn,

this leads them to be more likely to resist the most dire interpretations of analysts, journalists, and disgruntled members of the company.

So What to Do?

The first step in developing a strong investor communications platform is for directors to re-examine their definition of “investors.” Are investors outsiders, or are they financial partners? If partners, consider how this sense of partnership is conveyed. What can and should partners expect from their board? What should the board expect from investor-partners?

From a purely financial perspective, shareholders are there to provide capital, and directors serve as the link between management and shareholders. Sounds easy enough, but when disagreements arise between shareholders and the management team of the company, it’s up to the board to make sure both sides are treated fairly and given access to sound information.

Think of the recent debacles at Disney and Morgan Stanley, and

the picture is easily painted. Shareholders, angry over management issues, became so vocal that internal struggles at the respective companies turned into a media spectacle. If directors had established strong shareholder relationships before the crises occurred, shareholders could have become part of the solution rather than disruptive bystanders.

Success Stories

There are a number of companies who have done a great job of creating strong, two-way relationships between directors and shareholders. Consider Warren Buffet and his Berkshire Hathaway mega-investment firm. Of course, tremendous returns-on-investment do little to hurt shareholder loyalty. But Buffet’s clear, consistent communication skills, combined with loyalty-inducing shareholder meetings, have made Berkshire Hathaway’s shareholders some of the happiest, and most vocal, individuals in the industry.

Home Depot is another example of a company that owes much of its success to its strong communications with shareholders. Like “Main Street” stores of yesteryear, Home Depot went out of its way to understand its customers, and in turn, its shareholders. When the home-improvement giant started, they did a number of smart things to connect with their customers and shareholders. First and foremost,

“If directors had established strong shareholder relationships before the crises occurred, shareholders could have become part of the solution rather than disruptive bystanders.”

they made their employees brand evangelists. Over time, employees talked to customers about Home Depot's stock as well. Soon, Home Depot became a destination for shopping and investing. The company had customers buying stock, shareholders buying supplies, and a guerilla marketing team that came at no cost.

How to Open Lines of Communication

Today, directors operate in a more skeptical shareholder environment. But, the steps needed to open the lines of communications are essentially the same:

Be visible and forthright.

- Shareholders want, and need, to trust that their board is disclosing all of the information necessary for shareholders to make appropriate investment decisions. Find ways to “speak” to the investors. Use public relations support to find ways to communicate on a regular basis what is going on in the company.
- If something adverse occurs, act fast and do so openly. Investors are more impressed by those with the courage to convey bad news and are suspicious of “spin.”

Entice!

- Share your new products with your investors, literally or virtually. In some cases, you may want to offer a product description or update. In other cases, you may want to hand out prototypes at shareholder meetings, post three-dimensional displays on the company website or conduct a postcard mailing to investors.

“Don't assume alignment with management: test it, talk about it, check it.”

- Use electronic methods to communicate breaking news to shareholders. Tell them about the new products, sales results, newly appointed executives. The opportunities are many and low cost.
- Find out how the Investor Relations department in your company is doing. Really find out, call them up. Insist on performance that enhances the brand. Make it an asset.

Nurture relationships continuously, move quickly when problems arise.

- Operate with the assumption that squabbles will find their way into the news. What juicy stories did Disney and Hewlett-Packard provide? What did it cost them to have those played out in public? Better to have the humility to seek help than to attempt to sweep these difficulties under the rug.
- Don't assume alignment with management: test it, talk about it, check it. It's more beneficial to risk a discussion of the obvious than to find out things were not so obvious after all.

Make it Easy

- Investors and potential investors often do research on the company—and may be looking for specific information on earnings, management, ethics and board members. Don't make them feel as though you are trying to hide this information—it looks cagey. Be sure that corporate websites are up-to-date and easy to navigate.

Encourage Attendance at Shareholder Meetings

- Aside from the predictable small group of investors who attend every shareholder meeting, many shareholders rely on printed material alone for information about company performance and plans. Encourage all shareholders to attend at least one in-person meeting.
- Hold the meeting at your headquarters, at least sometimes. Do you want to send the message that shareholders are welcome there, or that you are trying to keep them out?

Relationships—whether they're with board members themselves, between C-suite executives or with the general shareholder population—are critical to the health of any public company, and can make-or-break investors' confidence in leadership.

With companies, both large and small, finding themselves at the brunt of heightened scrutiny and potential public humiliation, it's often best to go back to the basics. Quick, concise communications with shareholders can build interest and support for new ideas or products and help to mitigate the damage done by mishaps or missed goals.

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The Role of Boards in Corporate Reputation

By Larry Snoddon

It has become critical that boards understand what unique factors drive their company's reputation and the risks to that reputation.



Larry Snoddon

One of the most important and least understood areas of director responsibility today is corporate reputation. “Headline risk” has become part of the vernacular among professional investors.

Yet many corporate boards continue to see their role in terms of financial and strategic control. In a McKinsey survey of 250 corporate directors, the writers noted that non-financial risk “only gets anecdotal treatment” and, as one director stated, “boards absolutely do not understand the risks their companies face.” Only when a crisis threatens the company's reputation are boards placed in a spotlight, forced to take action and communicate on their own behalf.

It has become critical that boards understand what unique factors drive their company's reputation and the risks to that reputation. Their role must be to minimize the gap between these drivers and the company's actions. They must be effective monitors of reputation as they are monitors of the firm's financial status.

The investment community has recognized that non-financial factors, collectively determining corporate reputation, have become increasingly

important in determining corporate value as well as risk. The California Treasurer's Office has stated “shareholders need to send a clear message: company conduct counts. Too often, institutional investors have tried to construct a wall between their investment decisions and corporate responsibility.” In an Ernst & Young study, institutional investors said non-financial value drivers, such as the factors that create corporate reputation, were fully 35 percent of the rationale in rating a company's stock. They also said they are more important than financial factors in an IPO's success. When he was CEO of General Electric, Jack Welch said it was clear how to value corporate reputation—it is the difference between book value and a company's stock price.

Increasingly, business interests can no longer be separated from society's interests and expectations. And major corporations have to view themselves as virtual political institutions—constituency based, founded on trust, existing only by public consent (to paraphrase L.L.L. Golden).

In this environment, boards and managements are held equally accountable for the corporation. This has created a fundamental change in the way sophisticated boards see their priorities, how they must operate and communicate in the future.

What Factors Make Up Corporate Reputation?

Research conducted in more than 45 countries shows that expectations for major multinationals have indeed changed. Stakeholders, from government regulators to customers, expect companies to move from a compliance mode to affirmative and proactive interaction with their various audiences. This requires socially responsible companies to go beyond what they are required to do under the new rules. Companies that will be among the most respected and trusted will do just that.

What is Corporate Reputation?

To understand the expectations for well-respected corporations, opinion research was conducted throughout North America, Latin America, Europe and Asia over the past three years. This research examined the expectations of the general public (including the most attentive and active segments of the public) and senior officials in government, media, NGOs and financial institutions.

What resulted was a paradigm of corporate reputation asserting that a society's expectations of good corporate behavior define the specific attributes of corporate reputation; in other words, a company's reputation is based upon what society expects

“To establish and maintain trust and credibility in this new environment, directors will have to act outside the company as well as inside.”

of it. Furthermore, while many have tried to ‘fit’ standard measurement tools to assess corporate reputation, in reality, what defines a company’s reputation is unique for each and every company. It is essential that directors understand these unique drivers for their companies.

There are, however, some commonalities. Research for a wide range of companies in major industries, such as packaged goods, pharmaceuticals, oil, public utilities and financial services, identified several broad areas that are consistently cited as societal expectations. One of these was surprisingly consistent across geographies and segments of society.

What is heard across the world is that transparency, which includes honesty and ethical behavior and is a part of good corporate governance, is a critical element of reputation. It is not limited to publishing financial reports, but is expected to infuse the full range of actions and policies of a company, everything about how a company is governed and operates—from products and services and employment practices to philanthropy.

Beyond Disclosure

Furthermore, transparency includes an affirmative obligation for corporations to openly and honestly talk about their corporate social responsibility initiatives in a proactive and responsible way. This means it is not enough to provide complete and honest information—there is also an obligation to “find me and tell me”. Thus, the need for consistent, open and relevant communication is essential to building or rebuilding trust.

Obviously, one cannot proactively communicate about corporate responsibility in a transparent manner unless it is a fundamental

part of how business is conducted. So what role does the board play in building trust and determining corporate reputation? When and how must the board use its position to protect the company’s reputation, and ensure both its ROI and its ROR (Return on Reputation)?

The board’s role in approving corporate policy and assuring compliance is very clear. The board, however, also needs to be the standard bearer—and at times the arbiter—of ethics for the company. The board must make as much effort in this area as in finance—ensuring that the company has a culture of ethics (a sharing of values of people who want to do the right thing), not just a culture of compliance, shaped by lawyers.

Boards will find that they must establish their own public positions on these and other issues including the long-term sustainability of the company; the position of the firm within the body politic (to include issues, such as environment, safety, workers’ rights); the “ethics” of decision-making as well as legality (e.g. moving offshore for to avoid taxes). These positions must guide their decision making and, at times, their communication.

To establish and maintain trust and credibility in this new environment, directors will have to act outside the company as well as inside. They must communicate on their own behalf with key constituencies. At times, they will have to represent their own and key shareholder interests publicly and separately from management. They must weigh in publicly on matters of ethical decision-making and corporate social responsibility.

Along with management, they on occasion must speak on the issues of long-term sustainability of the

corporation. One consideration would be a periodic report from the board to shareholders and other key constituencies, explaining the guiding principles of the board. This might include how the board operates and determines priorities, provide comment on issues addressed in the past year, explain how the board balances financial and non-financial demands, review the ethical framework guiding the company, as well as social and business missions.

Increasingly, boards will have select involvement in public communication by the company on strategy and issues. They must seek new ways of working with management teams to support objectives by speaking to media and audiences on important issues (as a cadre of advisors to the country’s President might explain certain positions of an Administration).

Views of corporate purpose and the roles of boards are indeed changing. It is not the failures of companies that have increased expectations, but their significance to modern life and society—constituency-based, founded on trust, existing only by public consent.

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(Oshiki, from page 22)

Determining Support for a Strategic Business Realignment

Perception studies can also help guide major corporate decisions. One diversified company was for many years valued at a level that was considered by its board and management to be inappropriate given the growth prospects of its telecommunications business combined with the stability of its utility businesses. A perception study was commissioned by members of the company's board assigned to examine the issue.

Comparisons of extensive interviews among several groups, including institutional and retail shareholders, securities analysts, members of senior management and the board of directors, revealed a wide "disconnect." One significant finding was that market participants viewed the company as an assembly of two disparate and incompatible businesses, neither of which had enough critical mass to fully contribute to valuation. To the market, absent true synergy among

the businesses, the company's main investment attribute was its dividend—while management and the board believed that the company's growth potential (combined with the safe cash flows from its utility businesses to fund that growth) was the primary driver of value. Clearly, the market discounted the company's view and the study was the first, extensive documentation of the reasons.

The study was a catalyst for an extensive internal review of alternative business structures and, within two years, the company had eliminated its dividend and embarked upon a path to shed its utility businesses and add mass, through multiple acquisitions, to its telecommunications business, becoming a "pure play" telecommunications firm that was easier for the market to value appropriately.

Board Members and Perception Studies

In the past, a gap between a company's perceived value and its actual share price may not have required the intervention of board members. Given today's environment

of corporate accountability and the expanding concept of fiduciary duty, board members may find themselves increasingly compelled to act in such situations. Perception studies can illuminate the reasons for, and the extent of, any differences between the views of management and the market—a difference that, if significant enough, can adversely affect stock price. Knowledge gained from such studies can help guide investor communications as well as corporate policy on the highest strategic level.

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(Hynes, from page 23)

identifying tag for each individual item of data, XBRL benefits both the preparers and users of financial information. This helps automate analysis, giving advantages of speed and accuracy, as well as cost savings.

To date, no such reporting framework exists for non-financial information. However, the not-for-profit Enhanced Business Reporting Consortium is taking a lead in creating one. Its aim is to define and build XBRL taxonomies for different sectors, which would allow businesses to report on their non financial assets in a way that is easy for investors and stakeholders to use and compare.

And finally, a key piece of the jigsaw is the wide communication of this non-financial information. The information used to value a company, whether material or non-material, is worthless if it doesn't reach the widest audience possible. As financial information is fed through the media, such as news agencies, newspapers, radio, TV and the Internet, businesses can expect that the news disseminators are there to help ensure that their non-financial information, comparable and measurable in easy to use formats, is distributed to the widest possible investor audience.

True transparency in all aspects of corporate reporting is within sight.

Mark Hynes is managing director of investor relations services for PR Newswire. He is responsible for developing regulatory disclosure solutions and strategies. Hynes was recently appointed to the board of directors of the Investor Relations Society. He is a frequent lecturer at investor relations, transparency and governance conferences, a regular contributor to investor relations publications and writes the popular blog, "Transparency Matters," which offers opinions on the changing rules of transparency, best practices and the effect on investor relations' officers. Hynes also launched DisclosureResource.com in 2003, (<http://www.disclosureresource.com/>), a free online resource hosted by PR Newswire aimed at providing news, research and publications connected to the dissemination of price sensitive news by issuers around the world.



EXTRAORDINARY TIMES CALL FOR EXTRAORDINARY GOVERNANCE

Corporate governance continues to undergo substantive changes, which are impacting and redefining board activities. While many companies are evaluating and changing their governance practices, lasting reform takes time and vigilance. In response, Harvard Business School is offering a series of Executive Education programs throughout the year that focuses on helping directors of public companies understand their primary roles, their legal responsibilities, and the impact of their decisions. Developed to maximize board contributions, these intensive programs examine the critical, complex issues confronting boards today.

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