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U.S. and Canadian Corporate Governance Assessment

I. Background and Objective

As part of its Enhanced Analysis Initiative[1], Moody's will begin publishing Corporate Governance Assessments on selected major North American debt issuers.

The Corporate Governance Assessment (CGA), discussed in this methodology report, will focus on governance attributes and practices, with particular attention to potential implications for credit quality and creditworthiness. Our analysis will emphasize the board of directors, including its independence and the apparent quality of its processes. We will identify significant deviations from generally accepted best practices, including significant board and executive conflicts of interest. The CGA provides readers with our observations; it does not constitute a quantitative rating. Thus, there is no scoring.

The core objective of undertaking the CGA is to improve rating quality and help investors assess the credit risk of issuers. The CGA is part of Moody's credit research, and will assist in rating transparency by providing an opinion on corporate governance attributes. It also will help establish a discipline for consideration of governance issues throughout Moodys' public company rating groups that will become an integral part of our overall rating methodology. Initially, the full exercise of publishing a Corporate Governance Assessment will be limited to selected large issuers. Moodys' goal in selecting companies for CGA coverage essentially is maximum coverage of rated debt in North America, balanced by an attempt to cover a range of sectors and ratings categories. We did not select issuers based on perceptions of their corporate governance, either good or bad. Moody's will incorporate the insights from the assessments into its published ratings.

While market standards for corporate governance are significant, in considering governance, Moody's will not be bound by a "checkbox" approach that slights complexity, and will weigh broader factors, including quality of financial reporting and other indicators of whether the firm is run according to the best interests of shareholders and creditors.

At present, research on the impact of corporate governance practices on credit risk is limited. Moody's will be undertaking research to clarify these issues, and we expect to adjust our methodological approach over time in light of any findings in this research and in our study of corporate governance practices at leading companies. Through the coming months, Moody's also invites comment from market participants on this topic.

This methodological framework has been developed in the context of studying large North American, particularly U.S., publicly-held corporations. This context features deep equity and credit markets, dispersed ownership, and other particular legal and cultural factors that may not be present in other markets. As we consider corporate governance in other contexts (that is, non-U.S. markets, and for entities that are not publicly-held), the factors, and weight given to

1. *"Moody's to Introduce Specialized Analytical Teams to Enhance Corporate Credit Analysis," press release, June 13, 2002.*

those factors in our analysis, may differ from what is laid out in this document. However, the underlying concern remains the same — the strength and integrity of the structures of accountability of the rated company from a creditor's perspective.

II. Framework for the Corporate Governance Assessment

In undertaking consideration of corporate governance in credit analysis, Moody's is confronting two primary questions. First, what aspects of corporate governance are relevant from a creditor's perspective? Second, how should creditors assess the quality of corporate governance and how should that assessment factor into the credit decision?

Fundamental credit analysis incorporates evaluation of franchise strength, financial statement analysis, and management quality. [2] Corporate governance can be seen as an important analytic element of management quality. To the extent that shareholders as well as creditors and others have confidence that proper systems of management accountability and incentives are in place, they can have greater confidence in the present management of the company. In theory, they also can be more confident that, should management fail to meet emerging challenges, managers will be held accountable, either through early action by the board of directors, or through pressures, up to and including hostile takeover, in the market for corporate control.

This viewpoint derives from the notion that a key problem in corporate governance is an "agency problem" — that there is a danger that the managers (the agents) of the enterprise will make decisions in their own interests, or for expedience, rather than in the interests of the outside shareholders (the principals), and that those interests at times conflict. This concern becomes important in the context of widely diversified ownership, as is typical for large publicly-held U.S. corporations. At its extreme, such behavior, if unchecked, can endanger the viability of the enterprise. This danger can be realized through short-term risk-taking that may offer executives extraordinary opportunities for personal enrichment; this can include activities that border on illegality and market manipulation. Managers who may seek to entrench themselves pose a different risk, as they insulate themselves from personally negative outcomes from poor company performance at the long-term expense of the shareholder, the enterprise, and other stakeholders as well. Even less debilitating manifestations of the agency problem may be costly, at least to shareholders, as managers extract excess rents (that is, secure compensation in various forms above market rates).[3]

A separate key corporate governance question is of secondary concern in our analysis of most North American companies. This is the issue of whether controlling shareholders are in a position to take advantage of minority shareholders, or have any history of doing so. This concern can be significant at some North American companies, but tends to be a larger issue in most overseas markets, in which controlling shareholders are much more often present. ("Control" itself can be exerted through less than majority voting control; such control sometimes may be exercised by groups of close or like-minded shareholders.) Legal protections for minority shareholders, including fiduciary obligations imposed on company directors and executives, are critical in addressing this type of corporate governance problem. "Controlled" companies may occasion fewer worries about misalignment of managers and shareholders, exactly because there is less separation of management and control (at least to the extent that equity interest is equal to voting interest). A majority holder has power and motivation to monitor performance that a diversified shareholder base lacks.

Generalized implications for creditors of companies that have controlling shareholders are not clear to us at this point. At a minimum, generalizations will be limited by the large situational element — that is, the creditor impact to a significant degree will depend on *who* the controlling shareholder is and how that shareholder views fair dealing toward creditor interests. Having said that, a publicly-traded entity that is essentially privately-controlled may lack some measure of accountability to public equity markets. This lack of accountability may harm creditor interests in some circumstances, as entrenched managers fail to react appropriately because they lack objective understanding of the situation of the firm, or as the controlling shareholder seeks special advantage. However, in other situations, creditors may benefit from the protection afforded for long-term strategies by insulation from public equity markets.

The foregoing discussion on the agency problem suggests that creditors have an interest in proper accountability structures, even if the formal governance mechanisms principally are concerned with accountability to shareholders as opposed to some broader stakeholder grouping that would encompass creditors. [4] We believe this is correct, but it

2. *Of course, confidence in management quality is inextricably linked to financial statement analysis and evaluation of franchise strength. If, for example, the investor has reason to lack confidence in management integrity, the reliability of financial statements may be in question. In turn, the analyst working with faulty financials may misanalyze franchise strength.*
3. *"Corporate governance" as a concern comes to the forefront in consideration of risks inherent in the agency problem. Of course, there are fundamental strengths in what sometimes is labeled "managerial capitalism." The system is designed to permit investors to pool capital, and entrust managers to run the enterprise efficiently and dynamically. Critics of the current emphasis on strengthened corporate governance mechanisms worry that additional controls and limits on managerial power will hobble management efficiency and dynamism. The desirable outcome for both shareholders and creditors is a proper balance of controls and managerial freedom. Shareholders and creditors may have naturally conflicting views, however, on exactly what the correct balance is, given their varying risk appetites and return opportunities.*
4. *The theory behind this is that shareholders have only the governance mechanisms to formally assert their rights. Creditors have contractual rights, although such rights have real-world limits in the ability of the company to reorganize through bankruptcy. Of course, both shareholders and creditors have disciplining influence on companies economically, through their willingness (or lack thereof) to put up money at a particular price, affecting share price and spreads on credit instruments.*

oversimplifies. While there is substantial overlap between creditor and shareholder interests, there also are important potential conflicts. Perhaps nowhere is this more evident than in the effort over the last 15 years, particularly in the United States, to "solve" the agency problem through the use of executive stock option awards. A question we will seek to address is whether excessive use of such awards at times may endanger the enterprise by encouraging executives to "swing for the fences," and at times even to shade the truth about corporate performance. Even more than shareholders (or, certainly, diversified shareholders who want to encourage risk-taking), creditors are interested in the viability of the enterprise itself, at least over the length of the credit term. Of course, risk-taking is an important component of good long-term management, but creditors and diversified shareholders will have different views on the appropriate level of risk.

COMPONENTS OF GOOD GOVERNANCE

Moody's believes that there is not a single clear formula of good governance that is verifiable and adequate. The cookbook approach has severe limitations. Context is important, including legal and cultural context, industry characteristics, ownership patterns, company growth stage and other factors. But while "one size does not fit all," as many observers say, there are strong reasons to expect certain common good governance attributes in large publicly-held enterprises, including clearly independent oversight of management, comprehensible structures of management accountability and succession planning, and rational executive incentive structures.

Corporate governance, as we use the term here, consists of several components:

1. **The board of directors**, the fulcrum for managing governance relationships and the mechanism, generally elected by shareholders, by which managers are held accountable.
2. **Compensation arrangements and related practices**, such as any share-owning requirements, for members of the board of directors and executives. (As used in this report, the term "directors" refers to members of the board.) Related to these are management development and executive succession plans. Compensation and related arrangements can be used to promote alignment with shareholder interests.
3. **Public disclosure**, including financial and other reporting relevant to equity investors and creditors.
4. **The legal/regulatory structure and arrangements by which the public corporate entity exists**. In the United States, the chief elements are provided by state corporation law (with a majority of larger companies incorporated in Delaware), federal disclosure requirements and limited other federal regulations, stock market listing standards (which are a matter of contract between the corporate entity and the stock exchange or market), corporate charter, corporate bylaws, and certain additional stock-related instruments, such as share or convertible security offerings or shareholder rights plans (or "poison pills") that offer certain rights.
5. **Shareholder voting and other ownership prerogatives**, which of course are critically affected by legal structure and the nature of company ownership. (A large company with a highly diversified share base will have different characteristics from a firm that has one or several major holders.)

Moody's will focus particular attention on the first factor — the independence and effectiveness of the board of directors. We regard the quality and reliability of the board as critical to effective governance, yet recognize these are difficult to judge from outside the boardroom. Our presumption is that a board of directors that effectively promotes and protects long-term interests of shareholders and the corporate entity will, by and large, mitigate risk for creditors, by assuring proper oversight of management. Conversely, a board that fails in basic oversight of key areas — such as conflicts of interest, management succession, risk management, internal controls, financial reporting or strategic planning — poses an additional inherent risk, from a creditor standpoint.

Executive pay arrangements that provide large short-term incentives — particularly those related to equity valuations, which can be volatile and erratic — may pose excessive risk, particularly from a creditor standpoint. This is particularly true if there is a failure to tie compensation or executive stock ownership to longer-term success of the enterprise. Large grants of standard stock options — especially if vesting periods are short and/or stock holding requirements are lacking — may encourage excessive risk-taking and even aggressive and potentially misleading financial reporting.

The most important disclosure component (item 3) is financial reporting, which will be examined as part of separate Moody's Financial Reporting Assessments, and is largely beyond the purview of Moody's corporate governance work. However, the Corporate Governance Assessment will comment on availability and quality of information pertaining to governance structures, such as the board of directors, board committees and executive compensation. Moreover, quality and reliability of financial reporting itself relates to quality of governance, since the board of a public company has an affirmative responsibility to assure that management releases honest and informative accounting of

company financials. Aggressive accounting practices, restatements, and misleading disclosure raise important questions on the quality of management and board of directors.

Moody's anticipates putting less emphasis in its North American analysis, initially at least, on legal structures, or on issues of shareholder voting and related rights (items 4 and 5). To a significant degree, meaningful differentiation of legal structures within the U.S. context comes down to shareholder rights issues, and in particular takeover defenses and the market for corporate control. Moody's has not yet formed a view on the likely impact of standard variations in U.S. or Canadian takeover defenses on creditor interests, and we will be undertaking empirical research to help form a fuller view.[5] Theoretically, there are reasons for creditors as well as shareholders to worry about management entrenchment and insulation from the market for corporate control. These can protect weak performers and sap the financial strength of the company over time, diminishing the capacity of the entity to repay debt, and to survive shocks and cyclical downturns.

On the other hand, low barriers to takeover and a strong orientation to near-term shareholder values may encourage excessively high leverage, either by current management or following a takeover, which can weaken the financial strength available to fulfill existing debt commitments. This may increase enterprise risk and the possibility that bondholders will not be repaid. To the extent the latter factors predominate, shareholder and creditor interests will differ in this area. The fundamental reason for this is that shareholders — especially diversified shareholders — will have a greater risk appetite, since they benefit from the potential upside.

Nevertheless, particularly abusive entrenchment tactics and tools, and a clear willingness of a board and/or management to abuse rights of a particular class of securities, can be a red flag of potential risk for holders of other types of securities, including bondholders. An example of an abusive antitakeover tool is the so-called "dead-hand" shareholder rights plan. This is a type of poison pill — pills being dilutive mechanisms that prevent hostile takeovers — that may not be redeemed (that is, removed) if shareholders elect a new board in a proxy contest. Many institutional holders regard this mechanism as coercive and destructive of their voting rights, but the dead-hand pill nevertheless had become common by the late 1990s, until Delaware courts moved against them and institutional investors stepped up their opposition.

Also, aside from takeover implications, certain shareholder rights simply involve respect for shareholder prerogatives and voting rights. Corporate decisions that suggest disregard for shareholders may be red flags of corporate governance difficulties and inadequacies. In addition, dual class voting structures, with unequal voting rights, can result in a separation of ownership and control, with potential effects on the broader enterprise.

Ownership characteristics of a firm can have substantial impact on public shareholders and on creditors, although it appears to us that the effect is highly situational, as is suggested above. However, there may be reason for particular concern about the transition from a narrow ownership base with prominent family or venture capital role, to broader public ownership. Founding families, venture capitalists and/or others who are critical in shaping and controlling young companies can play a negative role as a growing company transitions to broader ownership, either through attempts to exert continuing control (and lack of acknowledgment of changes needed to meet challenges of growth), or, for venture capitalists, through potential conflicts of interest.[6] Corporate spin-offs and joint ventures also can create conflicts of interest that are difficult to manage, and that if mis-managed can damage creditors as well as shareholders. Perhaps the extreme version of this has been tracking stock structures, which for a brief time in the late 1990s were popular, adopted at companies like WorldCom. In these structures, boards have often-conflicting obligations to separate sets of shareholders. Moreover, the complicated structures may have offered particularly great opportunities for financial reporting gamesmanship, and Moody's is concerned with the mechanisms by which intra-company transactions in this context are monitored at the board level.

OUTSIDE EVALUATION OF GOVERNANCE

Moody's considers the quality of the board of directors as the most important factor in governance assessment from a credit perspective. Objective data points are limited, and the assessment of board effectiveness depends crucially on questions with large subjective content. For example, at what point does board collegiality give way to director and board passivity? What is the line at which appropriate director questioning and probing becomes meddlesome micro-management which inappropriately undermines the CEO and the executive team? How can a board of directors — essentially a part-time committee — make itself into a well-functioning group? How do the CEO and board relate to each other? Does the CEO feel accountable to the board, and seek directors' fully-informed judgment?

5. *Most academic research on takeover defenses, as in other areas of corporate governance, relates to impact on shareholders. While that research itself is ambiguous, with a variety of conflicting findings, there are some recent studies suggesting links between shareholder value and a shareholder orientation as indicated by low takeover defenses and strong shareholder rights. See, e.g., Paul A. Gompers, Joy L. Ishii and Andrew Metrick, "Corporate Governance and Equity Prices," Quarterly Journal of Economics, February 2003. Even from a shareholder standpoint, however, the particular mix of takeover defenses probably is less important than the nature of the board and management team, and their motivations, incentives and goals with respect to interests of shareholders, creditors and others.*

6. *Perhaps most starkly, as the technology boom ebbed in 2000-01, say some critics, VC firms sometimes were confronted with conflicting interests as they attempted to perform triage in particular market niches where they had invested in multiple companies.*

However, there are some objective components about which certain comments and observations are legitimate. Do the directors have financial or familial relationships with company executives that may compromise their independence? Are there significant links between the company (or its executives) and corporate, charitable and/or educational institutions managed by outside directors? Have the directors created appropriate committees, with memberships of qualified individuals, sufficiently-frequent meetings, good attendance and appropriate charters and procedures? What have directors done to assert authority in their proper sphere, such as in controlling the relationship with the internal auditor, external auditor and compensation consultant? How do the board and audit committee assure themselves that the company has adequate internal controls? Does the board have clear and credible criteria, and a process, for reviewing its performance?

Moreover, some policies and practices are red flags that raise questions that we believe can productively be posed to executives and/or members of the board. Most obviously, extended poor performance with no apparent board action raises questions of board assertiveness, though often too late for investors. Important disclosed conflicts of interest are always a red flag, and creditors should be satisfied that the reasons for such conflicts have been considered carefully, and the conflicts are well-managed. (Of course, significant conflicts of interest that are not disclosed but emerge in press reporting or otherwise are even more serious red flags.) It is anticipated that New York Stock Exchange companies will soon have to set and disclose explicit standards for director independence. If the standards for a given company appear loose or are evaded in practice, that would be a significant red flag as well.

Another concern is lack of a strong and clearly independent majority on the board, with audit, compensation and nominating/governance committees composed exclusively of independent directors.[7] A high standard of director independence is merited by the view that dispassionate, objective debate at the board level is integral to strong oversight of management.

When evaluating board independence and effectiveness, Moody's will consider stock market listing standards, along with best practice recommendations put forward by various organizations, including the Organization for Economic Cooperation and Development Principles of Corporate Governance and other international organizations. Within the national context, we will look to standards of practice put out by relevant professional and other bodies. For example, in the United States, where most of the initial work in this initiative is focused, such standards include recommendations of the National Association of Corporate Directors; the Council of Institutional Investors and other investor organizations such as TIAA-CREF and the California Public Employees' Retirement System; the Conference Board, and particularly its 2002-03 Commission on Public Trust and Private Enterprise; the Business Roundtable; board and audit committee practices of the major accounting firms; and suggestions by authoritative commentators, such as the members of the Delaware Chancery Court and leading academic experts in corporate governance. Legal requirements, including those provided for in the 2002 Sarbanes-Oxley legislation, are significant, although our assumption is that companies (particularly the large issuers which are our main focus for the Corporate Governance Assessment) will be generally in compliance with such standards. Such standards are useful, but Moody's does not intend to use these standards in a "checkbox" fashion, favoring a broader qualitative assessment. Moody's does *not* intend to police issuers for legal compliance.

Moody's also will consider indicators of board passivity. For example, one window on the board is the executive compensation scheme, for which U.S. companies provide extensive information (though the same is not true in many overseas markets). Executive pay that appears excessive relative to peer group and performance may indicate a passive board and compensation committee.

Aside from independence, a board composition that suggests a lack of balance in power and assertiveness between the CEO and the board, or an apparent lack of sufficient qualifications, is highly significant. Boards of directors of large, national and multinational companies have substantial responsibilities, and investors should expect that the boards of these companies will have directors with high levels of business operating experience who have the time and dedication to do a credible job, and that a given board will reflect the strategic needs of the company. A characteristic problem in corporate governance is the regional firm that has met with success, and has grown substantially, but has failed to adjust its governance structure to meet new demands and expectations.

Director compensation practice is another area of focus. Directors largely set their own compensation — unless company executives, in practice, set director pay. The latter may, in fact, better describe the reality at many companies, and obviously potentially undermines lines of accountability from managers to the board. In theory at least, "excessive" director pay (as well as company loans or loan guarantees to directors, or consulting or other arrangements) could compromise the independence of directors. On the other hand, expectations for director qualifications, time commitment and diligence clearly are increasing (and, arguably, perceived liability exposure also has increased). The correct balance in director pay is exceedingly difficult to identify. However, director compensation schemes that far exceed

7. *By relatively strict definitions of director independence used by the Investor Responsibility Research Center and other organizations, it appears that on average about 70 percent of directors at larger U.S. companies are classified as independent.*

general practice among national companies and/or industry group companies are suspect, as potentially compromising director independence and objectivity. Some director compensation arrangements that are substantial and rely heavily on stock options or other relatively "risky" pay elements also may merit comment as potentially encouraging risk-taking that could be excessive from a creditor standpoint.

Further red flags of potentially poor governance include the following:

- The apparent existence of an insider-dominated "board within the board," sometimes in the form of a particularly active and empowered executive committee, which may indicate the ostensible board is window-dressing.
- Where the CEO and chairman positions are combined, lack of a coherent leadership framework for the independent directors; our presumption is that the care and feeding of an effective independent board takes work and leadership on the part of the independent directors. Lack of a clear leadership structure for the independent directors may hobble the responsiveness of a board in a crisis.
- The presence of a celebrity and possibly overreaching CEO — particularly in combination with undisciplined pay structures and CEO compensation that is excessive relative to peers. These elements may indicate an imbalance of power between CEO and board and a lack of accountability of the CEO to the board.
- As suggested above, questionable composition of the board, with inadequate business experience and too many directors who appear to be on the board for their own celebrity, or for political or other influence. Boards also may lack functional balance.
- Risky and potentially highly remunerative top executive pay schemes that could encourage short-term actions that may be harmful to creditor interests in the longer term, or that could encourage excessive risk-taking. Certain relatively unusual pay structures (such as payment to the CEO of a percentage of net income, which can encourage excessive acquisition activity) also can be red flags.
- Serial acquisitions that in Moody's view lack compelling logic (and that harm creditor interests), and/or that cloud financial transparency of the company for reasons that may not be clear, and/or that clearly fail. What role did the board play? Is there an effective check on managers who may be motivated by a desire to build empires? Does the board review actual performance of acquisitions to benchmark against projections?
- The absence of an independent director nominating committee, or even the recent absence of such a committee, given that this likely will be required by the NYSE and Nasdaq at most companies going forward; the lack of such a committee up to now may indicate an expectation that the CEO and executives will control the director selection process.
- Lack of board independence at publicly-held companies that are exempt from stock market listing requirements because they are majority controlled. We believe management at such entities should be clearly accountable to independent directors, either through the entity itself or through the parent company. Even if the ultimate parent has a strong board of directors, we may bring a heightened level of skepticism to a publicly-held entity that lacks its own independent board or other mechanism that clearly protects minority holders and the entity itself. Protections against inappropriate encroachment by the parent entity may be critical.
- Accounting restatements or indications of unusual aggressiveness in accounting assumptions, which may indicate a lack of proper controls or effective director oversight, as may findings of various forms of corporate wrongdoing.
- Any history of unfair treatment of particular classes of security holders, particularly, for our purposes, bondholders. Past abuses may indicate a likelihood of similar future actions.
- Outside audit firms that have high levels of non-audit engagement with the company. All stakeholders in public companies, including creditors, depend to some extent on the integrity and completeness of the external audit. If the independent auditor's role appears to be compromised, financial statements may be less reliable, and management may not be appropriately challenged and checked.
- More generally, lack of evidence that the audit committee is firmly in charge of the relationship with the external auditor.
- Lack of strong and clear links between the audit committee and the internal auditor, the general counsel, and certain other officers (such as the chief risk officer, in some cases). We are concerned about reporting lines, regularity of interactions, and committee involvement and input on evaluations of such officers. A related question is the existence of a managerial disclosure committee to ensure appropriate disclosure.
- Director absenteeism, or lack of key committee meetings (particularly the audit committee), which may indicate a lack of proper diligence.
- Lack of director orientation and development efforts, which may indicate the board is regarded as a formality, and/or that directors are insufficiently knowledgeable of the company, the sector, or general corporate governance standards and requirements.

- Lack of reasonable director turnover, which may indicate the absence of fresh perspective. Regular director turnover may be encouraged by strong director evaluation procedures, a mandatory director retirement age, or director tenure limits.
- Lack of clear director engagement on CEO evaluation and succession planning, or on oversight of broad company strategy, risk assessment and management, and/or internal controls.
- Excessive takeover defenses, which may indicate an attitude of entrenchment and protectiveness toward executives and the status quo.
- Willingness to ignore shareholder views — for example through rejection of governance proposals supported by shareholders in proxy voting or unusual vigor in finding ways to bypass shareholder approval for certain policies. This may indicate a lack of respect for accountability mechanisms.
- An ethics policy that appears to lack coherence or clear methods for implementation, suggesting possible lack of commitment to ensuring ethical practices in the organization.

These are just some of the red flags that raise legitimate questions that Moody's intends to explore in exchanges with executives and directors. In many cases, there will be a good response; sometimes a flag is just a flag. Moreover, to the extent Moody's and others are looking at the same issues, some bad actors who would be affected by negative commentary are likely to game the system by, for example, having an otherwise moribund audit committee meet frequently. Similarly, where directors have strong personal ties to the CEO, or are otherwise less-than-independent in fact, the board may nevertheless meet particular specified objective standards of independence.

Moody's believes discussions with executives and directors that are conducted within the rating relationship will help us identify strengths and weaknesses in corporate governance that could potentially affect creditors. Still, we accept that there are clear limitations on our ability — and on the ability of investors — to assess board effectiveness from outside the boardroom.

We anticipate that we will be able to identify material governance concerns or particular governance strengths in only a minority of cases, at least within the North American context, where there is much commonality of practice. Nevertheless, we think this will provide a significant and meaningful enhancement to credit analysis and the understanding of risk.

III. Methodology

In developing a view on corporate governance of U.S. and Canadian publicly-held companies, Moody's begins with publicly available sources of information, principally the proxy statement and governance information appearing in other SEC filings and on company web sites; and the corporate charter, bylaws and related documents.

For selected large U.S. and Canadian issuers this year, Moody's will prepare and publish brief, written Corporate Governance Assessments. These CGAs will not include a score, but rather will be a textual opinion on the quality of governance. We will comment on conformance with standard and best practice recommendations, and will focus particularly on implications for creditors.

The initial analysis will be based on public information. Moody's seeks to gain a fuller view, however, through dialogue with the issuer on these questions at both the executive and outside director level. Moody's generally has not previously sought to engage outside directors in discussion. We believe understanding the perspective on governance of one or more outside directors is of significant utility in forming a view on the corporate governance of an entity.

The CGA is a relatively brief opinion; we plan to consider a wide range of possible issues, but intend to keep the assessments focused to issues relevant to the particular company. Therefore, we expect that unremarkable practices frequently will receive only cursory reference to compliance with standard practice. Particularly good or poor practices will receive more focus.

The CGA generally will have the following sections:

- **Board of directors:** This section provides a general discussion of the board of directors and will highlight significant departure from generally recommended best practices, as previously discussed. Subjects may include board and committee independence; apparent director quality, depth and diversity; board and committee leadership; general review of committee charters and processes and areas of explicit board responsibility (including stated mission and purpose); board and director evaluation; director training; and director compensation and related policies, such as share ownership guidelines.
- **Audit committee and key audit/accountability functions:** We examine separately the effectiveness of the audit committee because of its relevance for the reliability of financial reporting. We consider the audit committee charter, and the board's expectations of the committee in the areas of financial accountability, risk assess-

ment, internal controls and ethics policies and processes. (In some or many cases, portions of these oversight responsibilities may lie elsewhere with the board, including at the level of the entire board, which may make sense. We intend to discuss the subject in this section, however the particular board structures its operations.)

- **Conflicts of interest:** We highlight significant disclosed director and executive conflicts of interest, and discuss how those conflicts are managed.
- **Executive compensation and management development and evaluation:** This section focuses in particular on the CEO, and includes discussion of incentive structures and their possible impact on executive risk appetite and/or incentives that appear to pose dangers to long-term shareholder interests and creditor interests. This section also considers executive succession planning, a key area of board responsibility.
- **Shareholder rights:** As discussed above, this section will characterize shareholder rights and takeover defenses compared with general national and industry practice. We hope that over time we can contribute additional insight on implications for creditor interests, but believe our ability to do so initially will be limited.
- **Ownership:** We are particularly concerned with the presence of a majority or large minority holder of the publicly traded company, and implications this has for the governance of the corporation and for the interests of creditors. We also consider implications of director and management holdings, and executive share ownership requirements.
- **Governance transparency:** Requirements for governance transparency have increased substantially in recent years in a number of markets. We plan brief commentary on this, particularly on notable positive or negative departures from standard practice.

Moody's will provide senior management with the opportunity to review and comment on drafts of the assessment. We stand willing as always to listen to additional arguments at that point in the process, and to receive additional information. Specific corrections of fact or introduction of new information and perspective would be a basis for altering our assessment, although on some issues, as is generally true of our rating practices, our opinions may not change.

We anticipate that in a minority of cases, the Corporate Governance Assessment may raise material strengths or weaknesses that will merit mention in the Fundamental Credit Research Opinion.

Research Links

Rating Action

"Moody's to Introduce Specialized Analytical Teams to Enhance Corporate Credit Analysis," June 13, 2002

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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