

10 Minutes on Current Developments for Directors*

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

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Preparing for the new normal

Highlights

- The economic crisis highlights the need for a radical rethink of how companies run their businesses—everything from their operating plans to their business models.
- Some Fortune 500 companies have begun adopting key governance reforms to get a head-start on anticipated regulatory change.
- Companies are acknowledging risks in new and different ways, being alert to how rapidly risk can proliferate in the global economy's inextricably connected markets.
- Directors must demonstrate to investors, the public, and Washington that they're actively overseeing key business decisions and are accountable for them.

With the markets still in crisis, many businesses are focused more on day-to-day survival than on the emerging economic reality.

To successfully adapt to the new order, businesses will need to keep an ear to the ground, determining which long-held assumptions about market forces are losing currency. What takes the place of those assumptions will reflect both the changing business landscape and the evolving regulatory environment.

Directors are bringing their diverse experience and wisdom to bear as they help management negotiate the new terrain. 10Minutes discusses what that entails, pointing to actions directors are taking to keep their companies on course.

Directors will need to reconsider their approach to meeting key obligations

1. Maintain an independent perspective and avoid groupthink by having the right talent on the board.
2. Clearly understand risk management practices and how they are integrated with the business model and operating plan. Assess whether those practices are adequately driven through all areas of the business.
3. Be prepared to explain to investors and the broader public how the board determined compensation packages and why the compensation is appropriate.
4. Determine whether management's messages to the market are transparent and consistent with boardroom discussions about the company's financial condition and prospects.

At a glance

A wide range of issues demands the attention of boards now and in the coming months. Decision-making around these matters will require that boards do more than just weigh economic and legal considerations. Directors must also give significant weight to the political implications of their actions, anticipating how those might resonate with a variety of stakeholders.

Business considerations

- Liquidity, going concern, and business continuity issues
- Supply chain exposure
- Pension funding
- Rising cost of capital
- Layoffs, restructuring, closing of facilities

Risk management

- Counterparty risk
- The need to embed risk considerations in business plans and incentive programs

Tax reform

- Potential impact on individuals and companies

Financial reporting

- Application of fair value accounting in a troubled market
- Impairments
- Disclosures (e.g., about liquidity)

Regulatory reform

- Potential creation of a systemic-risk regulator
- Strengthening of standards for loan-writing and qualifying credit products

Corporate governance

- Wider adoption of say-on-pay policies and potential easing of barriers to proxy access

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Rethink fundamentals

Struggling to regain their bearings in a still-uncertain economy, businesses and the capital markets are looking for reliable points of reference. At present, few can be found. A year or more may pass before the dust from the economic crisis settles and the broader outcome of events becomes evident. What's already clear, however, is that when businesses emerge from crisis mode, companies will have to do certain things differently. That could require a change in mindset for both management and boards.

Resetting the compass

Chief among the things that will be different is the way businesses weigh and rely on historical experience. Which of the company's past assumptions remain valid? Which have become moot? And which are still relevant but should be considered in a different light going forward?

The answers to these questions could signal the need for significant changes in a company's operating plans and risk management program, or more fundamentally still, in its very business model.

Back to the future?

For some companies, a change in mindset might seem like turning back the clock: Government involvement may rival (and possibly surpass) anything we've seen in recent decades. With public dismay running high, Washington is under decided pressure to regulate Wall Street, not just assist it. Initial actions by Congress and the Obama administration suggest the government intends to pursue that goal aggressively.

Companies may also find themselves doing certain things for the first time in years, such as contemplating possible accounting impairments, considering going-concern issues, revising the way they analyze valuation allowances, and revisiting how management will be incented and compensated if a company's performance falters.

An end to laissez-faire?

After 25 years of steady deregulation in the United States, the pendulum has begun to swing back. Both the Obama administration and Congress have articulated the need to “regulate the unregulated” (e.g., credit default swaps, hedge funds, credit rating agencies, and private equity funds), to better safeguard the capital markets from systemic risk. The formation of a single systemic-risk regulator is one potential outcome.

Other regulation is apt to come in the form of consumer protection (e.g., for investors and borrowers). Companies should begin evaluating where and how upcoming regulation might intersect with their business units and models, contemplating potential responses now so that they can adapt quickly once the new regulation takes effect.

Governing companies from the shareholder ranks

With the US government as a major new stakeholder in many of the country’s top financial institutions, internal governance at those institutions will inevitably undergo changes. Shareholder initiatives that failed to pick up momentum in

recent years—such as proxy access and a shareholder advisory vote on executive compensation (“say on pay”)—could get a jump-start if the federal government decides to champion them in its capacity as a large investor.

The effect of such governmental influence could spill over to other companies as well. Already, several Fortune 500 companies have adopted say-on-pay policies this year. More companies may follow, in anticipation of potential legislative action or as a means of responding to investor activism in their own backyards.

A global crisis suggests a global response

Greater regulation will entail addressing interdependencies in the global financial system. In April, representatives from the world’s 20 largest economies will attend their next G20 summit, where discussion is likely to focus on closer regulation of the world’s interconnected financial markets and a move to a global set of accounting standards. Whether the G20 will have a notable impact on US policymaking remains to be seen.

Reassess risk

One thing the credit crisis has made plain is that multiple layers of risk in one sector of a country's economy can quickly fan out into other sectors, and across the globe. The alarming speed with which this can unfold in today's highly interconnected markets (where a company's supply chain may span continents) underscores the need for companies to step up their vigilance in assessing a broad spectrum of risk.

Managing manifold risk

The new economic landscape requires business leaders to play a form of chess in which various pieces may move simultaneously. To survive in this landscape, a company must anticipate a potential confluence of risks, as well as peel back additional layers (e.g., assess not only its supplier's liquidity risk, but also the liquidity risk of the supplier's insurer). Doing this will help management convert unknown risks into known ones, which the company can then mitigate.

Of course, some risks cannot be anticipated, and others may seem too remote to merit attention. Recent events, however, have highlighted the

importance of taking a wider range of unlikely (but possible) risks into account.

For directors, that may involve focusing as much attention on techniques for detecting unknown risks as they devote to more-traditional risk management techniques, which generally analyze known risks. Doing so will help risk management programs be more adept at responding to unforeseeable circumstances.

Better risk management ≠ less risk-taking

Too much risk-aversion inhibits economic growth. What's required therefore is not less risk-taking, but rather, clearly understood risk-taking.

For risk-taking to be clearly understood, the board and management must agree on what constitutes risk. Directors should push management to discuss with the board intangible risks (e.g., brand risk), not just risks that can be readily quantified. Boards should also press management to explain how it measures quantifiable risks. Such conversations will allow the board and management to agree on the company's risk appetite.

What directors can do

In this period of intense economic change and uncertainty, the oversight role of directors is more critical than ever. But some boards have come under fire in recent months, as investors wonder at the apparent recklessness of certain business decisions. To bolster investor confidence in board oversight and accountability, directors will want to approach their fundamental obligations with renewed vigor.

Venturing into the new normal: Director actions

- **Realign the company's executive compensation philosophy:** Perceiving a disconnect between executive pay and corporate performance at many companies, shareholders are laying the blame squarely at directors' feet. The board's compensation committee should be alert to the potential disparity, recognizing that it will be increasingly difficult to justify large compensation packages in a down economy.

The compensation committee should also take into account any restructuring, with an eye toward the company's long-term health (keeping employee morale and public perception in mind).

- **Change aspects of boardroom culture:** Directors reluctant to challenge management in the past should insist on robust discussions about executive decisions. Boards serving companies where the CEO doubles as board chair may want to explore ways to segregate the roles. Open debate in the boardroom could influence the company's culture overall, making room for dissenting opinions—a necessity for the health of any company, particularly now that it's become clear that readily accepted views might be unsubstantiated.

- **See that management exercises greater discipline in critical areas:** Insist that management provide clear and robust explanations of how it developed its most significant judgments and estimates underlying the company's business decisions and financial statements. Determine whether management is being similarly disciplined in maintaining internal controls during restructuring and downsizing.

For more information, see our publication *2009 Current Developments for Directors*, available in print and online: www.pwc.com/uscorporategovernance

Upcoming 10Minutes topics:

Realizing enterprise resource planning (ERP) value in a downturn

Across industries, at one level or another, enterprise applications (and their agility, efficiency, and cost-effectiveness) sit at the core of a company's ability to weather the current economic downturn—or capitalize on it. 10Minutes discusses how an economic downturn can be the best time to undertake a wide range of ERP-related actions.

How IFRS impacts US companies today

US financial reporting standards are undergoing broad changes due to the convergence of US GAAP and International Financial Reporting Standards—a process independent of IFRS adoption. Those changes, coupled with other factors, make it increasingly difficult for the United States to insulate itself from IFRS. 10Minutes discusses what companies can do to operate effectively in the evolving financial reporting landscape.

Recently published editions

As you help your company manage through the downturn and position itself better for the long term, consider our recently published 10Minutes editions on these topics:

- Rethinking pivotal talent
- Sustainable cost reduction
- Making divestitures successful
- Finance & accounting shared services
- Bolstering corporate liquidity

How PwC can help

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