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Philips Electronics N.V.

Konjinklijke Philips Electronics N.V./Royal Philips Electronics ("Philips") was one of the largest manufacturing companies in the Netherlands.[1] Operating in a country where international trade accounted for more than half of the GDP, Philips leadership looked to foreign markets for growth, making it one of the world's largest electronics companies and a leader in the global market in lighting, electronic shavers, and DVD recorders.[2] Between 2004 and 2005, the company's sales increased by 12.4%; in fiscal year 2005, the company's revenue totaled $35,972 million (see **Exhibit 1**).[3] Philips was led by an eight-member board of management and governed by a 10-member supervisory board. Philips was recognized for its sustainability by Dow Jones, the Global 100, and the Amsterdam stock exchange, in addition to being recognized for good corporate responsibility by the FTSE4Good Index Series. Alan Cathcart, senior vice president of investor relations, also pointed out Philips' high marks for corporate governance: "In any corporate governance survey, you are likely to find Philips' scores extremely high because we have been working on that for a long time."

History of Philips

Philips was founded in 1891 by the Dutch industrialist Gerard Philips in Eindhoven, the Netherlands. The company first produced carbon-filament lamps; by the end of the century it had become one of Europe's largest producers. The company began diversifying its products in 1918 with the introduction of the medical X-ray tube. Then in 1925, Philips joined the forefront of television experimentation. Over the years, the company introduced other new products including radios, electronic shavers, audio cassette tapes, CDs, and DVDs, in addition to new lighting and imaging technology. Entering the twenty-first century, Philips leadership was concerned that the company was seen as only a consumer products company, whereas they wanted an image that reflected all of Philips' product areas.

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[1] Company summary, OneSource Information Services, Inc.

[2] Dutch Ministry of Foreign Affairs, "Welcome to the Netherlands," http://www.minbuza.nl/default.asp?CMS_ITEM=MBZ302336, accessed July 26, 2006.

[3] Hoovers, Inc., "Royal Philips Electronics N.V.," http://www.hoovers.com/philips-electronics/--ID__41823--/free-co-fact sheet.xhtml, accessed July 26, 2006.

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Product Divisions

In the spring of 2006 Philips had six operating product divisions: Medical Systems, Domestic Appliances and Personal Care, Consumer Electronics, Lighting, Semiconductors, and a sixth category labeled Other Activities, which included important segments of the business that did not fit in the other product divisions. At the turn of the twenty-first century Philips began divesting low-margin activities and strengthening the higher-margin technological products. On August 3, 2006, Philips announced the sale of its semiconductor unit for $4.4 billion to a number of private equity firms.[4] As this divestiture indicated, Philips leadership had decided to concentrate more efforts on the medical system segment of the company and to limit emphasis on other areas of electronics.

Medical Systems The Medical System division developed and manufactured products for medical imaging, patient monitoring, customer services, medical transcription services, and support IT systems for healthcare institutions. The division was being transformed from a supplier of specific medical products and services to a supplier of products and services for the "entire cycle of care," which included points of diagnosis, treatment, and followup. In order to become more of a full-range supplier, Philips acquired four companies between 1998 and 2001; the companies specialized in ultrasound, positron emission tomography and radiation therapy; cardiac ultrasound and monitoring systems; and computed tomography. Other Philips' technologies included X-ray, magnetic resonance and patient monitoring and resuscitation. For many of these products and services, Philips led the market.

Domestic Appliances and Personal Care The Domestic Appliances and Personal Care (DAP) division focused on shaving and beauty, oral healthcare, food and beverage appliances, and home environment care for both garments and floors. Globally, Philips led the market in electric shavers for men, which sold in the U.S. under the Norelco brand name. The company began producing electronic shavers in 1939 with the Philishave.

Consumer Electronics The Consumer Electronics (CE) division concentrated on Connected Displays, Home Entertainment Networks, and Mobile Infotainment. Products included: flat-screen televisions (LCD, Plasma), conventional TVs and projection TVs, video products such as Home Theatre in a Box (HTiB), DVD, DVD+RW, VCR and TV-VCR systems, audio systems, separates and portables, LCD and CRT computer monitors, mobile phones and cordless digital phones, set-top boxes, and accessories such as headphones and recordable media.

Lighting Philips began in the lighting industry as early as 1891 and since then had been a leader in the market. In the 1970s, Philips' research contributed to the introduction of new energy-saving lamps, and in the 1980s, Philips acquired Westinghouse's lamp business. The Lighting division included four businesses: (1) Lamps, (2) Luminaries, (3) Automotive, and (4) Special Lighting & UHP and Lighting Electronics.

Semiconductors Philips' Semiconductors division had produced semiconductors for more than 50 years. Before the company's decision to sell the unit, Philips' silicon applications were sold in the consumer, communications, automotive, and computing markets. The division's market share had eroded in the past decade. To address this trend among semiconductors, the division introduced a Business Renewal Program in May 2005, which was "intended to make the division a simpler, more agile and market-focused organization and to reduce earnings volatility."[5]

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[4] "Royal Philips Sells Unit for $4.4 Billion," *The New York Times*, August 4, 2006.

[5] Philips Annual Report, 2005.

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Other Activities This segment included activities outside the other divisions, or responsibilities of divisions once sold or dismantled. Significant clusters within this group included the Technology Cluster; Research and Development; Patents and Licenses; Corporate Investments; Global Service Units; Philips Design; Optical Storage; and NAVTEQ, which provided digital map information.

Corporate Governance Requirements and the Dutch Code

As a multinational company headquartered in the Netherlands, Philips' primary stock exchange listing was Euronext Amsterdam, the Amsterdam stock exchange, which in 2000 merged with the Brussels stock exchange and the Paris stock exchange. Philips was also listed on the New York Stock Exchange (NYSE). The chief legal officer and general secretary, Arie Westerlaken, said the NYSE listing "probably is the most important listing because that set the terms and most of Philip's competitors are listed there." Listing on two exchanges required Philips to comply with two sets of listing requirements, which according to Westerlaken was facilitated by the fact that "there is a convergence tendency among these two stock exchanges."

Listing on the NYSE required Philips to comply with the U.S. Sarbanes-Oxley Act, which in the view of Westerlaken had benefited the company; "I think that our internal control systems have improved. . . . People may complain about the great details and the administrative burden it gives, but by and large, I think our financial administration has improved under the fashion of Sarbanes-Oxley."

As a Dutch-listed company, Philips was required to comply with the Dutch Corporate Governance Code (the "Tabaksblat code" or "the code"). The code consisted of "principles of good corporate governance and best practice[s]" and was authored by leaders of various Dutch companies as well as people in academia, the government, banking, and law. It was put into effect on December 9, 2003. The Dutch code stated that "unconditional freedom to decide whether or not to apply the code is not desirable."[6] The code, however, did grant limited flexibility for compliance.

"The Dutch code is more mandatory in the sense that there is a statutory provision[7] which obliges you as a listed company to either apply provisions or to explain why you did not apply provisions," explained Albert Verdam, senior vice president and legal officer at Philips. "According to the law, each company had to insert in its annual report a paragraph on corporate governance." In this paragraph, the code required a company to explain whether the company deviated from the code and if so, "why and to what extent" the company chose to deviate.[8]

The Philips website posted a "Summary of the significant differences between Philips' corporate governance practices and the New York Stock Exchange (the "NYSE") corporate governance standards." A major difference listed was the use of a two-tier board structure. The Dutch code was based on the concept of the two-tier board, which was a "corporate structure consisting of a Board of

[6] "The Dutch corporate governance code," Corporate Governance Committee, December 9, 2003, p. 4, http://corpgov.nl/page/downloads/CODE%20DEF%.20ENGELS%20COMPLEET%20III.pdf.

[7] The provision was often referred to as the "comply or explain" principle.

[8] The Dutch corporate governance code, p. 4.

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Management consisting of executive directors under the supervision of a Supervisory Board consisting of non-executive directors."[9]

Other differences included the definition of independence for members of the supervisory board, the committees Philips had established, the process of equity compensation approval, and the use of a code of business conduct applied to all company employees.

The Board of Management

The board of management, which reported to the supervisory board, was responsible for running the company. Philips had what its CFO, Pierre-Jean Sivignon, called a "two-layer management structure," which included a board of management and the group management committee. The board of management was chaired by the CEO and met every two weeks. Until 2006, the board of management consisted of four members chaired by the CEO (see **Exhibit 2**). In the spring of that year, Philips, board of management was expanded to eight members, including the CEO, CFO, and the five division heads. The supervisory board and the board of management agreed to increase the size of the board of management in order to deal with the supervisory board's concern about the succession to the board of management. By adding members to the board of management, the supervisory board was exposed to more members of management regularly, and an increased number of executives had a chance to take part in discussions at the company level. All members of the board of management also served on the group management committee, which included other key Philips officers (see **Exhibit 3**).

According to a document describing Philips' corporate governance, "The members of the board of management have collective powers and responsibilities. They share responsibility for the management of the company, the deployment of its strategy and policies, and the achievement of its objectives and results."[10] Members of the board of management including the CEO were elected by shareholders upon recommendations from the supervisory board. Gerard Kleisterlee, president and CEO of Philips, explained that he periodically discussed with the supervisory board any contemplated changes for the structure of the board of management, the division of the roles, and membership.

The Supervisory Board

The supervisory board as described in the annual report was "a separate and independent body from the board of management," which "supervised the policies of the executive management (the board of management) and the general course of affairs of Philips and advised the executive management thereon."[11]

The supervisory board consisted of 10 members, including a chairman and a vice chairman (see **Exhibit 4**). Members served terms of four years but could not serve more than three terms according to the Dutch code. All members with the exception of one (and not more than one) were required by the Dutch code to be independent.

[9] "Summary of significant differences between Philips' corporate governance practices and the New York Stock Exchange corporate governance standards," http://www.philips.com/shared/assets/downloadablefile/NYSE_differences-13775.pdf.

[10] "Corporate Governance of the Philips Group" (company document), February 13, 2006, p. 2.

[11] Ibid., p. 5.

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The Philips supervisory board was described by one member of management as being "international" in make-up, with members from seven different countries: France, England, Belgium, the Netherlands, Singapore, Canada, and the United States. The chairman of the supervisory board, W. de Kleuver, added that collectively the board had a "broad set of experiences," including backgrounds in "general administration, finance, capital expenditures, and acquisitions."

The Board annually met a minimum of five times a year in addition to a two- to three-day strategy session in June. One supervisory board member, Sir Richard Greenbury, commented on the importance of reviewing strategy annually and being willing to change strategy as necessary. "Things happen so quickly now that you have got to be quick on your feet, and you have got to be able to say, well, that looked to be a good strategy a year ago, before whatever happened did happen, but now we have to think again. And meeting every year to think only about the future of the business and the way it should be going, I am convinced, is a good principle."

Kleisterlee explained that regular supervisory board meetings were structured as a "sort of three-tiered meeting." The meetings started at 9:00 a.m. or 12:00 p.m., at which time the supervisory board traditionally met with members of the board of management. This part of the meeting was typically the longest. At the end of the meeting with management, the supervisory board usually met with only the CEO for about a half an hour, which was followed by an executive session. In recent years, the board had started to incorporate more executive sessions into its routine. In the words of Westerlaken, "We have tried to institutionalize executive sessions. For a long time, the supervisory board felt no need to do that. Then, there was a change in chairman." The new chairman requested that at the end of every supervisory board meeting there be an executive session, which usually lasted one to one-and-a-half hours. Board meetings usually lasted between five and six hours.

One frequent criticism of Dutch boards mentioned by J-M Hessels, a member of the supervisory board, was that these boards "are a group of people that all know each other." However, Hessels clarified that while directors may "know each other to certain extent because the Netherlands is a very small country, the board is not a fraternity at all. By nature the Dutch supervisory boards were always truly active and involved. The Dutch are not masters in elegance like the French or circumlocution like the Italians or even a few Brits. They most of the time tell it like it is, and they are not afraid of challenging management. Disagreement generally is more than tolerated." Some members of the supervisory and board of management agreed, although they wondered if at times there was too much emphasis on consensus.

Over the years, the supervisory board had adopted several roles. One was the supervision and approval of policy, which the board of management was then responsible to execute. In order to approve policy, the supervisory board had to have faith in the company's information systems and believe that the management had provided the board with the information needed to make its decision. Therefore, "as a board we try to understand that internal systems are healthy," said board chairman de Kleuver.

The supervisory board also served as an advisor to the board of management. According to Kleisterlee, "the supervisory board keeps the management focused. And, I would say, holds up the mirror from the perspective of asking the questions that need to be asked."

De Kleuver identified the appointment of the CEO as the supervisory board's most important and most difficult role. "It is not easy to choose the right people," explained de Kleuver. In completing this task, de Kleuver said, "our weakness is how to get to know the potential candidates every six years" and then how "to predict how he would do in the CEO role." In order to expose the board to more members of management, the chairman explained he was pushing to allow the board to see

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"local color and the people by holding one supervisory board meeting each year at a Philips site beside the company headquarters."

The Relationship between Boards

The two boards were split conceptually between supervision and execution, and there was intended to be a distance between them. Westerlaken pointed out, "We even state in our charter for the supervisory board that they should keep a certain distance and should not necessarily interfere in day-to-day management."

The company's Articles of Association officially articulated the roles of the supervisory board and board of management. For example, one of the roles of the supervisory board was to supervise policy. It was the responsibility of the CEO to decide what issues he and the chairman of the supervisory board should bring to the supervisory board. Kleisterlee explained, "There is a process laid down for that where both on the investments, divestments, or capital expenditures there is a certain limit where we would have to have supervisory board approval. Below that limit, if it is incorporated in the long-term plans that have been discussed and agreed to, management could act without seeking supervisory board approval."

Supervisory board member Greenbury acknowledged that at one time he had objected to the two-tier governing system, preferring the unitary system as in the U.K. But later he decided he liked the idea of a supervisory board for large, multinational companies; "Part of the beauty of the system is the relationship between the supervisory board and the board of management. The board of management must discuss everything with the supervisory board. I am not talking about how they run the business day-to-day, but on major issues; and this can lead to quite detailed discussions between the boards." Greenbury also explained that at times "the supervisory board can make a decision more easily than a highly involved executive director."

De Kleuver added: "Formally, the role between the two boards is clear, but how it works actually depends very much on the people on the board." The tradition and culture of the company also defined the relationship between the two boards. Kleisterlee added: "I think that in Philips there has been, on the one hand, a very open and transparent working relationship between the management team and the supervisory board, from the perspective that the supervisory board gets a lot of insight in what is going on in the company. We provide ample information so they have full access."

CFO Sivignon echoed Kleisterlee's opinion: "I think that the situation is open and gradually getting even more open." He explained that the management had increasingly been providing more information to the supervisory board on the short- and long-term budget in addition to issues such as acquisitions and divestitures. Sivignon believed that the Articles of Association were not specific enough, however. With regard to acquisitions, he said that Philips had "gone to a rather informal process where . . . subjects were discussed more in an informal manner." He expanded:

> We are changing that right now, and I am pushing to change that. We are actually specifying what level acquisitions [determined by purchase price] should be discussed at the supervisory board meeting . . . and that level, that threshold, is actually being brought down. If anything, we are giving more exposure than less to the supervisory board in terms of adding details of acquisitions before they actually take place.

Although Kleisterlee said that the supervisory board had gradually become more active, he stressed that the supervisory board gave the board of management the necessary independence to run the company: "I think the supervisory board has been . . . guiding from a distance. There is

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considerable freedom for management to operate, and as management, if you make your case on an issue, I have not seen that the supervisory board would not support them."

Both members of the supervisory board and the board of management agreed that the relationship between the chairman of the supervisory board and the CEO was an important determinant of the tone of the relationship between the supervisory board and the board of management.

Role of the Supervisory Board Chairman

Compared with the British chairman, "the Dutch chairman is much less powerful as a rule," said Westerlaken. "There may be exceptions . . . but basically he is much more detached from operations than the British chairman."

While it was once common for Philips' new CEO to assume the position of chairman of the supervisory board after obtaining some experience as CEO, Philips had ended that practice years earlier. De Kleuver, a former executive vice president of Philips, was the chairman in 2006.

Westerlaken explained that the chairman "spends one or two days a week at least in the office of the company. In our case, the chairman of the supervisory board does not have his own office here. He did not think it was necessary. We offered it to him and his predecessors."

De Kleuver's primary responsibility was running the meetings of the supervisory board. He was also responsible for creating the agenda for the meetings, which he developed with the CEO. Apart fro regular phone calls, the chairman and COO met twice a month.

The topics for each supervisory board meeting were decided in early January. The agendas reflected the management agenda for the year. Kleisterlee would identify five or six points that he thought were of "critical importance" for the company to achieve that year. Other topics were added to the agenda over the course of the year, including any concerns expressed to the chairman by supervisory board members.

Since de Kleuver had been chairman for less than a year, the bulk of the agenda for the current year had been set before he assumed responsibility in 2006. He added ad hoc issues that came up as the year progressed, however, and gave the final approval for each agenda before the meeting.

The chairman of the supervisory board was also responsible for providing the members of the supervisory board with information in a timely fashion before a board meeting. The general secretary, who kept the board minutes, assisted the chairman in providing information. De Kleuver placed great importance on this task; he said, "I think preparation is important. We want to get to the right decision, so people should feel well-prepared."

Besides setting the agenda for the meeting and assuring that information was distributed, the chairman took an active role in the meeting. The role that the chairman took depended on the personality of the chairman. Supervisory board member Hessels described de Kleuver as saying, "He really stimulates open discussion; he invites discussion; he shows his hands very early on, indicating the direction which seems to be wise." He went on to say that de Kleuver was direct and tried to bring supervisory board discussions to a final conclusion that could be brought to management.

Finally, the chairman was responsible for the evaluation of the supervisory board of itself and the supervisory board's evaluation of management. De Kleuver conducted the evaluation with the legal

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officer, Albert Verdam. The legal officer met with each member of the supervisory board and then summarized the comments. De Kleuver reported on the feedback to the CEO, and the two placed the issues raised by board members during the evaluations on the agendas for the supervisory board meetings throughout the year. Incorporating all of the issues suggested "is a slow process since we meet only six times a year," explained de Kleuver. Each committee also independently conducted evaluations of its activities.

The chairman sat on two supervisory board committees: the corporate governance and nomination & selection committee and the remuneration committee. (See **Committees** below.)

Company Strategy

Both the supervisory board and the board of management played an active role in defining the strategy of the company. Management often conceived ideas, which then were presented to the supervisory board. Within management, Philips had one executive focused entirely on strategy. This position reported to the CEO and had a group of six to seven people to assist in examining and developing strategies. According to Sivignon, "a lot of ideas actually come from this particular organization. In terms of origin—the source of acquisition projects—they come from the strategy group who is working jointly with the product divisions. They come up with ideas, and the ideas are then executed by the financial department. There is a mergers and acquisition team, but they are an execution team which takes charge of the projects and presents them to the supervisory board."

Every year in June, the supervisory board met for two to three days to discuss solely the "big picture" strategy of the company. Kleisterlee stated, "The supervisory board sets the strategic direction and agrees to a four- or five-year plan." The first step in actually implementing the strategy would come months later in November and December, when the operating budget for the following year had to be approved.

Committees

The supervisory board had three established committees: the audit committee, the remuneration committee, and the corporate governance and nomination & selection committee. Each committee advised the supervisory board on their respective areas. According to Philips' document describing its corporate governance, "In principle, the (entire) Supervisory Board remains responsible for its decisions even if they were prepared by one of the Supervisory Board's committees."[12]

Audit Committee

The audit committee (see **Exhibit 5**) met a minimum of four times a year before the quarterly earnings reports and press releases were published. Additionally, the committee met in between to deal with any large agenda items such as acquisitions. Typically, the committee met for two supplementary meetings annually.

The audit committee had three members. The Dutch code required that at least one member of the committee be a financial expert and that the other members be financially literate. The

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[12] "Summary of significant differences between Philips' corporate governance practices and the New York Stock Exchange corporate governance standards."

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supervisory board at Philips chose not to directly comply with the Dutch code on this point. The supervisory board did not name one individual as a financial expert. Hessels, audit committee chairman, explained: "Collectively we have enough talents and expertise and experience in-house to be able to swear . . . we have enough financial expertise."

Accounting regulations in both the U.S. and other counties changed in the wake of numerous accounting scandals around the turn of the twenty-first century. This resulted in expanded roles for members of the audit committee. Hessels stated, "We are even more aware of what can go wrong. We have become risk managers, looking very much at the worst possible case scenarios."

The increased focus on compliance had required audit committees to allocate more time to its tasks. What once took the audit committee a few hours to complete took twice as long. The committee had to consider more items as well as check across countries to guarantee that the company was compliant everywhere. The emphasis on compliance led to increased awareness by not only members of the audit committee but by all board members. Hessels explained, "I think there is more willingness to ask the third question, and the fourth question, and not just the second question."

The new regulations changed the relationship between the audit committee and the outside auditor. The outside auditors became more dependent on the audit committee rather than the CFO, and the audit committee, in particular the head of the committee, had become more likely to challenge the outside auditor. One practice that existed in some Dutch companies including Philips (even before the increased regulations) was a one-on-one session between the audit committee and the outside auditor without the presence of management. Hessels remarked, "That is something very significant. It helps build personal relationships and (sometimes) raise interesting points."

Additionally, the new regulations cost money, which some thought would become less significant as the regulation was routinely put in place. Regardless, there would always be a maintenance cost. In the mind of some members of management, the regulation was excessive. Kleisterlee commented, "What concerns me is that with Sarbanes-Oxley and the different codes, we went overboard on the number of things where we believe we can regulate good management. We have seen that time and again legislation tries to catch up with what went wrong, and then some years down the road you will again find somewhere that things have gone wrong."

Remuneration Committee

The remuneration committee (see **Exhibit 5**) met twice a year and made recommendations to the supervisory board about the compensation of the members of the board of management and the group management committee. In addition, the committee drafted an annual remuneration report.

Greenbury, who served on the remuneration committee, explained that management remuneration is not a science. Each year the remuneration committee received compensation figures for management at comparable companies, which served as one tool to set management compensation at Philips, but Greenbury pointed out that identifying a comparable company was difficult. "Are we going to compare ourselves with technology companies, or are we going to compare ourselves with Sony and people like that?" asked Greenbury.

The committee also compared management compensation at Philips to compensation among fellow Dutch companies such as Shell and Unilever. Greenbury noted: "And by and large, the Dutch are as restrained and sensible as most of the British companies, I would have to say." Of course, not

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all Philips employees worked in the Netherlands, and therefore the remuneration committee had to consider compensation in other countries where Philips retained management.

Remuneration for members of the supervisory board was decided by vote at the annual meeting of shareholders. Remuneration of supervisory board members "was not dependent on the results of the company,"[13] as were the salaries of management. As a result of changes in the degree of regulation, the compensation for supervisory board members serving on committees was raised to compensate for the increased time commitment. Kleisterlee said that in the Netherlands, "in general . . . board compensation is probably lower than it was in the U.S. and also in the U.K." Shareholders still pointed to variable compensation as an area of concern in the Netherlands. Variable compensation included stock options and an annual bonus.

The Corporate Governance and Nomination & Selection Committee

The committee on corporate governance and nomination & selection included at least two members, the chairman and the vice chairman of the supervisory board (see **Exhibit 5**). The committee's primary function was to review the company's corporate governance principles once a year, in addition to advising the supervisory board. According to the company website: "It also (a) draws up selection criteria and appointment procedures for members of the Supervisory Board, the board of management and the group management committee; (b) assesses the size and composition profile of the supervisory board; (c) assesses the functioning of individual members of the management committee; (d) consults with the president/CEO and the board of management on candidates to fill vacancies on the supervisory board, the board of management and the group management committee." Finally, the committee oversaw the policy used by the board of management in selecting and appointing members of management.

Independence

Under the Dutch code, all members of the supervisory board (with the exception of not more than one person) must be independent. Independence was defined differently in the Dutch code than in the U.S. According to the Dutch code, a member of management of a company could never be independent, but in the U.S. a member of management could be considered independent after three years outside the company.

Philips' supervisory board traditionally had one ex-management member. This member had a good understanding of the company and the industry from years of experience, and therefore brought a level of expertise that other members of the board lacked. In 2006, the chairman, de Kleuver, was a former executive vice president of Philips.

Kleisterlee raised a concern that truly independent directors would not start with a good understanding of Philips' various businesses. One way that Philips leadership addressed this issue was through director education.

[13] "Corporate Governance of the Philips Group," p. 7.

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Education

Philips' supervisory board did not have a formal process for educating new directors. Kleisterlee explained: "We have given the new board members that came on board in the last two years a sort of introduction program by organizing a number of meetings with senior officers, and also [by] organizing visits to a few of our locations where they see the individual parts of the company."

Providing accurate and regular information to directors was another means of educating members of the supervisory board. This process was facilitated by the management, the chairman of the supervisory board, and the general secretary of the supervisory board. Members of both the supervisory board and the board of management believed that there was a good flow of information and that the processes producing the information were sound. Kleisterlee added, "I rarely have had [a] request for information that we have not provided, in the five years that I have dealt with that."

Providing information to directors had become more important over the years. Westerlaken explained, "I can still remember the time when some board members came in and started opening the package of documentation during the meeting and left it when they went home. That is not possible today. The time and the attention required for non-executive board members has, I would say, doubled in the last 10 years, and is probably going to increase further when more things are delegated to committees."

Shareholders

The rules of procedure of the supervisory board stated: "In fulfilling its responsibilities the Supervisory Board and its members will act in the interest of the Philips group and give specific attention to the relevant interests of the Company's shareholders and of the employees, customers, suppliers and other stakeholders of the Philips group."[14]

Hessels clarified: "In the case of Philips, we very much think of the shareholders. On the other hand, we are conscious of the fact that this is a very valuable high-tech company, a center of expertise, [with] lots of important implications in society outside, and then also, here."

Kleisterlee found it difficult to think of shareholders as owners of the company "because with ownership comes responsibility, and many, many shareholders just buy and sell." He explained that employees had a large stake in the company, and it was the customers who brought in the revenue. Although there were many stakeholders in the company, Kleisterlee remarked that "it is clear that share price performance is the ultimate measure of the performance of a company."

Kleisterlee added: "I think you will find a range of views on the supervisory board. You can say there is a stakeholder view and a shareholder view, but at the end of the day, what difference does it make? At the end of the day, I think it is about group leadership, group management, and running a company from the perspective of long-term value creation."

Philips' primary shareholders were large institutions. According to Kleisterlee, "the largest shareholder has around 5% of the company."

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[14] "Rules of Procedure," Royal Philips Electronics, http://www.philips.com/About/Investor/Section-13640/Section-13945/Index.html#art1s1, accessed July 26, 2006.

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Shareholders in the Netherlands, like those in the U.S., had become more active in recent years, and society in the Netherlands had "become a bit more litigious," explained Westerlaken. Therefore, he said "dissatisfied shareholders are more willing to sue than they [were] 15 years ago."

Investor Relations

Members of Philips management repeatedly emphasized the importance of the relationship between the company and the shareholders, and the effort the company made to strengthen that relationship. "Philips takes pride out of this," pointed out Sivignon.

Philips' investor relations contacted its shareholders in several ways. [Alan] Cathcart, senior vice president of investor relations, explained the company's contact in marketing terms: "We have a product—information on the company—and there are end customers." Further, he stated "there are distribution channels to get our message through to people that decide to buy or not to buy shares."

- The first channel was the company's communication with sell-side analysts.
- The second was the communication with the buy-side analysts.
- The third channel was to visit shareholders directly.
- The fourth channel was the company website, which provided company information.
- The fifth channel was to have company executives make annual presentations at broker's conferences.
- Finally, as explained by Cathcart, the company hosted its own conferences "so as to educate the market as much as possible on what its divisions are doing, and the end game is that the market then values it correctly by having more information."

Cathcart did not include the annual shareholder's meeting as a form of contact because while "it is called a shareholder's meeting, it is not a meeting of shareholders. It is a meeting of mostly small private shareholders. The big institutions do not go along." Large institutional shareholders hold the majority of shares and account for the majority of the shareholder voting for Philips.

(CFO) Sivignon explained that "we spend a lot of time with shareholders." Cathcart, with the help of the CEO and the CFO and occasionally divisional management, gave 450 to 500 presentations in various formats throughout 2005.

From the time Cathcart spent meeting and talking with shareholders, he believed he gained an understanding of who the company's shareholders were and what they wanted, or what they were concerned about. He explained his policy that he "will not pay a euro to a consultant." He wondered why "if you are out talking to people and you are prepared to listen to what they have to say, which is not the case with all companies, then why would you want to go to a consultant to get an investor perceptions study?" At the end of every meeting with shareholders, Cathcart asked to have the last two questions so he could ask: "What would you like this company to do that it is not doing?" and "What would you like it to stop doing that it is?" He considered what the shareholders had to say free advice.

Philips' management tried to give "a complete picture" to investors, potential investors, and the market. Rather than giving the market an estimate of earning per share, they "tried to give a series of building blocks which helped the market get in the ballpark" in which Philips management expected

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to be. The building blocks included "anything that is going to drive the market one way or another." Philip's press release included a section called "looking ahead," which Cathcart said was "designed to give some of the building blocks."

Before publishing a press release for the quarter, Cathcart and his team considered what the market would focus on. He explained, "We know what the results are that they [the market] do not know. We know what their current focus is. We know how they think because we study that and therefore, we have a really good feel for how they are going to react when they see the figures come out. So, we focus on what they are going to focus on. Then we measure that against our latest internal focus and if there is a gap somewhere or other, we make some sort of mention in the press release."

Cathcart said with regard to investor relations: "When you boil everything down, it is a communication function with end investors; you do not get involved in side shows."

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Exhibit 1 Consolidated Statements of Income of the Philips Group for Years Ended December 31 (in millions of euros unless otherwise stated)

	2003	2004	2005
Sales	27,937	29,346	30,395
Cost of Sales	(18, 881)	(19, 485)	(20, 577)
Gross margin	9,056	9,861	9,818
Selling expenses	(4, 599)	(4, 549)	(4, 751)
General and administrative expenses	(1, 485)	(1, 326)	(1, 182)
Research and development expenses	(2, 571)	(2, 514)	(2, 553)
Write-off acquired in-process research and development	X	X	(6)
Impairment of good will	(148)	(596)	X
Other business income (expense	249	710	453
Earnings before interest and tax	502	1,586	1,779
Financial income and expenses	(244)	216	108
Income before taxes	258	1, 802	1, 887
Income before tax benefit (expense)	15	(358)	(586)
Income after taxes	273	1,444	1,301
Results relating to unconsolidated companies including net dilution gain of EUR 165 million (2004: gain of EUR 254 million, 2003: gain of EUR 53 million)	506	1,422	1,681
Minority Interests	(56)	(51)	(31)
Income from continuing operations	723	2,815	2,951
Discontinued operations	(14)	21	(83)
Income before cumulative effect of a charge in accounting principles	709	2,836	2,868
Cumulative effect of a change in accounting principles, net of tax	(14)	X	X
Net income	695	2,836	2,868
Weighted average number of common shares outstanding (after deduction of treasury stock) after the year (in thousands)	1,277,174	1,280,251	1,249,956
Basic earnings per common share in euros:			
Income from continuing operations	0.56	2.2	2.36
Income (loss) from discontinued operations	(0.01)	0.02	(0.07)
Income before cumulative effect of a change in accounting principles	0.55	2.22	2.29
Cumulative effect of a change in accounting principles	(0.01)	X	X
Net income	0.54	2.22	2.29
Diluted earnings per common share in euros:			
Income from continuing operations	0.56	2.19	2.36
Income (loss) from discontinued operations	(0.01)	0.02	(0.07)
Income before cumulative effect of a change in accounting principles	0.55	2.21	2.29
Cumulative effect of a change in accounting principles	(0.01)	X	X
Net income	0.54	2.21	2.29
Dividend paid per common share in euros	0.36	0.36	0.4

Source: Annual Report 2005.

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Exhibit 2 Board of Management

Gerard Kleisterlee (Dutch)
President/CEO; Chairman

Pierre-Jean Sivignon (French)
CFO

Gottfried Dutiné (German)
Executive Vice President

Theo van Deursen (Dutch)
Executive Vice President
CEO of Lighting

Jouko Karvinen (Finnish)
Executive Vice President
CEO of Medical Systems

Andrea Ragnetti (Italian)
Executive Vice President
Chief Marketing Officer
CEO of Domestic Appliances and Personal Care

Rudy Provoost (Belgian)
Executive Vice President
CEO Consumer Electronics

Frans van Houten (Dutch)
Executive Vice President
CEO Semiconductors

Source: Company website.

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Exhibit 3 Group Management Committee

Tjerk Hooghiemstra (Dutch)
Responsible for Human Resources Management

Daniel Hartert (German)
Chief Information Officer

Barbara Kux (Swiss)
Chief Procurement Officer

Rick Harwig
Chief Technology Officer

Source: Company website.

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Exhibit 4 Supervisory Board

W. de Kleuver (Dutch)
Member since 1998; Chairman

Former executive vice-president of Royal Philips Electronics

L. Schweitzer (French)
Member since 1997; Vice-Chairman and Secretary

Former CEO of Renault and Renault Nissan BV; chairman of the board of Renault and AstraZeneca. Non-executive director of BNP Paribas, Electricité de France, Véolia Environnement, Volvo AB and L'Oréal.

Sir Richard Greenbury (British)
Member since 1998

Former chairman and CEO of Marks & Spencer and former director of Lloyds TSB, British Gas, ICI, Zeneca and Electronics Boutique plc.

J-M. Hessels (Dutch)
Member since 1999

Former CEO of Royal Vendex KBB and currently chairman of the supervisory board of Euronext and member of the supervisory boards of Amsterdam Schipol Group, Heineken and Fortis.

Prof. K.A.L.M. van Miert (Belgian)
Member since 2000

Former vice-president of the European Commission and former president of Nyenrode University, member of the supervisory boards of RWE, Agfa Gevaert, De Persgroep, Munich Re, Anglo American, Vivendi Universal and Solvay.

J.M. Thompson (Canadian)
Member since 2003

Former vice-president of the board of directors of IBM and director of Hertz an Robert Mondavi; currently chairman of the board of Toronto Dominion Bank and a director of Thomson Corporation.

C.J.A. van Lede (Dutch)
Member since 2003

Former chairman of the board of management of Akzo Nobel and currently chairman of the supervisory board of the Dutch Central Bank, member of the supervisory boards of Akzo Nobel, Heineken, KLM, Scania, Reed Elsevier, Sara Lee Corporation, Air Liquide and chairman of the board of directors of INSEAD.

E. Kist (Dutch)
Member since 2004

Former chairman of the executive board of ING Group and currently member of the supervisory board of the Dutch Central Bank, DSM and Moody's Investor Services.

N.L. Wong (Singaporean)
Member since 2005

Chairman and CEO of Venture Corporation Ltd. Also serves on the boards of various listed and private companies, including DBS Bank Ltd., DBS Group Holdings Ltd. and SIA Engineering Company Ltd. Chairman of the National University of Singapore Board of Trustees.

J.J. Schiro (American)
Member since 2005

CEO of Zurich Financial Services. Also member of the board of directors of PepsiCo, vice-chairman of the Swiss-American Chamber of Commerce, member of the International Business Council of the World Economic Forum, and member of the European Financial Services Roundtable and The Financial Services Roundtable (US).

Source: Company website.

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Exhibit 5 Committees

Audit Committee

E. Kist

J-M. Hessels

Prof. K. A. L. M. van Miert

J. J. Schiro

Remuneration Committee

W. de Kleuver

Sir Richard Greenbury

J. M. Thompson

C. J. A. van Lede

Corporate Governance and Nomination & Selection Committee

W. de Kleuver

L. Schweitzer

Source: Company website.

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