



2010 Current developments for directors

Navigating changing times

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To our clients and friends:

Too big to fail. Jobless recovery. Systemic risk. It seems like the past 15 months has brought a new lexicon to our business community. It also has brought challenges and opportunities unique to this generation of directors.

So where to go from here? Since it's unlikely 2010 will be a year of aggressive growth and expansion for most companies, how will your company approach a moderately-paced recovery? Is this an opportunity to make strategic acquisitions (of businesses or people), or is this the time to realign your company so that it is better positioned for possible future bumps in the road? Will lenders or investors be there to provide the capital you need to fulfill your plans? How will the regulatory and legislative landscape look during 2010, and what does that mean for your company's operations?

While there are many questions, there are three things we know. First, the past year has been tough on businesses and employees around the world. Second, the economic crisis, coupled with a new administration, has brought about an agenda of regulation and reform in Washington, with implications for all of us. Third, the government has taken on a new role in the banking and auto industries—the role of shareholder in key companies—and that new role may well have broader consequences.

In the wake of the recession, businesses have begun to think about growth again. That said, the road ahead presents many challenges. Proposed tax changes may increase the tax burdens of US-based multinational companies. Liquidity continues to be a concern, especially if the tight credit market persists. Shareholders are demanding more information about how companies manage risks and develop compensation policies, and are seeking greater say on issues that used to be reserved for directors. Directors will have to help management navigate these challenges in the coming year, even as they position their companies for the future.

On Capitol Hill, the past year has seen game-changing legislation introduced around healthcare, the environment, and the financial services sector. While at the time of this writing, the final form these bills will take is still under discussion and debate, if they ultimately pass, they will usher in both new costs and potential opportunities for businesses.

In addition to the legislative agenda, the regulators have been active. The SEC has markedly increased its focus on enforcement. And it has proposed new rules to give shareholders proxy access and to expand companies' disclosures on items like compensation and director qualifications—topics that will increase the level of engagement between directors and shareholders.

Finally, at the companies (mostly in the financial sector) that have received direct investment from the government, another level of change exists. These investments have come with a level of government involvement in the leadership and management of these companies that poses challenges to their directors, and possibly to the directors of other companies. Our special focus section deals with these new dynamics for directors of companies that have heavy government involvement.

Whatever the economy holds in 2010, PricewaterhouseCoopers is committed to helping you understand the challenges and work through them. This document not only covers the emerging developments, but also suggests actions for directors. We would be pleased to discuss the contents of this publication and, in whatever ways are helpful, deliver to you and your board colleagues the full resources and experience of our firm.



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Themes for directors in the current environment

As the economy recovers, directors are looking for ways to help their companies prosper, while meeting the challenges that remain. You also are doing so in an environment of intense scrutiny. Whether your company is in the spotlight or not, what can you do to respond to these realities in our complex world?

Revisit incentives and compensation practices. Be aware that shareholders, regulators, policymakers, employees, and the broader public are watching. Understand that this focus almost obliges directors to be prepared to explain how the board determines compensation packages and why the compensation is appropriate. Through discussions with management, make sure you're satisfied that incentive packages don't encourage employees to take risks that are inconsistent with the long-term interests of the company.

Strengthen relationships with shareholders and other stakeholders.

We are in an era of rising shareholder power. With say on pay and proxy access increasingly likely, there are new imperatives to communicate with shareholders—both to hear their concerns and to ensure the company is sharing its views on issues. Understand how management is handling this complex relationship, and consider the need for direct board involvement in certain communications.

Understand also the growing role of government and the new areas of emphasis for regulators. As government involvement intensifies, realize your company may feel the effect, even if you haven't received direct assistance from Washington. Recognize the increase in enforcement activities around the world—whether related to corruption, antitrust, financial reporting, or tax. Understand regulators' views on how your company is doing, and encourage management to build positive relationships. (See a description of the CAMELS scorecard in Appendix B for an example of how regulators evaluate certain businesses.)

Solicit input from outside advisors. The complexity of issues and the often-conflicting demands make navigating through especially challenging. Draw on the perspectives of objective advisors to help you form your view of how best to proceed.

Strive for transparency. There are increasing demands for information about company and board activities, running the gamut from compensation practices to risk management and from director qualifications to the impact of the company's activities on the environment. Check that the information management is providing is clear, relevant, and consistent with boardroom discussions about the company's operations and prospects.

Addressing business
challenges, given the
state of the economy

The financial crisis has put tremendous pressure on US companies and their directors. The deepest recession in 60 years forced a focus on cash flow, costs, and core operations at many businesses. Moreover, the speed of the downturn exposed vulnerabilities in usually quiet corporate corners such as short-term cash management, and focused discussions on subjects like counterparty risk that had rarely ever hit the front pages.

The economic outlook has improved. A recovery from the March 2009 lows in the stock markets underpins growth, business and consumer confidence, and a renewing tolerance for risk taking. Yet, at the time of this writing, asset values are still depressed, debt levels remain elevated, and high unemployment persists—a combination expected to weigh on consumers, who are the engine of the economy. Management has to forecast demand for a recovery of uncertain velocity and duration in a time of continued cautious lending. It won't be business as usual in 2010.

Directors play a critical role in overseeing strategic decisions that may have been deferred during the recession and that now are returning to the forefront. Where and how should your company expand? What operations are core, and which can be outsourced or divested? What is the appropriate head count? How should your company manage compensation and health and pension benefits? What changes should the board make to its involvement in overseeing risk management processes?

An understanding of the likely economic recovery scenario in the United States as well as the broader business trends—including evolving government policy—will help directors to prepare for another eventful year.

The pace of recovery

The strength and speed of the recovery vary considerably around the world. Asian countries, led by China, were the first to emerge. France and Germany unexpectedly resumed economic growth in the second quarter of 2009, a step ahead of the United States. Directors of multinational companies will want to understand management's plans to take advantage of these differentials and how they may influence growth strategies. For companies and investors, the uneven global recovery is likely to accelerate globalization trends that have been under way for many years. The weakening US dollar in the latter half of 2009 will influence, and in places encourage, foreign investment in US businesses and markets. The weaker dollar also makes US products more competitive abroad. It is for this reason—the relative strength of global trade—that some economists believe exports can help lead a recovery in the United States.

At the time of this writing, the US economy has technically emerged from recession in the third quarter of 2009. Most economists are projecting a moderate US recovery, which could take the form of minimal to modest growth and last for an extended period before activity fully returns to pre-recession levels. That said, the more pessimistic prognosticators attribute much of the third-quarter 2009 improvement to companies rebuilding inventories and to temporary government incentive programs supporting car and home purchases.

Depending on the type and location of your company's operations, certain economic indicators may be relevant. Directors should understand which indicators management believes are important (which may include unemployment levels, US consumer debt levels, consumer demand and confidence, the real estate market, and state budget crises, among others) and how they impact the company's strategies and plans.

Challenges to address in a moderate recovery

The characteristics of a moderate recovery have numerous implications for management and directors as they work together to ensure the company takes advantage of opportunities, while managing through the continuing challenges.

Securing credit

One concern that affects the speed and sustainability of the recovery is credit. Starting in late 2008, banks tightened lending standards and terms. Although credit availability has improved, directors should continue to focus on the state of the company's financing arrangements, given that an estimated \$440 billion in debt comes due between 2012 and 2014. Although many companies have already refinanced, those that haven't might want to begin working now to extend their loans or to refinance ahead of schedule.

Secondly, understand how management is weighing the prospects of improved demand for company products and its plans to raise the capital needed to invest for growth. In the current credit environment, some companies have found it tough to secure bank commitments. Credit has been tight and expensive. Some large companies have been able to tap the thawing equity and bond markets. Other companies are more tethered to the US banking system, which continues to see some major lenders experience difficulty. As the economy improves, banks will face more demand for new loans. As directors, are you discussing with management whether funds will be available to support your company's operations and expansion plans? Even if your company can get the funding it needs, will funding be available for your key suppliers and customers as well?

Funding pensions and other benefit costs

Company cutbacks on pension-related and healthcare costs have accelerated during the downturn. These measures include shifting more healthcare premium costs to employees and cutting matching 401(k) contributions. Benefits advisors expect these gradual curbs on benefit costs to continue if companies remain under cost pressure amid a moderate recovery, and as the weak job market dampens employee expectations for richer benefits packages. Given that benefits constitute a substantial portion of employee-related costs, companies will need to continue to review alternatives. Directors should make sure management has weighed its options for benefit-related cost containment against the importance of employee retention—indeed, more recently, some companies have begun reinstating certain benefits they cut previously.

The funded status of pension plans declined sharply in 2008 amid losses in the equity and bond markets. As a result, defined benefit pension plans at many companies are underfunded, and for some, the implications on future cash flow and credit profile may be significant. There are also financial reporting implications. Directors should understand the extent of any funding gap and management's plans to address it.

Outsourcing and offshoring

It's not unusual for companies to offshore or outsource call centers, data processing, and systems programming, as well as transaction-related services such as accounts payable and receivable. As US companies continue to seek lower-cost jurisdictions and acquire greater comfort in working in a global environment, they are moving to outsource or offshore more analytical, knowledge-based operations, such as legal research, product innovation, and even cash management and related treasury functions.

In short, a broader trend in outsourcing “up the curve” on knowledge-based skills is under way. For directors, understand how management is assessing the skills needed to support your company's operations and expansion. Has management reviewed what it can more cost-effectively outsource or offshore? How will the company identify and monitor risks related to outsourcing?

An understanding of the likely economic recovery scenario in the United States as well as the broader business trends—including evolving government policy—will help directors to prepare for another eventful year.

Other business considerations

The supply chain: The economic crisis exposed how much companies rely on one another. As the economy improves, directors will want to understand management's confidence level with key vendors and other business partners. Many such businesses are emerging from a focus on capacity cutbacks and costs. Can these suppliers return to normal profitability without materially affecting your company's production assumptions about cost and deliverables?

Acquisitions and divestitures: In what many consider a "buyer's market," has management identified businesses it may need to acquire to support future growth and market positioning? Has management identified noncore or nonperforming businesses, and if so, are strategies in place to either improve or dispose of those operations? How is management deciding the right time to sell or buy? [See *Appendix A: Acquiring assets in bankruptcy* for an overview of the way some companies are choosing to grow.]

Investors: Understand the messaging to investors. They are looking at how well the company is positioned to thrive during the recovery. Shareholders of a company operating in a sector where government involvement has intensified will seek answers on how the board is balancing regulatory demands and possibly shorter-term government goals with longer-term corporate strategies. [For more discussion, see the section *Special focus: Government involvement in business*.]

People: Understand what skills the company could benefit by bringing in, especially considering the number of highly-qualified professionals in the market.

Directors' actions

- Discuss with management its options for altering the company's strategic and operating plans and for addressing any liquidity concerns, depending on the pace of the recovery.
- Understand how management is positioning the company to take advantage, in a disciplined way, of unique opportunities that may arise—in terms of access to markets, people, or portions of businesses.

Focus on governance
initiatives

As part of an effort to avoid future crises, policymakers and regulators are exploring changes to corporate governance practices. They want enhanced transparency, greater director accountability, and a greater voice given to shareholders in certain boardroom decisions.

Ultimately, the final rules may be different from the many proposed rules described in this section. It's clear, though, that companies will want to monitor the pending regulatory changes and prepare directors for the impact.

Executive compensation

Executive compensation remains under intense scrutiny, particularly for financial services companies and others receiving government aid. The focus is on how pay policies align with performance, risk, and a company's long-term growth. One key concern: whether compensation programs focus overly on short-term incentives and on metrics that do not take risk into account, and thus could encourage employees to take actions that harm the long-term health of the company. Another concern: the size of compensation packages.

In July 2009, the SEC proposed rules requiring all public companies to expand their proxy disclosures to describe how compensation policies may create incentives that affect the risk the company takes on. The disclosures would need to consider policies for employees across the organization, not just at the executive level. With this change, compensation committees might want to become familiar with how management:

- Designs incentive plans, sets metrics, and mitigates risks in the compensation policies across the company
- Identifies business units that may constitute a significant portion of the risk profile or that have unique compensation structures
- Administers the incentive plans, including qualitative processes that may override, when necessary, proposed bonuses that might have rewarded employees for actions that exposed the company to inappropriate risk

The SEC also proposed a change for the value that companies report in various Compensation Discussion and Analysis tables for stock and option awards. Companies would have to disclose the aggregate grant date fair value of the awards granted in a given year, instead of the amounts recorded in the income statement (which include partial attribution of awards that may have been granted in previous years). Interestingly, many companies have already been providing this information to explain the decisions made during the year. While determining the amounts to be disclosed is relatively easy, sharing the board's perspective on the rationale for the amounts and explaining volatility from year to year may prove to be more challenging.

Policymakers are attempting to address concerns about executive compensation levels by seeking to give shareholders an advisory vote on executive compensation and severance arrangements (a say on pay). Although the ultimate legislation is not finalized at the time of this writing (a bill passed the House; one with similar provisions awaits action in the Senate), many believe it will ultimately pass. Indeed, companies receiving TARP funds already have to allow “say on pay” votes, which commenced with the 2009 proxy season.

Companies that either voluntarily adopted say on pay, or were mandated through TARP to do so, typically received overwhelming shareholder support in those votes. But given the sensitivity and high-profile nature of executive compensation issues, companies shouldn’t be complacent that these votes will pass with such support in the future. Directors should help management ensure that descriptions in the proxy of the company’s executive compensation philosophy, policies, and procedures are logical and clear, and they should understand shareholders’ perspectives when considering any fundamental changes. Further, companies may want to consider approaches to engage with their shareholders on executive compensation issues more directly.

Say on pay questions on proxies also may lead institutional shareholders to rely more heavily on recommendations from proxy advisory firms. Why? Investors may not have the resources to adequately review and analyze compensation disclosures for the hundreds of companies in which they invest. Ultimately, say on pay may further increase the influence of proxy advisory firms.

With all the focus on compensation at financial institutions, the US Department of the Treasury also weighed in, issuing principles (see box) to better align compensation practices with sound risk management and companies’ long-term growth.

The Treasury principles encourage companies to:

- Properly measure and reward performance
- Structure compensation to account for the time horizon of risks
- Align practices with sound risk management
- Reexamine golden parachutes to ensure they align shareholder and executive interests
- Promote transparency and accountability in the process of setting compensation

Despite the fact that shareholders have long sought to nominate directors, relatively few proxy battles have occurred in past years. That may reflect the expense shareholders had to bear under existing rules.

The Treasury principles are targeted to all companies, not just financial institutions. The principles focus on how to avoid incentives that promote unsustainable short-term performance and how to discourage behavior that may put the company in a worse position over the longer term. Accordingly, companies are using a number of approaches, including:

- Considering alternative or additional performance measures that account for risk.
- Modifying payout mechanisms and time horizons associated with incentives—for example, by paying significant portions of bonus rewards in stock instead of cash, and deferring portions of those payments until the performance being rewarded is ultimately deemed to be reliable and sustainable. Interestingly, as regulators seek greater deferrals of compensation, current tax rules discourage many deferral arrangements.
- Reviewing compensation governance and related processes, such as the role of management control functions (financial reporting, risk, and HR) in determining and reviewing incentive amounts.

Compensation committees and compensation consultants

Shareholders and regulators who are concerned with compensation levels are also often skeptical about the independence and effectiveness of compensation committees and their advisors. Pending legislation would require stronger independence for compensation committee members, preventing them from receiving any consulting, advisory, or other fees from the company, other than what they earn in their capacity as directors. In practice, this change may have little impact—many companies already curtailed hiring their own directors for such special projects.

Policymakers are also seeking to set independence standards for compensation consultants. Although compensation committees would have the authority to retain any advisors, companies would have to disclose the process and rationale underlying the choice of advisor.

The SEC proposed having companies disclose the nature and extent of additional services provided by the compensation consultants, as well as the fees they were paid. This disclosure would cover compensation consultants who provided other services to a company beyond advising on the amount or form of executive or director compensation. The disclosure also would cover the extent of management's involvement in deciding whether to engage the particular compensation consultant for these additional services and whether the board or compensation committee approved the services.

Greater transparency around the company's use of compensation consultants can be useful for investors. Such transparency may also help boards to retain the decision-making power to hire whomever they believe will provide the most value. Boards may find it more efficient for consultants to leverage their experience from past projects to deliver new services for a company, and in many cases compensation consultants may work with both management and the board to deliver such services. Regardless of the services provided, the board should consider the impact of the potential new disclosures when hiring a compensation consultant and consider the shareholders' perception of the consultant performing such services.

Director elections

The voting process

The director election process will be different starting in 2010. A new rule prohibits brokers who are members of the New York Stock Exchange from voting in uncontested director elections unless they've received specific instructions to do so from their clients.

The rule change is extremely important. Brokers traditionally vote uninstructed shares in support of the company's recommendations on routine matters, including director elections. Estimates are that brokers hold approximately 80 percent of stock, a significant percentage of which is held for institutional shareholders. While institutional investors typically do provide voting instructions, many retail investors don't. Without brokers casting such uninstructed votes, the overall number of votes cast in a director election likely will decrease. That means institutional investors who coordinate their efforts could have greater influence in "withhold vote" campaigns. Companies concerned about how voting results may change in light of the new broker nonvote rule could analyze voting history to get better insight. A proxy solicitation firm may be helpful in understanding how—and whether—groups of shareholders have traditionally voted their proxies.

Some companies also have moved to the electronic distribution of proxy materials, the "notice and access" model. This allows them to save printing and mailing costs of delivering paper proxies. But many also are experiencing a sharp reduction in retail shareholder votes. These changes impact director elections and highlight the need for companies to assess their approach to reaching and educating shareholders on the importance of voting. Companies with high levels of retail shareholders could consider sending physical proxies and implementing outreach campaigns to "get out the vote."

On a related note, the SEC has proposed a rule to improve the timeliness of reporting the results of shareholder voting—requiring companies to file results within four business days after the annual meeting. With this earlier deadline, management should critically review voting results to be satisfied with their accuracy so the company can report correct information in the shortened time frame.

Expanding information about nominees

Providing investors with more information about director nominations is another developing area. The SEC proposed rules that would require more information about director nominees' backgrounds and qualifications, specifically, a nominee's:

- Experience, qualifications, and skills to serve on the board or on a committee
- Directorships held during the past five years at public companies
- Involvement in any legal proceedings for the past 10 years (versus the current rule of five years)

Companies may find it beneficial to approach this potential disclosure by first describing the skills the board collectively needs to be effective. Such disclosure can provide context for the discussion about the specific skills and experience the individual directors bring and how they fit into the broader picture.

Easing rules for shareholders to nominate directors

Director elections may change even further if rules are adopted to allow shareholders to place their director nominees in the company's proxy statement. The SEC once again tackled this controversial issue by proposing new rules in May 2009. Shareholders' access would be based on company size and ownership thresholds. (See box.) Shareholders could nominate up to 25 percent of the board nominees and would have to represent that they are not seeking a change in control. The proposal would allow access based on a "first in the door" concept: The first shareholder (or group of shareholders) meeting the required thresholds can nominate director candidates. The proposed rule also would allow shareholder proposals that modify a company's bylaws surrounding director nominations. This provision could conceivably allow shareholders at an individual company to agree on lower thresholds at which they could nominate directors. The SEC is assessing the more than 500 comment letters it received and is expected to issue a final rule in 2010.

| Which shareholders get proxy access rights under the proposed rule? | |
|---|--|
| Company size | Ownership threshold |
| Large accelerated filers (companies with worldwide market capitalization of \$700 million or more) | Shareholders who hold at least 1 percent of voting securities for one year or more |
| Accelerated filers (companies with worldwide market capitalization of \$75 million or more but less than \$700 million) | Shareholders who hold at least 3 percent of voting securities for one year or more |
| Nonaccelerated filers (companies with worldwide market capitalization of less than \$75 million) | Shareholders who hold at least 5 percent of voting securities for one year or more |

Importantly, during 2009, federal and state law changes were proposed or enacted to address some of the legal issues that had prevented proxy access from moving forward. For example, Delaware state law now allows companies to adopt bylaws permitting shareholders to have their director nominees included in the company proxy, and bylaws requiring reimbursement for proxy expenses. This is important given the number of companies incorporated in Delaware. Bills also have been introduced in the US House and Senate to expressly allow the SEC to establish proxy access rules.

Despite the fact that shareholders have long sought to nominate directors, relatively few proxy battles have occurred in past years. That may reflect the expense shareholders had to bear under existing rules. Companies may reduce the chance of a contested election by engaging shareholders on director nominees—and even canvassing shareholders for potential director candidates when the board is looking to add particular skills and experience.

Policymakers and regulators are exploring changes to corporate governance practices. They want enhanced transparency, greater director accountability, and a greater voice given to shareholders in certain boardroom decisions.

Risk management

Under other proposed SEC rules, companies would disclose the board's role in overseeing the key risks facing the company. Some companies may find it challenging to articulate how the board oversees the broad range of risks.

Companies may find these general risk management concepts useful when drafting the new disclosures:

- Management is responsible for managing risk.
- The board's responsibility is to oversee both the risk management process and how management handles the major risks. Elements of this oversight may be allocated to different committees or be handled by the entire board.
- The board should define with management the information it needs to form its own views on risks.
- Board members should possess diverse skills and experiences to provide different perspectives on risks.
- The risk management process should:
 - Address a broad range of risks, not just financial risks
 - Approach risk management systematically across divisions and functions
 - Establish a robust business continuity plan and consider various business scenarios for unknown risks

For the 2010 proxy season, the SEC also announced changes to the way it considers shareholder proposals that ask for more information about risks that relate to major policy issues. Companies will no longer be able to automatically exclude such shareholder proposals from their proxies. That might mean a proposal asking for more information about the board's role in overseeing risk could have to be included in the proxy.

Many believe risk oversight is most effective when the full experience, knowledge, and skills of all directors are brought to bear on this complex subject. Legislation introduced in 2009 proposed requiring all companies to establish a risk committee of independent directors. The final legislation may not ultimately include this requirement. Nevertheless, directors should monitor its status, and consider how best to oversee risk.

Separating the chair and CEO roles

Another element of the SEC's proposed rules focuses on disclosures about board leadership, including whether the positions of CEO and board chair are combined or separated. In situations where the two roles are combined, the company would further disclose whether it has a lead independent director and what role that person plays in the company's leadership structure. Other legislative proposals were made to require companies to separate the roles of chairman and chief executive; however, they appear less likely to pass.

Many believe that each board is best positioned to determine what leadership structure works for its specific situation. That said, a CEO transition provides a good opportunity for the board to consider whether there should be a change in board leadership. As a point of reference, the roles of CEO and board chair are combined at 63 percent of S&P 500 companies, according to the Spencer Stuart 2009 Board Index. Splitting the CEO and board chair roles is a practice common in the UK, much of Europe, Canada, and Australia.

Similar to the changes on shareholder proposals about risk, the SEC also announced that, starting in the 2010 proxy season, companies will no longer be able to exclude from their proxies shareholder proposals that request information about CEO succession policies, including the board's involvement in the process.

Directors' actions

- Discuss with management how it will assess whether compensation policies for all employees may create incentives that promote inappropriate risk-taking.
- Be comfortable that management is building productive relationships with key shareholders to engage them on sensitive issues such as director nominations, leadership structure, risk management practices, or significant executive compensation changes.
- Understand the voting policies of significant shareholders and the possible impact of the elimination of broker discretionary voting on future director elections.
- Discuss with management any shareholder pressure to adopt say on pay, and monitor any legislative or regulatory action, particularly on proxy access.
- Consider whether the board has a robust process to oversee risk management.

The impact of global tax trends

Outlook for corporate tax reform

US multinationals are likely to see significant changes in the taxation of income earned by their foreign subsidiaries. How significant? As nearly half the income of US multinationals is earned by their foreign subsidiaries, the proposed changes are likely to increase the tax burden of these US companies.

The proposals would impact US companies' ability to defer US tax on foreign earnings that the companies continue to reinvest in those foreign operations, by deferring certain deductions and diluting the credit for foreign taxes paid.

These proposed changes in US tax law would be in contrast to the trends seen in most other developed industrial nations. Our major trading partners, including most Organization for Economic Cooperation and Development member countries, largely exempt foreign earnings from tax even when they are distributed to the parent company. The United States needs to be sensitive to the tax burdens borne by US companies compared to their foreign competitors, and the possible challenges the proposals would create for US companies competing in global markets.

No legislative action has been taken at the time of this writing on these international revenue-raising tax proposals, although some are predicting that changes to US international tax rules will be considered in 2010 as part of a broader tax reform debate. As part of this broader reform, Congress also might seek to address the high US statutory corporate tax rate—which is the second highest among OECD countries.

At President Obama's request, former Federal Reserve Chairman Paul Volcker is heading a tax reform task force to consider ways to simplify the tax code, close tax "loopholes," and reduce tax evasion and corporate "welfare." Certain of the policy options it recommends could be considered by the administration for inclusion in the president's fiscal year 2011 budget, which will be submitted to Congress in early February 2010.

The current political and economic environment could increase the risk that Congress will consider enacting corporate revenue-raising proposals to pay for its social and economic priorities. It is expected that policymakers will continue to look toward international taxation as one area for potential revenue increases.

Directors' actions

- Discuss with management the potential effects of the tax proposals on the company's competitiveness and financial performance, including the possible impact on the company's tax rate and plans to repatriate cash from foreign operations.
- Consider the extent to which management should engage with key policymakers to share perspectives on the business effects of the proposed legislation.

Increased coordination by tax authorities

Tax authorities in the United States and other countries around the world are sharing information with one another to enhance the effectiveness of their examinations of multinational companies.

Historically, tax authorities have used "exchange of information" agreements to combat tax evasion and potentially abusive tax transactions. More recently, they are expanding their cooperation to share best practices and observations on a range of cross-border tax enforcement issues. They now have multilateral agreements under which participating countries can conduct simultaneous examinations to facilitate addressing issues of common interest.

This increased cooperation and communication among tax authorities comes at a time when governments around the world, facing fiscal constraints, need to increase revenue. Aggressive tax compliance efforts may be an attractive option to raise revenue.

Directors' action

Discuss with management how it is addressing increased coordination by tax authorities, including whether management:

- Is evaluating the global risks inherent in cross-border transactions and transfer pricing arrangements, and is prepared to respond to challenges from tax authorities.
- Has a process in place to ensure the information shared with tax authorities in each country is consistent. This is particularly important given how tax authorities are exchanging information.
- Is considering working with tax authorities to obtain advance rulings on tax issues in what could be an increasingly contentious environment.

The focus on directors and tax

Internal Revenue Service Commissioner Shulman addressed the National Association of Corporate Directors' Corporate Governance Conference in the fall of 2009. He expressed the view that directors should play a role in overseeing business tax risks and tax strategies and described the types of information they should receive to enable them to effectively monitor tax risk. The speech further indicated that other countries have also begun to emphasize the importance of board involvement in company tax matters.

Directors' action

Understand the significant tax issues and complex tax structures being used, and discuss how management is addressing them.

The current political and economic environment could increase the risk that Congress will consider enacting corporate revenue-raising proposals to pay for its social and economic priorities.

Financial reporting developments

While lacking the fanfare of the standards that became effective in past years for merger and acquisition accounting and fair value measurements, recently issued standards could significantly impact many companies. New consolidation guidance taking effect in 2010 requires companies to carefully analyze their various business relationships. Longer-term projects that the standard setters are developing promise potentially dramatic changes in future financial reporting.

New consolidation guidance

Changes are coming in how companies determine whether to include certain entities (“variable interest entities,” where the controlling interest is not based on majority voting rights) in their consolidated financial statements. As a result of the changes, many companies will include more of these entities in their financial statements.

The standard applies across all industries, affecting joint ventures, equity method investments, and other common business arrangements. The new guidance requires companies to regularly reassess the need for consolidation of related entities and arrangements. The guidance takes effect in January 2010 for calendar-year-end companies, although the FASB deferred the application of this standard for certain companies that have the attributes of investment companies.

The determination of which party has the controlling stake will require management to exercise significant judgment. The company that is determined to have the controlling stake will include the entity’s assets, liabilities, and results of operations on its own balance sheet and income statement. Companies will need to identify the significant activities that drive the economics of variable interest entities and which party possesses the power to direct these activities.

Finally, the new standard does not allow for “grandfathering” previous consolidation conclusions on existing entities. Companies must evaluate each arrangement under the new guidance. In some companies, this could mean a considerable amount of analysis for the finance department.

Directors will want to understand how this new guidance might impact:

- Debt covenants—Adding debt from newly consolidated entities may trigger covenant violations.

- Financial ratios—Changes to the entities included in the consolidated financial statements will impact performance measures such as gross margins and return on assets and equity. These changes will need to be considered both for internal measures, such as compensation plans and budgeting, and for external communications with shareholders.
- Systems, processes, and internal controls—Newly consolidated companies will be subject to internal control certifications of the parent, potentially expanding the scope of internal control testing required.

Directors' actions

- Understand how this new guidance will impact the company's financial statements and related debt covenants, financial ratios, and compensation arrangements, as well as its internal control report.
- Understand how this guidance is impacting management's long-term planning, and check that the potential accounting ramifications don't deter the company from pursuing transactions that make economic sense.
- Understand how management will communicate these changes to shareholders and other parties.

The fair value saga continues

As a refresher, the FASB's fair value literature provides a standard definition of fair value where the term is used throughout the accounting standards. This definition applied to financial assets and liabilities in 2008 and nonfinancial assets and liabilities in 2009.

Throughout the financial crisis, there has been vigorous debate over the use of fair value accounting for financial instruments. Both fair value and historical cost provide useful information, yet neither method alone meets the needs of all financial statement users. The FASB and International Accounting Standards Board are working jointly to determine the best way to present the information, and these deliberations are likely to continue well into 2010.

The challenge is that it is difficult to determine fair value during times of market illiquidity or when a market simply doesn't exist. There may be minimal information available on which to base valuation assumptions. Without market-based transactions, assets' values are based in whole or in part on models, assumptions, and estimates that are not always easy to support or validate.

Establishing fair value is challenging enough for financial instruments, which often have at least limited markets or established valuation models. The challenge is compounded for nonfinancial assets and liabilities, as they often lack any established markets and require management to apply substantial judgment. The process for developing fair value measurements for nonfinancial assets and liabilities will need scrutiny and refinement as practice evolves.

Directors' action

Understand the methods management uses to determine fair value of nonfinancial assets and liabilities, the valuation resources it needs, and how it will determine that any valuations provided by third parties are appropriate.

Checking in with IFRS

Even though the economic crisis had moved a US transition to International Financial Reporting Standards (IFRS) down on the priority list, it is moving back up. Directors should recognize that IFRS is already impacting your companies. Many US trading partners, including the UK and most of Europe, operate under IFRS, and more countries (such as Brazil, Canada, South Korea, and Mexico) will adopt these standards in the next two or three years. The support for a single set of high-quality global accounting standards still exists.

Further, the convergence of US GAAP and IFRS is evident in nearly every significant area of accounting guidance being developed. In 2008, converged standards—standards jointly developed by the FASB and IASB—on business combinations were issued, and this movement is expected to continue with major projects in the works including revenue recognition, leases, and financial statement presentation. This path to convergence and the other impacts of the global community's adoption of IFRS will change the way US companies structure contracts and financial agreements, deal with international counterparties, and manage foreign subsidiaries.

Directors should recognize that IFRS is already impacting your companies.

Business implications of IFRS that directors should be satisfied management is considering

Foreign subsidiaries

- Manage foreign subsidiaries' ongoing adoption of IFRS to embrace efficiencies in the company's consolidation process.
- Plan for the impact on companywide and subsidiary IT systems.

Foreign counterparties

- Know how IFRS influences a foreign counterparty's negotiation biases by understanding the IFRS accounting treatment of critical components of the transaction.
- Consider how IFRS impacts the structure of long-term contracts and agreements.

Without question, there is uncertainty about the time frame for a US move to IFRS, but we believe this transition will take place eventually.

Directors' action

Stay alert to developments in the transition to IFRS, and understand how management is preparing for this change.

Big changes on the horizon

The FASB and IASB have made significant progress on several joint projects. Two that will likely have major impacts on companies' financial statements are highlighted below.

An overhaul of lease accounting

Lease accounting in its present form has been in place for more than 30 years. Critics contend it relies too much on bright-line rules to differentiate operating leases—which a company does not reflect on its balance sheet—from capital leases. Accordingly, the FASB and IASB are proposing wholesale changes to the lease accounting model.

Most significantly, the proposal would end the off-balance sheet treatment of operating leases for lessees. Instead, the rights and obligations for all leases would be on the balance sheet as an asset and corresponding liability. The amount of the asset and liability would be measured based on the terms of the lease contract and then remeasured throughout the lease term.

Of note, there is no indication that older leases would be grandfathered. This means that companies may have to record the assets and liabilities for all leases, regardless of when they were entered into, upon the adoption of the new standard.

What are the implications for companies that lease assets?

- Significant new assets and liabilities will be presented on the balance sheet. This will impact financial ratios used by lenders.
- Performance measures such as EBITDA will improve as rent expense is replaced in the income statement by depreciation and interest expense.
- Large companies will need to account for hundreds, perhaps even thousands, of lease contracts. These may be difficult to measure initially and on an ongoing basis throughout the lease term. Finance departments may need more resources to address the volume.

The project to date has focused primarily on lessee accounting. However, perhaps the most significant business impact from the coming changes may hit those companies that lease assets or properties to others. If their customers are more inclined to buy instead of lease, it will impact how lessors sell their

products and services. In addition, the guidance may also affect those that sell through sales-type leases, because immediate revenue recognition may no longer be allowed. Instead, revenue would be recognized over the lease term. Both of these factors could negatively affect the leasing industry or companies' leasing divisions.

The FASB and IASB are expected to issue a final standard in 2011 with an effective date no earlier than 2012.

Rethinking revenue recognition

The FASB and IASB are focusing on developing an accounting model that will result in revenue being recognized in a consistent manner for similar contracts, regardless of industry. The initial concepts they are considering include that:

- Inherent in a contract with a customer is a company's right to receive consideration (contract asset) and a company's obligation to provide goods or services (contract liability)
- A company recognizes revenue based on increases in these contract assets or decreases in these contract liabilities that result from the company's satisfaction of its performance obligations
- A company satisfies a performance obligation when it transfers control of the asset to the customer

Future deliberations are expected to focus on further developing these concepts and ways they can be applied in practice. If issued, this guidance will replace more than 100 pieces of accounting literature in US GAAP and the two primary standards on revenue recognition in IFRS.

Although the details of the proposed changes are still being worked out:

- The model under consideration would significantly impact revenue recognition practices for many companies, particularly those that follow industry-specific guidance under US GAAP and those with multiple-element arrangements
- Companies will need to consider how these changes would impact how contracts are negotiated

The FASB and IASB are expected to issue the standard in 2011, with an effective date no earlier than 2012.

Directors' action

Understand how management is planning for these significant changes. Discussions should include how the changes might impact the way the company sells its products and services, how it might structure transactions differently, and what changes likely will be needed to systems, controls, sales targets, and compensation. Discussions also should cover changes to the company's balance sheet, financial results, debt covenants, and other key metrics, and how the company will communicate the impacts from these changes to shareholders.

Unprecedented challenges, unprecedented change

The new guidance released in the past few years has been significant both in its impact on financial reporting and in the speed at which companies have had to move to implement the changes. This pace of change—akin to “drinking from a fire hose”—shows no signs of slowing in the coming years. The leasing and revenue recognition projects, for example, represent wholesale shifts in accounting that will fundamentally alter balance sheets and timing of revenue. In addition, other projects on financial statement presentation and on classification of liability versus equity will have similarly significant impacts. All of these projects will likely require further investments in systems and processes as they put additional strain on the financial reporting function and present additional challenges for timely and accurate reporting.

The pace of change in financial reporting—akin to “drinking from a fire hose”—shows no signs of slowing in the coming years.

Regulatory developments

As you might expect, there was a great deal of regulatory focus during 2009 related to the financial crisis.

In June, the US Department of the Treasury released its analysis of the causes contributing to the financial crisis. Two of these are the failure of companies' risk management systems to detect the risks inherent in new financial products and the growth in consumer debt that was accommodated by dramatically rising home prices. Treasury's proposed solutions include improving oversight of various financial markets and expanding the measures the government could take in reaction to situations that may pose a threat to the country's financial stability.

The SEC has also been active. Under the leadership of Mary Schapiro, it is developing new rules for the companies it regulates and focusing on changes in how it operates. Among these changes:

- Given the spotlight on the Bernard Madoff fraud, the SEC is placing a great deal of emphasis on its enforcement programs. The Division of Enforcement has a new director, Robert Khuzami, a longtime federal prosecutor. The division has hired more investigators and is reforming its policies and procedures to enable faster investigations through, among other things, a simpler subpoena process. It also is upgrading the systems used to track unusual activity and to analyze tips and complaints from whistleblowers.
- As discussed in our "Focus on governance initiatives" section, the SEC is seeking a package of measures designed to expand and improve the quality of information that companies provide to investors and to give shareholders new authority. One proposal would require companies to describe their controls over employee compensation policies so compensation doesn't incent behavior that might pose a material risk. Another would expand shareholders' power by allowing them to nominate directors.
- The SEC is proposing to improve the information that credit rating agencies provide. The agencies would have to disclose their methods of developing the credit ratings so that investors could better assess how much reliance to place on those ratings in making their investment decisions.
- The SEC is considering proposals related to hedge funds and derivatives to bring the oversight of hedge funds, other private pools of capital, and their related investment advisors under its regulatory umbrella.

While the SEC focuses much effort on the changes described above, it continues to concentrate on the quality of disclosures in companies' reports to shareholders. One such area is management's description of the various risks facing the business. The SEC doesn't want this discussion to be simply a listing of risks, but believes it should answer questions such as:

- What are the risks and the potential financial and operating impacts to the company if large customers or vendors go out of business?
- What are the risks if the company's lenders fail, and how would that impact the stability, growth, and operations of the business?
- What are the risks and the potential financial impacts if counterparties (including those on derivatives contracts) fail to meet their obligations?

The SEC believes this information is important for investors to make informed investment decisions. As companies begin to prepare their annual reports, management should consider what additional disclosures would allow investors to better assess the potential impacts from these and other risks.

Directors' action

Recognize this shift in regulators' emphasis toward enforcement activities, and discuss with management any issues that may cause concern for regulators.

The SEC is placing a great deal of emphasis on its enforcement programs.

Major ongoing legislative initiatives

Healthcare

As a primary piece of the Obama administration's platform, the reform of the US healthcare system has been headline news throughout 2009. These potential changes—whose full breadth and implications are unknown at the time of this writing—could change the degree of government involvement in healthcare.

Regardless of one's view as to the best solution for the future of healthcare, most agree that healthcare costs are a significant issue for both individuals and the business community. Even recently when the US economy was in recession, medical costs continued to grow and significantly outpace both inflation and wage increases.

Indeed, the employer costs of healthcare are expected to increase by 9 percent in 2010. As a result, many companies are revisiting their health benefit strategies, a trend that began in recent years. To control costs, some are changing plans and exploring options such as high-deductible health plans, wellness initiatives, and disease management programs. Companies will need to continue to explore such options and additional alternatives regardless of whether government programs ultimately are created.

Directors' action

Understand how pending healthcare legislation will impact your company and its cost of employee benefits, and what options management is considering to manage this significant cost.

Energy and climate change

While details are still unclear, both the Environmental Protection Agency and Congress continue to explore ways to curb carbon emissions. Government agencies have already been asked to reduce their energy usage and to track and report their environmental impact and that of their vendors and contractors. Companies should weigh the potential business impacts of such efforts and how they could influence business operations and strategy.

Companies with sustainable strategies to reduce their energy use can realize bottom-line benefits. Companies in renewable energy and other clean technology sectors will see opportunities to help customers reach their

voluntary emissions reduction goals. Tax incentives, government grants, and loans are already available to encourage companies to invest in “green” technology, and these incentives are expected to continue.

If energy reform continues to focus on regulating carbon emissions at the federal level, the cost of carbon will have a measurable impact on a variety of business activities. For example, companies in heavy-emitting industries may need to invest in technology to reduce future emissions. Most other companies, even those that don’t generate large amounts of carbon emissions, will be affected as their suppliers face increased energy or commodity costs. And companies that deal with end consumers could see more demand for information on the carbon footprint of their products, as individuals focus on the impact of their buying decisions.

If enacted, companies may need to track their activity to comply with new reporting requirements and they will need to develop supporting systems and processes to allow for this expanded transparency and accountability. In addition, separate from any legislative or regulatory activity, shareholders increasingly are asking for greater corporate disclosure about carbon emissions and sustainability activities.¹

The nature and size of the potential shift to a lower-carbon economy mean that more companies will want to have a long-term climate change strategy in place to maintain their corporate reputations and brands.

Directors’ actions

- Recognize that while most companies operate under some environmental compliance rules now, management needs to consider how an expansion of these programs and requirements will affect operations.
- Discuss with management how it is working to use energy more efficiently as part of existing cost-reduction programs.
- Given increasing shareholder, media, and employee scrutiny, understand the company’s message, and be comfortable with the level of transparency on environmental issues.

1. See the “Why care about sustainability” section in *Current Developments for Directors 2009*, available at www.pwc.com/uscorporategovernance.

Increased antitrust focus

The past year saw a marked increase in US government activity around antitrust issues in a wide range of industries. These changes, consistent with the new administration's tougher stance on collusion and anti-competitive behavior, have resulted in record fines during 2009.

The United States is not alone in this focus. A growing number of national anti-competition authorities such as those in Brazil, Canada, China, Japan, and Australia are more active and aggressive in identifying and prosecuting anti-competitive behavior. Also, there is a meaningful increase in the number of countries establishing their own competition enforcement authorities. Further, we see a marked expansion of cooperation among these international bodies.

What factors increase the risk of antitrust allegations?

- **Where the company does business:** Vigorous global enforcement today means there are no safe havens. While more countries are introducing their own anti-competitive programs, the standards for what is acceptable behavior may be different. For example, local market business norms may lead to communications between competitors that in the United States would be considered improper.
- **How the company does business:** Considerations such as high market share, discounts and rebates, price announcements, and collaborations with competitors may be red flags to regulators.
- **With whom the company does business:** Selling products to end consumers through third-party distributors or resellers; contracting with agents overseas; or bidding on large projects, tenders, or long-term contracts could pose risks from the company's own behavior or that of its business partners.

Directors' actions

- Understand how susceptible the company is to antitrust issues based on the nature and geographic spread of operations, the current economic landscape in which the company operates, and how management assesses antitrust risk and monitors compliance with the company's standards and policies on antitrust issues.
- Be comfortable that management identifies and addresses antitrust exposures as changes in the business take place—for example, as the company increases its market share or acquires other companies.
- Understand how management has addressed risk without losing profits, possibly through oversight of agents and enforcement of the company's code of ethics.

The buck doesn't stop with antitrust

Although this section focuses on antitrust, directors should be aware that enforcement of anticorruption laws also has increased. Here again, enforcement agencies from various countries are coordinating their investigative efforts. This is another area of emerging risk that could merit discussion with management. For more information, see *Corruption crackdown: how the FCPA is changing the way the world does business*, available at www.pwc.com.

If energy reform continues to focus on regulating carbon emissions at the federal level, the cost of carbon will have a measurable impact on a variety of business activities.

Special focus:
Government involvement
in business

There can be little doubt that the massive levels of federal financial support and involvement are reshaping American business, particularly in the financial and auto sectors. And different levels of government involvement correspond to the differing levels of investment.

Seven major companies in banking, insurance, automotive, and related automotive credit (the Seven) have had material—even extraordinary levels of—government support, and so face the greatest degree of government involvement. Other (mostly financial sector) companies took TARP funds, and face a lesser, but still meaningful, degree of involvement. Even financial institutions that didn't receive any direct assistance face more regulation and oversight, which will likely change behaviors and operations to some degree. At the time of this writing, it remains to be seen what additional measures may be applied to the companies deemed “too big to fail.”

Policymakers have homed in on excessive risk-taking as a key contributor to the crisis. Many claim that deficiencies in performance measurement and incentive compensation structures promote excessive risk-taking that is out of sync with the long-term needs of some companies and, by extension, the health of the US economy. Shortcomings in the regulatory framework are being cited, as well as corporate governance practices.

The emergence of the government as a major shareholder in the auto, banking, and financial sectors raises a new set of challenges for directors at these companies. This section focuses mostly on the impact of government involvement at the Seven, what it means to these companies and their directors, and what it might mean to companies that transact with these institutions. A review of the impact of government involvement in three specific areas can help directors navigate the forces affecting them in their role as stewards of companies that have a complex mix of shareholders and other stakeholders to satisfy.

Impact on boards and corporate governance

The government invested billions in the Seven and so became a major—if not the majority—shareholder. The boards of these companies have been transformed in a short amount of time, with many directors replaced. Some of the new directors were selected by the US Treasury and, in the case of the auto companies, also by the Canadian government and union interests. One focus was to bring more industry knowledge onto these boards, and that's evident in the backgrounds of many of the new directors.

The reformed boards bring a new dynamic to the boardroom as directors work with management (many of whom also are new) to implement turnaround strategies and to plan for the future. The scale of change in the boardroom amplifies the importance of directors getting to know one another and quickly gaining a robust understanding of the company and its operations. They must evaluate the company's strategies and risks and learn to work together constructively.

Assuring a positive dynamic is especially important given that many directors were placed on the board by different constituencies. They may find conflicting agendas emerge, such as when considering executive appointments in weighing seasoned, internal candidates against pressure to bring in outside talent. Political objectives also may influence board decisions.

In addition, these constituencies may have different perspectives simply from having different time horizons. The government investments in the auto industry are generally expected to be short term. On the other hand, some degree of government ownership in the financial sector may last for years, even though the government has signaled it's not intending to remain a long-term owner. If the government focuses on returning taxpayers' investments as quickly as possible, boards may find it difficult to gain consensus for a long-term strategic investment. Yet directors are aware they have broader responsibilities, which extend to the safety and soundness of their companies and entail decisions that require long-term investment.

Directors at the Seven are in a challenging position. Their decision-making authority in certain areas has been weakened. In other areas, the government may have veto power over a board's decisions. Even so, these directors' fundamental role in safeguarding all investors, including minority shareholders, remains intact. Just as directors should be prepared to challenge management on its business strategies and market assessments, they also should be prepared to discuss and challenge a government decision when they believe the decision is truly detrimental to the company's prospects. In that vein, directors may need to consider obtaining counsel from advisors as input to the board's deliberations.

What does this mean to directors of companies that deal with these companies—as a major customer, supplier, or counterparty? It means that since these companies may have had to evolve because of the changes in their leadership, it's vital to stay engaged with the companies and keep relationships strong. In addition, these companies may face pressures from within to buy from or deal with entities that are preferred by their new owners, thus creating an uneven playing field.

Impact on compensation

Perhaps most significantly, the government's involvement in these companies has had a direct impact on executive compensation practices at the Seven. Treasury has determined pay packages for a wide range of executives at these companies—not just those at the top.

A key concern is that sharply reducing pay packages—or deferring a greater proportion of compensation—will drive talented executives to rival businesses or away from US companies altogether, particularly in the financial services sector. There is deep concern about the ability of these companies to recruit needed talent and to keep current employees motivated while pay practices remain uncertain. Directors should be prepared to make the case to any external overseers that the company needs to attract and retain talented people.

For directors of other companies, recognize that although the government or regulators might not have direct say over your company's compensation, scrutiny of executive compensation is spreading—not just by financial services regulators, but also by shareholders and employees. Indeed, many directors believe that even companies that are not participating in government relief programs will feel the effect of the government's moves in their compensation discussions. Accordingly, directors should consider the transparency of their processes for developing compensation levels and be able to explain or defend them if necessary.

Impact on company operations and management

The impact of government involvement on operations and management may be harder to discern than on pay, but it remains influential. Some of the Seven have had to sell profitable business units. Others are constrained by the need for the government to approve major expenses. More noteworthy is simply the amount of time some executives are spending with regulators and the degree to which regulators and government officials are actively involved in the day-to-day operations of their businesses.

At some companies, this contact between management and the government is on a weekly—or even daily—basis. The benefits to open communications with government agents, including regulators, include a better understanding of each party's objectives and views and the status of issues. A downside is that intense government involvement can distract management, taking time away from the key operational focus that is particularly critical in this economy. [See *Appendix B: CAMELS Scorecard* for an example of how regulators are looking at companies.]

Lead directors or board chairs at some of these companies are becoming involved in the regulatory relationships. This helps them better understand regulators' concerns and monitor whether any issues are becoming roadblocks and need to be elevated to the entire board.

Government influence over operations also factors in when government funding is involved. Companies often make certain assurances before receiving the funds, and such assurances cover a range of obligations relating to how the money is spent. Directors should first be aware of these obligations and secondly understand the type of reporting the government may need. The reporting requirements, as government contractors have long understood, can be significant for accounting and finance departments. Finally, directors should be prepared to ask management how it is tracking the funding. In some cases, reporting requirements may mean government funds cannot be considered as fungible as general company funds.

Directors should be aware of the heightened reputational risk for their companies, as well as for government officials whenever they directly invest taxpayer money in companies: the “bad headline” risk. For a number of these and other companies leveraging government assistance, the consequences for “business as usual” practices have been striking.

Navigating the potential conflicts inherent with this level of government involvement presents a challenge for affected directors. Demanding transparency from management as to the company's opportunities, risks, and financial condition—and, importantly, understanding how these are viewed by its government investors—will help directors see potential issues approaching and work within this new board dynamic to make sound decisions that will benefit all shareholders.

Directors should be aware of the heightened reputational risk when the government has invested in their companies.

Appendix A: Acquiring assets in bankruptcy

Why, in a publication designed for directors, would we include a discussion involving bankrupt companies? Because, although traditional merger and acquisition activity has understandably been well below ordinary levels during 2009, bankruptcy courts' activity has been in high gear. Many strategic and financial buyers have taken advantage of opportunities to purchase some or all of the assets of companies in bankruptcy to add capacity or expand into new markets and regions.

Buyers can purchase assets from a company involved in a Chapter 11 bankruptcy either through the plan of reorganization or through a "Section 363" asset sale, named for the relevant section of the US Bankruptcy Code. The former requires that each class of creditors votes to approve the sale. Conversely, a purchase of assets under Section 363 requires only the approval of the bankruptcy court, subject to creditor objections, and is arranged through an auction process.

Section 363 sales are becoming increasingly popular. During 2009, two major US automakers participated in this type of transaction, with newly formed companies buying certain assets and assuming specific liabilities from the bankrupt entities.

Why are Section 363 sales attractive?

The advantages include:

- The buyer gets the acquired assets free and clear of most liens and claims.
- The buyer generally can "cherry-pick" the assets, contracts, and parts of the business it wishes to accept. This allows the buyer to get the components of the business that are beneficial and leave behind those that would be a burden or are duplicative to the buyer's existing operations.
- The time frame to close a Section 363 sale is a fraction of that ordinarily seen in a traditional reorganization. The shorter time frame usually results in lower legal costs for the buyer and the bankrupt company.

A Section 363 sale typically requires the "stalking horse" to commit substantial resources to prepare a bid, and the results of such due diligence are available to the other bidders. Thus, the stalking horse faces the risk of doing all the work without closing the deal.

What is a stalking horse?

A stalking horse is the party chosen to enter the initial bid in a Section 363 auction. Although the stalking horse bidder can increase its bid during the auction, if the stalking horse doesn't ultimately win, it is generally entitled to a breakup fee and reimbursement of its expenses.

Although a Section 363 sale offers many advantages, some buyers choose to acquire assets through the plan of reorganization. Why? This route could allow a buyer to negotiate favorable terms with the bankrupt company's existing lenders and creditors rather than having to arrange third-party financing. In addition, this type of acquisition can be done via a stock sale, allowing for the transfer of the bankrupt company's tax benefits. Section 363 sales generally would not include these tax assets.

Seizing an opportunity

For many companies, an acquisition of assets through a Section 363 sale might present a great opportunity. By focusing the purchase on components of the business that are profitable and leaving behind those that hindered the bankrupt company, it is possible to acquire a strongly performing entity or a significant portion of its assets without the baggage that caused it to enter the bankruptcy process.

Directors' action

Understand, if management is evaluating potential opportunities for acquisitions, whether management has explored the possibility of acquiring assets available through bankruptcies to increase the company's capacity or expand into new markets or regions.

How does a Section 363 asset sale work?

Although these sales can take many forms, one common scenario begins with the company in bankruptcy seeking bankruptcy court approval to proceed with a sale under the Section 363 process. During this process, the company and its advisors identify and establish the procedures to hold the auction and to solicit other bids. Creditors and other interested parties have the right to be heard prior to the court's approval of the 363 sale and can object to the sale if they believe it is not in their best interest.

Once approved, the initial bidder, the "stalking horse," negotiates an agreement with the bankrupt company to purchase some or all of its assets. The stalking horse bidder in many cases gets to set the terms of the auction, including the specific assets (and, in some cases, specific liabilities) that are to be included in and excluded from the transaction and how competing bids must be structured.

After a solicitation period during which additional bidders are invited to participate, the auction takes place, and the bidder that offers the "highest and best" value for the transaction is declared the winner. A hearing is held to approve the auction results, and the consideration is transferred to the bankrupt company in exchange for the assets. The bankrupt company is responsible for distributing the proceeds to the creditors of the estate under the supervision of the court.

Appendix B: CAMELS Scorecard

Bank regulators use the six criteria in the CAMELS scorecard to evaluate financial strength and quality of management. Directors could consider these measures for evaluating their companies.

Capital adequacy—Although this measure of strength applies to banks, directors at any company with financial products and investments will want an understanding of the degree of financial leverage and how it could impact earnings.

Asset quality—Directors should understand the quality of assets—on and off the balance sheet. Could any be a drag on earnings? What are the disposition plans, if any?

Management—Understand the incentives embedded in executive pay packages. Also understand management succession plans, as well as the bench strength of the current management team and the level and quality of management oversight of operations and risk management systems.

Earnings—Bank regulators get nervous when investments are riskier and earnings become volatile. The takeaway for all directors is to understand the quality and source of earnings at your company. How much of the earnings are generated by noncore operations? What proportion is generated by new products, for which the full risks might not be recognized? Understand trends in your company's expenses and how effective the budgeting and forecasting systems or models have been.

Liquidity—Many companies were surprised at how quickly their sources of cash dried up in the midst of the credit crisis. Understand the availability of funding—long and short term—and how diversified the sources of it are. Also understand the role and effect of off-balance sheet structures in creating or requiring liquidity.

Sensitivity to market risks—Understand management's ability to identify, measure, monitor, and control exposure to market risks, including interest rates, foreign exchange rates, and commodity and equity pricing. Although this appears very banking focused, many companies face tangible risks in dealing with volatile exchange rates and commodity prices.



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Corporate governance information available from PricewaterhouseCoopers

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