

**STANDARD
& POOR'S**

Setting the Standard



Rating Compliance & Corporate Responsibility

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Congress*

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The McGraw-Hill Companies



Ongoing Initiatives to Enhance Standard & Poor's Analytics

- ❑ Accounting
- ❑ Analytical Training
- ❑ Surveillance Enhancement
- ❑ Management & Governance
- ❑ Risk Management Enhancement
- ❑ Policy & Review Control Practices



Corporate Governance Analysis

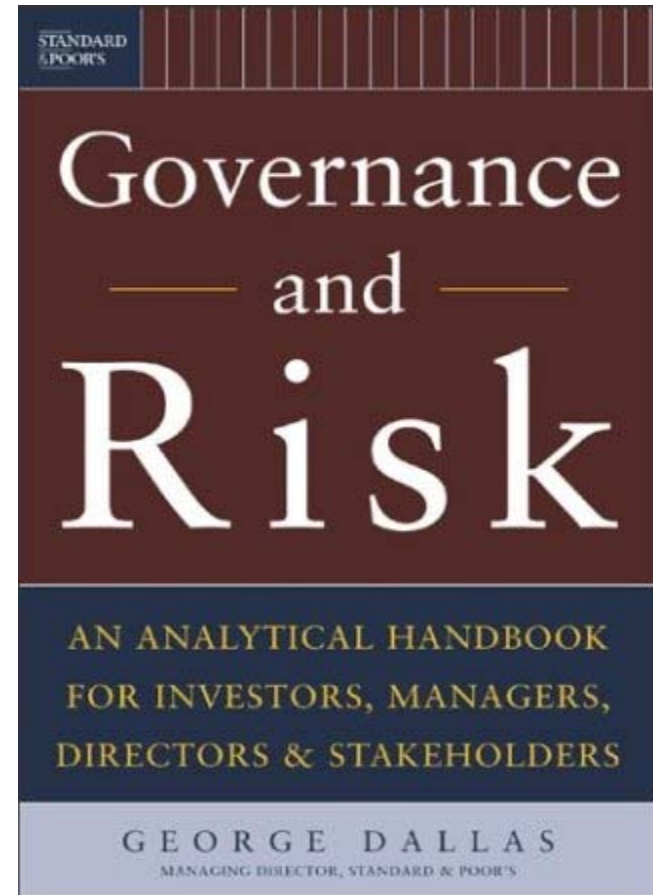
- At its most basic level –

it is the interaction of a company's

- **management**
- **board directors**
- **shareholders**

to direct and control the company to ensure that all financial stakeholders (shareholders and creditors) receive their fair share of the company's earnings and assets

- In 1998, Standard & Poor's researched and developed criteria to review companies governance.





Corporate Governance Analysis

- ❑ Historically, management & governance have been factored into ratings

- ❑ Today, identifying risk factors is more structured and systematic
 - Enhancing rigor of credit committee discussions
 - Increasing disclosure via publication

- ❑ Common element of corporate failures is a heightened risk profile
 - Aggressive management culture
 - Weak board oversight

- ❑ A combination of risk factors can be symptomatic of a heightened risk profile and can result in an incremental governance review



Corporate Governance Analytical Framework

Weak corporate governance:

□ Allows:

- Inappropriate allocation of corporate resources
- Management incentives that can compromise long-term stability
- Inadequate oversight of the integrity of financial disclosure

□ Undermines creditworthiness

□ Leads to heightened funding and liquidity risk



Pharmaceutical Manufacturers Rated by S&P

35 Pharmaceutical Manufacturers are rated
17 are investment grade including the big eight

- ❑ **Abbott Laboratories Inc**
- ❑ **Bristol-Myers Squibb Co.**
- ❑ **Eli Lilly & Co.**
- ❑ **Johnson & Johnson**
- ❑ **Merck & Co. Inc.**
- ❑ **Pfizer Inc.**
- ❑ **Schering – Plough Corp.**
- ❑ **Wyeth**



Problems facing the Pharmaceutical Industry

- ❑ Pricing pressures
- ❑ Large & inefficient R&D programs
- ❑ Empty near – term R&D pipelines
- ❑ Patent expirations
- ❑ Public furor of rising drug costs,
- ❑ Pressures from HMOs
- ❑ Marketing scandals & record fines
- ❑ Accounting improprieties



Problems facing the Pharmaceutical Industry

Lack of new products to drive growth

- ➔ more aggressive promotion of existing products
- ➔ to marketing violations and record fines.

Under-investment in maintaining manufacturing facilities in full compliance and stricter FDA manufacturing standards

➔ several manufacturing noncompliance issues resulting in:

- Product delays
- Product withdrawals
- Loss of market share
- Major fines
- Drain on resources



Corporate Governance Analytical Framework

1. Ownership Structure & External Influence

- Transparency of ownership
- Concentration and influence of ownership & external stakeholders

3. Transparency, Disclosure & Audit

- Content of public disclosure
- Timing of, and access to, public disclosure
- Audit process

2. Shareholder Rights and Stakeholders Relations

- Shareholder Meeting & Voting Procedures
- Ownership Rights & Takeover Defenses
- Stakeholder Relations

4. Board Structure and Effectiveness

- Board structure and independence
- Role & effectiveness of board
- Senior Executive & director compensation



The audit process

- ❑ Standard & Poor's assesses the audit process at the board level.
- ❑ Outsiders want to know what processes are in place for managing risk inside the company.
 - We assess the processes by which internal control & risk management strategies and accounting policy choices are made and the sufficiency of oversight of this process.



The audit process

- This assessment is often driven by our interviews with:
 - audit committee members,
 - the internal audit team, and
 - the lead partner from the company's outside auditor.



The audit process

- ❑ Our discussions with audit committee members reflect their:
 - ❑ knowledge of and oversight of the company's financial statements, internal controls and risk management procedures.
 - ❑ articulation on how major risks to the business are monitored, and on how they respond as directors as risks and risk tolerances change



Audit Process

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"Oh, that three billion dollars."



Corporate Governance

Analytical framework

Board structure and effectiveness

Board Composition and Independence

- Board size and structure
- Skill mix, diversity, experience
- Chair/CEO split
- Director selection
- Director shareholdings
- Board Independence
- Board committees and committee composition
- Director nominations and tenure

Role & Effectiveness of the Board

- Lines of responsibility
- Reporting systems
- Setting company purpose, mission and ethical parameters
- Strategy setting, board cohesiveness
- Management appointment, oversight & succession
- Monitoring internal control & risk management
- Self-evaluation/training
- Meeting frequency and attendance/external commitments

Senior Executive & Director Compensation

- Link of pay to performance
- Who determines compensation?
- Compensation policy and comparators
- Compensation consultant relationship
- Cash/share balance (senior management)
- Stock options (management and directors)
- Compensation disclosure
- Executive contracts
- Dilution overhang
- Perks and other benefits

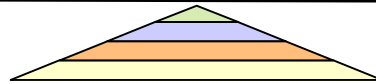
Corporate Governance Analysis

Board Structure and Effectiveness

- Frames the balance of power between

Managers

Directors



- Is subjective - Addresses qualitative concerns

- Concerns invisible to public disclosure

- Captures board atmosphere & internal dynamics

Integrity - Independence - Teamwork



Corporate Governance Score Board Structure and Effectiveness

- ❑ Director's "Independence of Mind" from:
 - Chairman
 - CEO
 - Other board members

- ❑ Going beyond the simple appearance of independence

- ❑ "Independence of mind" is reflected in:
 - Engagement
 - Being well informed
 - Having diverse skill sets and perspectives



Corporate Governance Score Board Structure and Effectiveness

- An effective board avoids:
 - *Fractious* behaviour,

but not
 - *Constructive conflict* or
 - *Differences of opinion*



Corporate Governance Score

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"What we didn't have but obviously needed was an alarmist."



Executive Compensation

- ❑ Is pay linked to real increases in company performance?
- ❑ Executive contracts and severance agreements are examined to determine the structure of specific pay packages and the incentives embedded within them
- ❑ Is pay distributed over several forms with different measures, restricting opportunities to “game” the system
- ❑ Who owns the relationship with the outside compensation consultants?
- ❑ Standard & Poor’s evaluates and benchmarks the dilutive effective of equity-linked awards to the company’s peers



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