



METAPRAXIS LTD

DRAFT DOCUMENT FOR CONSULTATION PURPOSES ONLY

23-Aug-2002 (Version 2)

The Directors' Early Warning (DEW) Report

CONTENTS

OBJECTIVE OF THE DEW REPORT	3
RELEVANT UK LEGISLATION	3
RELEVANT US LEGISLATION	4
CURRENT BOARD REPORTING PRACTICE	6
FOCUS OF THE DEW REPORT	6
COMPARISON WITH CURRENT REPORTING PRACTICE	6
IMPLEMENTATION	7
INTERESTS OF INVESTORS AND OTHER PARTIES	8
CLIENT REFERENCES	8
AGENCY	9
CONFIDENTIALITY	9
SUITABLE CORPORATIONS	9
COMMISSIONING DIRECTORS	10
FEE BASIS	10
PRACTICAL SUPPORT	10
TERMINATION	10
LIABILITY	10
IMPACT IN ADDITION TO PERSONAL RISK MINIMISATION	11

Objective of the DEW Report

This document describes the Directors' Early Warning (DEW) Report, a new professional service aimed at helping the directors (both executive and non-executive) of large companies to reduce the risk of failing to detect significant existing or future financial problems within their subsidiaries and thereby exposing themselves to a possible accusation of failing to discharge their fiduciary duty to shareholders.

Relevant UK Legislation

Existing and draft UK legislation and consultative reviews emphasise the importance of this issue and the requirement for practical solutions.

In 1998 the London Stock Exchange incorporated as changes to its Listing Rules the Hampel Committee's recommendations on Corporate Governance which state that *"the effectiveness of the Board is dependent on the information it receives from management. The Combined Code includes the obligation for management to provide the Board with appropriate and timely information"*.

The Consultation Paper on the "Review of the role and effectiveness of non-executive directors" led by Derek Higgs (June 2002) includes in its terms of reference questions such as *"How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?"*.

The UK Government's White Paper on "Modernising Company Law" (July 2002) contains a draft clause which is expected to make it mandatory for companies above a certain size to include in their "Operating and Financial Review" a discussion on *"the dynamics of the business – i.e. known events, trends, uncertainties and other factors which may substantially affect future performance, including investment programmes."* In this context it is important to note also the comment that *"the Government agrees that...all the directors of a company should be subject to the same set of general duties, regardless of any particular duties they might have under service agreements as employees"*.

Relevant US Legislation

In the US there has been a more rapid transition from consultation to action, with the Sarbanes-Oxley Act of 2002 requiring the principal executive officer and principal financial officer of all publicly listed companies (around 14,000 firms) to file a sworn written statement certifying to the accuracy of their financial reports. Based on this act the SEC issued a deadline of August 14th for 695 such firms with a calendar year-end and annual revenues above \$1.2 billion to sign a declaration in support of Section 302 (see panel alongside), with a further 250 to follow later in the year. These requirements also apply to UK and other international companies with significant US activities, eg. those operating with ADR status.

On August 5th one such company (Interpublic) announced that it was postponing its earnings announcement by a week so that its audit committee "*could complete its review prior to management certification of its financial statements.*" Uncertainty regarding the grounds for this delay caused the credit agency Standard and Poor's to announce that it might downgrade the advertising firm's credit rating and the stock dropped by 15% the following day.

Meanwhile the US legal profession has lost little time in issuing proceedings against the officers of companies whose assets have been devalued by alleged incompetence or malpractice, even if those officers can demonstrate that the information reports they were receiving at the time made no mention of such problems. Moreover Congressman Mike Oxley is Chairman of the House Committee on Financial Services which has issued subpoenas to corporations such as Citigroup in relation to document disclosure regarding Worldcom.

In this context it has been suggested that the inclusion in the Act of the phrase "*To the best of my knowledge*" arguably provides a degree of personal immunity to CEOs and CFOs faced by this requirement. However, it seems unlikely that a zealous US lawyer will not, soon or late, persuade a presiding judge that the adjective "best" both implies and also requires a stance of proactive competence rather than a track record of self-serving ignorance.

One Hundred Seventh Congress of the United States of America

AT THE SECOND SESSION

Begun and held at the City of Washington on Wednesday, the twenty-third day of January, two thousand and two

An Act

To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the “Sarbanes-Oxley Act of 2002”.

.....

SEC. 302. CORPORATE RESPONSIBILITY FOR FINANCIAL REPORTS.

(a) REGULATIONS REQUIRED.—The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m, 78o(d)), that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—

- (1) the signing officer has reviewed the report;
- (2) based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- (3) based on such officer’s knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;
- (4) the signing officers—
 - (A) are responsible for establishing and maintaining internal controls;
 - (B) have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
 - (C) have evaluated the effectiveness of the issuer’s internal controls as of a date within 90 days prior to the report; and
 - (D) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
- (5) the signing officers have disclosed to the issuer’s auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function)—
 - (A) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer’s ability to record, process, summarize, and report financial data and have identified for the issuer’s auditors any material weaknesses in internal controls; and
 - (B) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer’s internal controls; and
- (6) the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Current Board reporting practice

The well-publicised problems of companies such as Enron, WorldCom and Marconi have highlighted the dangers for directors (particularly non-executives) of relying solely on conventional Board reports as their primary source of periodic briefing. Such reports are usually:

- (a) retrospective in their primary focus;
- (b) an aggregation of the qualitatively different results of many underlying subsidiaries;
- (c) coloured by the optimism or pessimism of the appropriate management teams (especially regarding forecasts); and
- (d) presented as a sequence of "walls of numbers" that makes diagnosis and interpretation difficult or even impossible for non-specialist directors.

In some documented cases there has also been a deliberate intention to conceal worrying trends or dubious financial practices from the Board.

Focus of the DEW Report

The Directors' Early Warning (DEW) Report addresses these issues by providing a comprehensive, impartial and objective automated monthly scan across the internally reported results of each of the corporation's many subsidiaries. Graphical business performance visualisation techniques are coupled with underlying econometric and statistical analyses to answer questions such as:

- Is any significant information not being reported by the subsidiary?
- Are there any suspicious or unusual data values?
- Does the historical trend indicate any recent turning points?
- What is the future risk range for key business indicators such as sales, profit and cashflow, using a range of objective scenarios?
- In which subsidiaries is the local management profit forecast significantly different from this objective risk range?
- What is the likelihood of the corporation as a whole failing to meet its year-end profit targets?

Comparison with current reporting practice

The DEW report is therefore:

- (a) Prospective in its primary focus, concentrating not only on historic data but also on the next financial year-end and beyond;

- (b) Automatically applied to every single subsidiary to protect directors from the “*iceberg syndrome*” (i.e. the fact that a small subsidiary which can never make a very substantial profit can nevertheless make a very substantial loss);
- (c) Objective in its assessment of the risk of meeting future forecasts; and
- (d) Presented as a digestible and user-friendly sequence of graphs and diagrams that do not presuppose specialist financial expertise in the reader.

The DEW Report is intended to complement, not to replace, current Board reporting documents. Because its production depends entirely on objective data analysis, the DEW Report does not contain any qualitative information about a subsidiary’s markets, competitors, new product launches or other management actions. Its value lies in its impartiality and its ability thereby to provide directors with an objective view of the future which they can then compare with the more subjective views of the management teams who control the businesses concerned.

For example, if a profit forecast from management is markedly different from the risk range provided by the DEW Report, this does not necessarily mean that the management forecast is wrong - it simply means that its achievement is of relatively high risk. The DEW report therefore enables the Board to prioritise its efforts by understanding the risk associated with each subsidiary meeting its targets.

Implementation

Implementation of the DEW Report is carried out as a professional service under a strict nondisclosure agreement. Each month the corporation's consolidation system (i.e. the database which holds the historical results, budgets and forecasts of each subsidiary) is accessed and the most recent results are extracted, together with any changes to prior months. This procedure is almost entirely automated and requires little or no expenditure of effort by company finance personnel.

The data is then programmatically analysed by specialised algorithms corresponding to the above questions and the DEW Report is subsequently produced. The process is managed by trained consultants who ensure that circumstances such as incorrect source data do not jeopardise the relevance or accuracy of the DEW Report itself.

Delivery of the DEW Report takes place in either paper or electronic format and individual directors within a corporation can opt for alternative presentation formats. Directors wishing to access the DEW Report on-line can do so via a secure website that enables them to digest the risk profile of their company via a standard web browser, without the need for any specialist downloaded software.

The DEW Report can be generated within a turnaround time of as little as 24 hours after the provision of the appropriate month’s data.

Interests of investors and other parties

Investors clearly have a direct interest in preserving and increasing the value of their investments. Any techniques that detect adverse performance earlier than would otherwise be the case offer investors, via the Board of directors, the opportunity to improve returns or to limit losses to a level that might not otherwise be obtained. In certain extreme cases, regular DEW reports may provide Board directors with sufficient early warning signals to prevent the company from a total “meltdown” and consequent wholesale loss of value for the investors. For example, majority private finance investors in unquoted companies who already receive monthly internal management accounts will find the DEW Report an efficient technique for troubleshooting problems and identifying specific subsidiaries that are at risk.

Investors in US public companies who are not entitled to receive detailed internal monthly information can nevertheless access the company’s “Form 10-Q” quarterly SEC filings. In those cases where an external investor is the client for the DEW Report, the same diagnostic principles can also be applied to these public filings. Although a computerised database of such SEC filings has been available for some years (EDGAR), this process has recently been considerably simplified and also substantially accelerated by the August 6th announcement: *“Nasdaq, Microsoft and PricewaterhouseCoopers Launch Pilot Program to Make Financial Documents Easier to Analyze, Distribute and Share”*.

The website <http://www.nasdaq.com/xbml/> now contains the computer-analysable quarterly SEC filings of about 20 companies, using the emerging technical standard “XBRL”, and it is expected that many more companies will follow. This means that DEW analysis can be applied very efficiently to public domain data as well as to confidential internal results. The primary difference is that NASDAQ XBRL filings are quarterly and consolidated, whereas internal management accounts are generally produced monthly and are available in detail for each subsidiary.

Advantages also accrue from the DEW Report to third parties such as D&O insurers (Directors and Officers Liability Insurance), since companies using DEW clearly present a reduced risk in this regard. In this context it should be noted that in the interests of transparency and also as a core component of a company’s general policies aimed at regaining public trust, most DEW clients will wish to make public the fact that they are deploying DEW techniques.

Client references

The DEW Report uses proven management diagnostics that have been developed and refined with over 200 client corporations since 1984. A comprehensive client list and documented “Success Stories” are available at the company website www.metapraxis.com and an article discussing the nature of the diagnostic need and the techniques that have been developed to address it is available at the same website under the title: *“After Enron: 10 pragmatic questions for non-executive directors to ask the auditors”*.

Agency

The DEW Report uses business analysis and computer software techniques that have been developed by Metapraxis Ltd. It is implemented and managed for client corporations either by Metapraxis itself or by licensed associates who have already established a relationship of trust with their clients that includes privileged access to their clients' monthly financial data.

Such a relationship normally exists for auditors, advisory accountants, bankers, corporate finance advisers, company solicitors and other professional firms. Alliance partnerships are currently being established with such firms for the purposes of providing them with DEW Report capabilities for their own clients. The directors of organisations interested in adding this facility to their own service offerings are invited to contact the Alliance Partnership Director at the address below.

Confidentiality

Confidentiality of client data is clearly paramount and this aspect is treated with the utmost seriousness. Client data undergoing DEW analysis is normally stored via the Advanced Encryption Standard (AES). This is the successor to DES, the Data Encryption Standard and uses a 128-bit block cipher with a 128 bit key. It is generally believed that breaking AES using truly-random 128-bit keys is currently infeasible even by governments. The use of this standard generally provides clients with a higher level of data security than that which exists within their existing consolidation system.

Where company directors opt to access their monthly DEW Reports via their Internet browser, this is provided via a highly secure website hosted by a trusted third party, using encryption and password authentication protocols of the same degree of robustness.

Consultants working on client data for DEW analysis purposes are restricted to a small named team. All consultants are made continually aware of their responsibilities with regard to client data under the appropriate insider legislation.

Suitable corporations

The DEW Report is intended for the Board Directors of large corporations with a network of subsidiaries (including multiple hierarchies such as both geographical units and global product groups). Clients will normally have annual sales of not less than \$1 billion (approx. €1 billion or £600 million) and will operate in sectors such as industrial manufacture, consumer goods production and sale, service delivery, utilities, banking or insurance.

The DEW Report is not at present intended for use by public sector or other not-for-profit organisations.

Investors wishing to apply DEW techniques to the quarterly SEC filings of US corporations can consider commissioning the complementary *Investors' Early Warning Service* which deploys public domain information in conjunction with the XBRL technical standard referred to above.

Commissioning directors

The Chairman of the Board will normally convene a meeting with consultants from the appropriate DEW Report service agency to discuss the opportunity presented by the DEW Report. This meeting will usually also be attended by the Head of Audit Committee, the Chief Executive Officer and the Chief Financial Officer.

Fee basis

The fee basis for the DEW Report depends on factors such as the number of corporate subsidiaries, the degree of standardisation of the consolidation system, the choice of delivery medium and the required turnaround time. A short survey is performed without obligation and this information is then used to generate a fee quotation. The DEW Report is normally delivered monthly and the service is annually renewable.

Practical support

The DEW Report service includes an initial Board briefing on how to interpret the DEW Report together with annual updates thereafter. Additional sessions can be arranged as required e.g. for newly appointed directors.

Termination

The service can simply be terminated at the end of the appropriate financial year.

Liability

The DEW Report service employs statistical and visual communication methods to identify unusual performance according to the criteria set out above. Although every

effort is made to ensure that the DEW Reports represent a statistically and numerically correct interpretation of the underlying data that has been provided by the client, the DEW service is provided on the basis that in the event of any errors that may be contained within the reports that are delivered (whether arising in turn from errors in the client's base data or as a result of errors in the DEW diagnostic process itself, or both), the liability of the DEW service provider shall be limited to the amount of the DEW service fee for that reporting period.

Impact in addition to personal risk minimisation

Because of its use of impartial and objective statistical techniques, the DEW Report removes the emotion from discussions about targets, forecasts and budgets and replaces this by fact-driven decision-making. As a result, the severity of existing downturns becomes precisely understood and the range of their likely future impact can be calibrated with comparable precision. As well as helping to ensure that Board directors comply with their legal obligations, this process also assists the Board in managing the future of the business rather than dwelling on historical data schedules.

The introduction of this focus on the future significantly accelerates the timescale in which critical business decisions are taken. In a recessionary climate this brings forward the date at which necessary but unpalatable actions are implemented, while at times of expansion the techniques help the Board to reach a rapid consensus on the need for early investment.

The combination of these two effects normally results in major bottom line impact within the first few financial years at a level that greatly exceeds annual expenditure on DEW Report fees.



Companies who wish to consider commissioning the DEW Report service should contact our Business Development Division.

Professional service organisations who are interested in offering the DEW Report service to their own clients should contact our Alliance Partnership Division

**© 2002 Metapraxis Ltd., Hanover House, Coombe Road, Kingston upon Thames, Surrey KT2 7AH, U.K.
tel: +44 (0) 20 8541 2700 fax: +44 (0) 20 8546 2105 e-mail: info@metapraxis.com website: www.metapraxis.com**