CORPORATE
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Board Governance Series

SERIES CONTRIBUTORS

Meridian Compensation Partners, LLC | PwC

Dear Corporate Director:

Looking across the governance horizon in 2011, you might be tempted to say that the more things change, the more they stay the same. Risk management, executive compensation, and building the bottom line continue to be steadfast targets on corporate boards'—and their investors'—radar, requiring vigilance on the part of directors to manage risk and leverage value for shareholders. There is something new in the air, however. Compared to the last several years, companies appear to be more hopeful about making forward strides in growth and performance.

To turn that hope into reality, today's directors need to stay informed so that they can be prepared to act upon opportunities ahead. Globalization, emerging technologies, and the slow, steady economic recovery are all ingredients that will allow companies to carve out new markets and capitalize on innovative growth strategies. In any organization, good governance practices must run parallel to strong strategic initiatives in order to adequately manage risk and ensure capable leadership.

This 17th volume of the Board Governance Series—a collection of informative commentary from leading consultants and business advisory experts—addresses top concerns for today's boards. In this report, you'll find discussions on what directors should know about combatting financial reporting fraud, the impact of say-on-pay rules, principles of sound compensation philosophies, and how to understand the distinctions between share-ownership and share-holding requirements. In addition, this supplement includes an interview summing up what CEOs are predicting about economic growth, based on PwC's annual survey titled Growth Re-imagined. In that spirit, we at Corporate Board Member also hope to see optimism become the driving force for 2011.

I invite you to visit each of our series contributors' websites, as well as to view online the webcasts highlighted in this printed publication. We hope these will become an integral part of your board's overall educational efforts to stay apprised of the most pressing issues in the year ahead.

TK KERSTETTER
President
Corporate Board Member
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Series Host

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COMPENSATION PARTNERS, LLC

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Four Principles of a Sound Compensation Philosophy

Let's start by explaining how companies state and effectively communicate their compensation philosophy. What can you tell us about that?

The objective of the compensation philosophy is to provide a blueprint to set and establish compensation programs for the organization. The compensation philosophy acts as this blueprint for helping set not only the levels—but the design and how you benchmark pay programs. In essence, a company's compensation philosophy is the committee's road map to setting and establishing appropriate compensation programs for the organization. It is important to recognize that the compensation philosophy needs to be tailored to and support the business strategy of the organization. That being said, as an organization's business strategy changes, it would be appropriate to update the philosophy to keep it in line.

There's a belief that too many boards routinely overpay executives by paying above the 50th percentile. What is your position on that?

What does it take to get the right talent? I think, at the end of the day, our position on this is that we encourage clients to make what I call an educated, informed decision. In doing that, they meet the basic tenants of the business judgment rule. So, as long as they're informed about what the differences are between the 50th and 75th percentile, or between the 50th and their pay objective above the 50th, we don't have an issue. For example, if you think about it, there's a significant delta difference by component of pay when looking at the relationship between the 50th and 75th. Using a general industry peer group, if you look at base salary, you would find roughly about a 10% to 15% premium when you go from 50th to 75th percentile. When you consider incentive pay, that premium magnifies. For example, when you look at long-term incentives, you're going to see a premium of 35% to 45%. So it's pretty significant. Most importantly, when setting the pay objective, an organization needs to make a connection back to the relationship between the pay objectives and performance expectations. In essence, are you setting performance expectations consistent with industry norms and pay opportunities at the 50th percentile, or setting target compensation at the 75th percentile and only achieving median performance expectations?

On balance, we have seen a strong migration from the 75th percentile pay objectives, to a median pay philosophy with enough leverage on the design to reach the 75th, if performance is strong.

Gerard S. Leider
Partner and Senior Consultant
Meridian Compensation Partners, LLC

What are the critical parts that need to be included in a compensation philosophy?

You're going to find there are a couple of major parts. First, what are pay program objectives? Second, what level of pay is the company targeting by component of pay? For example, is the organization targeting 50th percentile, or targeting something larger or smaller than that? The third part you want to see is the connection back to your business strategy. What are you trying to accomplish as a business? Your compensation philosophy is there to support that business strategy. So in essence, organizations that are trying to preserve cash may be more conservative on fixed pay—lower base salary—and more leveraged on incentive pay. The other component a solid compensation philosophy should identify is the criteria used to select appropriate peer companies to benchmark against.

You talked about pay objectives and targeting pay. What is common market practice for those?

Well if you look at the Fortune 1,000, the most common practices are as follows: roughly about 80% of the Fortune 1,000 set base pay at the 50th percentile. The majority of the rest set base salaries greater than the 50% percentile. Only about 5% of the Fortune 1,000 will establish market-based salaries below the 50th percentile. Again, it's a unique situation, but it goes back to their business strategy and the affordability question. As you look at incentive pay, you'll see those percentages change. Looking at the Fortune 1,000 again, you'll see that about 60% of organizations will target long-term incentives at the 50th percentile. Now, this has changed dramatically in the last couple of years. In general, you've seen the market become more conservative. If you looked five to 10 years ago, you would've seen a much greater percentage of organizations targeting incentive pay above the 50th percentile. Today, as I alluded to, about two-thirds of the organizations basically establish a target bonus and/or long-term incentives at the 50th percentile. The balance will target incentives in the third quartile.

A company's compensation philosophy is the committee's road map to setting and establishing compensation programs and pay levels for the organization. — **Gerard S. Leider**, Meridian Compensation Partners, LLC

How do you help clients establish the right peer group?

That's a tricky question. I think you're going to get different answers and different perspectives, but it all goes back to where do you compete for your executive talent? Where do you attract talent from? Where do you lose talent to? Organizations typically start with industry peers, but in my mind, it goes beyond that. As you look at general roles and the expectations of your incumbents, you'll go much broader than that. So if you think about it in terms of the ideal peer group, we start looking at similar size and scale (e.g., revenue, market cap, complexity) organizations that are within your industry. So you may look at other organizations within your SIC or GICS code. From there, you'll ask questions like where do I recruit talent from? That may be on a geographic basis; it may be on a national or global basis. But in essence what type of skill sets do I need? You'll see certain roles will be industry specific, while others will be broader in nature. At the end of the day, it's going to be an issue of credibility and data availability. As you look at jobs, you'll go beyond just your named proxy officers. You'll need to use private sources.

Gerard, you've worked with boards and management teams for over 15 years. Do you have any rules of thumb that you'd like to share?

I like my clients to make an educated, informed decision. Data isn't always the answer. Market data is a place to start. There are basic rules of thumb out there. As you look at market compensation values and setting market pay levels, for example, the majority of the market uses regressed market values. It's usually strongly correlated to revenues. Well, the basic rule of thumb that I use a lot with my clients is that if you double in revenue size, you see a 10% to 15% increase in base salary. This rule of thumb is a simple example that can help clients set pay objectives and make an informed decision about how a company will establish market-based and defensible compensation levels.

What Directors Should Know about Combatting Fraud

Financial reporting fraud can be a stressful topic for directors. Why are we discussing fraud?

Fraud is a topic that we tend to be uncomfortable discussing. But directors are often at least a little concerned about the extent to which fraud may be happening in their companies, and they wonder what they should do about it. I want to share some perspectives on fraud and directors' role in preventing it.

First, what is the definition of fraud?

Fraud covers a wide range of bad behavior—everything from misappropriating assets, to insider trading, to bribery and corruption, to tax fraud. But probably the most devastating fraud a company can face is financial reporting fraud. And so in this discussion, I'll delve into issues around this type of fraud.

What happens at a company if there is financial reporting fraud?

There are a number of things that can happen, and none of them are good. There's a cascade effect when there is financial statement fraud, and it starts with the fact that your company's stock price will likely plunge. You then will probably face a number of class-action lawsuits that you will have to defend and deal with. But more importantly, you are going to see significant costs in terms of time, resources, and dollars to deal with both the investigation and the restatements that have to happen. These investigations can get very big, very quickly.

Catherine L. Bromilow
Partner, Center for
Board Governance
PwC

For example, if financial reporting fraud is found in one non-U.S. subsidiary, there are going to be questions such as: "Is it happening in other countries? How widely do we have to investigate? What do we have to look at?" All of that investigation has to be done, and you have to have final answers before you file your restatement. Because as disruptive as one restatement is, you never want to be in the situation where you have a restatement and then find something else, and so on. At the same time, many things—the stock price crashing, class-action lawsuits, and just the staggering costs of investigation—can combine to distract management from running the business. Finally, there is also the follow-on reputational hit that stems from a financial reporting fraud, not only for the company as a whole, but also for individuals—and perhaps even directors.

That sounds pretty scary. So what should directors be doing?

Financial reporting fraud is very daunting when it happens at a company, and there are a number of things directors should do, but I'm going to boil it down to three keys.

The first is to be skeptical. I understand that this is tough. You wouldn't serve on a board if you didn't trust management, because you don't want to risk your reputation. So you start from a point of trusting your management team. With that said, we know that financial reporting fraud happens, so you have to maintain a sense of skepticism. You should look for red flags. For example, is your company experiencing some pretty significant operational problems but still able to make its numbers? Are there factors that make your company more likely to face fraud? Are there aggressive Wall Street or analysts' expectations that, in turn, put pressure on your company to meet them?

A second key is to look at internal factors. How are compensation programs and policies structured? Are incentives based on hitting certain financial targets?

How much are employees being pushed to meet those targets so they get incentive pay?

Third, make sure you're comfortable with the tone at the top—the ethical stance and the expectations for behavior that management sets throughout the company. You can look for things such as how management deals with individuals in the company who always seem to operate in

Make sure you're comfortable with the tone at the top—the ethical stance and the expectations for behavior that management sets throughout the company. — **Catherine L. Bromilow**, PwC

the gray, or just near the boundaries. Does management make sure they are removed from the company, or do they get transferred around, or even promoted?

So those three things—maintaining your skepticism, understanding what risks may be present in the environment, and making sure you're satisfied with the tone at the top—are the keys.

If directors want more information on financial reporting fraud, what do you recommend?

A good study was issued at the end of 2010 by the Center for Audit Quality entitled "Deterring and Detecting Financial Fraud." It's available on the CAQ website (www.thecaq.org). I would encourage directors and members of management who want to understand more about where the risk areas are, and what you could be doing to address fraud, to get a copy of that report. It's written at an executive level with specific steps that directors can take, and it may help you understand what other actions you could consider taking in overseeing the risk of fraud.

Holding and Owning Shares: What Boards Need to Know

Don Kalfen, partner and senior consultant at Meridian Compensation Partners, is here to talk about share-ownership and share-holding requirements. Let's first give a little background on this important board topic. How do share-ownership and share-holding requirement differ?

Both of these policies are very critical in helping to align executive interest and shareholder interest, but there are important differences between the two. With respect to share-ownership policies, these policies require executives to own shares equal to a specified value, usually as a multiple of their salary. For CEOs, this generally is five times their salary and for more junior executive officers, three times, and it goes down from there. Typically, officers have up to five years to accumulate enough shares to reach or exceed their target value ownership requirements. Holding policies, on the other hand, require executive officers to maintain ownership of certain shares they acquire through equity compensation programs. Often this is around 50% of the net after-tax shares they acquire either through options or restrictive shares or the like.

How have companies integrated share-ownership and share-holding requirements?

Among the Fortune 250 that have both requirements, typically they are integrated. Specifically where there are share-holding requirements, executives are required to hold at least a specified percentage of the shares acquired, until they meet share-ownership requirements. After that the holding requirement ceases, except with respect to the shares necessary to maintain ownership levels. However, some companies, and this is a minority practice, maintain the holding requirements even after share-ownership guidelines have been met. So shares that are acquired through compensation arrangements after the guides have been met continue to be subject to the share-holding requirements. Only a very few companies have shareholder requirements only and without any share-ownership guidelines.

Share-ownership requirements tell the investing public that officers must have a specific level of skin in the game.

— **Don Kalfen**, Meridian Compensation Partners, LLC

Why would organizations choose to utilize both share-ownership and share-holding requirements?

That's a good question. They serve very distinct purposes. Share-ownership requirements tell the investing public that officers must have a specific level of skin in the game. They have to own a significant value of shares outright or shares granted but not yet vested. This way, investors know that the executives bear the same risks as investors, and typically this is disclosed in proxy statements so investors know what degree of investment executive officers will have in their corporations. Share-holding requirements, although they can serve the same purpose, do not have specific goals in mind in terms of specific levels of ownership. In contrast to ownership levels, they require shares acquired through equity

Don Kalfen
Partner and Senior Consultant
Meridian Compensation Partners, LLC

compensation programs to be held for a specified period of time, and usually it's a percentage such as 50% of the shares acquired through an equity compensation program. The reason for this, in addition to facilitating and getting up to the share-ownership goals, is to ensure that any risks that may be taken during the course of business are fully integrated into share value that is ultimately retained by the executives. So in some respects it's viewed as a risk mitigator, in that the bets that executives have made are fully realized over time, presumably in the share price. That's what the holding requirements ultimately get at as opposed to ownership guidelines. If they liquidated their positions shortly after attaining the shares, there would be a potential mismatch between the risks and the ultimate share-price value realized.

What kind of future trends are you seeing with share-ownership and share-holding requirements?

I think both requirements are going to be integrated more so than today, and we'll ultimately see the majority of companies maintaining both. We are likely to see more companies using share-holding requirements, in order for executives to get to share-ownership targets. In addition to that trend, share-holding policies go beyond the ownership targets and require executives to hold shares, at least a percentage, until termination of employment or, in some cases, beyond.

What CEOs Predict about Economic Growth

We are here to discuss PwC's 2011 CEO survey. PwC has conducted this survey for 14 years all over the world. What is unique about this year's survey?

This year we saw a big upward spike in optimism. More than half of CEOs said they were highly confident about growth over the next 12 months and over the next three years. For the last couple of years, they were concerned about the recession and the recovery. So CEOs are seeing light at the end of the tunnel in terms of the economic situation, which we thought was quite interesting.

Is CEOs' optimism consistent all over the world?

Well, there was one exception. In most of Western Europe confidence wasn't as high. Clearly there is concern about economic problems in Ireland, Greece, and Spain.

The title of this survey is Growth Re-imagined. Why did you choose that title?

CEOs are optimistic about growth for different reasons than they were before financial crisis. They're seeing the globalization trend really taking hold again. They're optimistic about growth in the emerging world. They see growth in China, India, and Brazil. They're still focused on their domestic markets, but they see new opportunities in different places around the world. This source of optimism makes sense when you think about where the world is going, with a huge middle class emerging from "the other" 90% of the world's population. That huge new group is going to start consuming products, and that's what CEOs are targeting.

Tom Craren
Managing Partner, Brand and Thought Leadership
PwC

Did any of the findings surprise you?

Most surprising to me was how well the U.S. fared. We tend to believe that the U.S. is losing jobs to the developing world and that it's not a place that's seen as a source of future growth. But in fact, after China, the United States was named by CEOs as the second-most-favored place to source, to build products, and to open plants. We believe this is partly due to the sheer size of the U.S. economy, but it's also because CEOs see the U.S. as a safe place to invest—they see it as a center of innovation. While it's true that low-cost outsourcing is going to India and China, the smarter sourcing—where innovation is applied and new products developed—is coming here.

So does that mean that CEOs are feeling good about an economic recovery in the United States?

We believe they are. Most of them have said they're going to expand hiring, and that is a huge improvement from what we saw over the last two years. Because CEOs by nature are optimists, you have to temper their optimism a bit. But even so, we see undeniable improvement from when we were in the depths of the recession. CEO optimism about growth really is good news.

What issues most concern the CEOs?

They're worried about government overreach and they're worried about fiscal deficits, which is probably not a big surprise. In the U.S., the relationship between government and business is a problem—worse than anywhere in the world. Compare this to China, where government actively supports business. In the U.S. there has been an adversarial relationship. The administration is now trying to change that. What business and government leaders are figuring out is that it's not helpful to U.S. companies if the government is not supporting them. It hurts them competitively overseas. This is how I would paraphrase this issue, "Gee, we need to work better with the government; we need to get on the same page to promote U.S. business interests. Punish the bad guys when something goes wrong, but work together when it's in our mutual benefit." If you think about the job creation agenda, companies won't hire people unless there's a level of certainty about government regulation and how the government is going to work with the business sector.

That's a good point. Is there anything else in this survey that executives and directors can learn from?

One very important point for directors is that in the emerging world, there is confidence about growth alongside concern for greater risk. If a company is doing business in a place like India or Brazil, they see the opportunity for growth quite clearly, but they really don't understand the business climate as well as they do in the U.S. This has created a renewed focus on risk. To help understand and manage these risks, companies are going to have to look at bringing on more diverse executive teams. Many CEOs are saying, "Listen, we can't move a manager from the U.S. to work in Brazil because they don't understand it as well." So the way they're looking at talent is going to be quite different. And I think this is a very important factor for board members in their oversight of companies. They are going to have to be really attuned to the fact that companies are doing business in much different locations with much different risks than they have seen before. Having the right teams in place to manage these new risks will be crucial.

One very important point for directors is that in the emerging world, there is confidence about growth alongside concern for greater risk. — Tom Craren, PwC

It sounds like there is certainly a lot to think about, but it's good to hear that CEOs are feeling optimistic about a recovery.

Yes, they're now focused on growth instead of survival. Business issues have risen to the top of their agendas again. There was a huge increase in how CEOs rank innovation. They see innovation as the key to developing new products. In particular, they're looking at developing new products for consumers in the emerging world. I mentioned the renewed focus on talent and having the best work force, which also rose in importance. We're seeing some of the fears about the economy receding. No doubt this renewed focus on growth and doing business will change directors' agendas as well.

Will Say-on-Pay Rules Change the Current Compensation Committee's Thought Process?

TK Kerstetter
President
Corporate Board Member, moderator

Catherine L. Bromilow
Partner, Center for Board Governance
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Don Kalfen
Partner and Senior Consultant
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Will say-on-pay rules change the current compensation committee thought process?

Catherine Bromilow: They probably will. Say on pay will, first of all, put a lot more focus on disclosure. Companies are considering adding a mission statement as an introduction to their Compensation Discussion and Analysis (CD&A) to outline what they are trying to accomplish with compensation. Then they need to make sure that the detail in the compensation discussion corresponds to what they have described in their mission statement. From a broader perspective, though, we think say on pay will change the lens compensation committees use when they look at their decisions. As they make a compensation decision, they're going to have to think about how it would look in the CD&A, how shareholders will react, and how it might impact say-on-pay votes. We know, for example, that shareholders are scrutinizing company performance and peer groups. For example, if a compensation committee decides to pay a retention bonus, yet the company hasn't performed well this year, that's the kind of decision that's going to look contradictory and will probably give shareholders concern.

The other thing is to think through whether or not the board or the compensation committee wants to directly engage and get the views of shareholders on pay packages. If so, how are they going to do it? Are they going to go out and talk with the portfolio managers, or do they want to speak with the people who make the voting decisions?

Bottom line: We do think the say-on-pay votes, as they start in 2011 for most companies, are going to have an impact on compensation committees.

Don Kalfen: Certainly say on pay has the attention of all compensation committees, and no compensation committee wants to see shareholders vote down their executive pay programs. However, it is fair to say that over the last few years, compensation committees and management have been modernizing their pay programs. With the current issue of say on pay, they clearly have been refreshing those design practices and determining if there is any area that needs to be critically reviewed or eliminated and asking whether there are any problematic pay practices. Basically, say on pay is a continuation of a long trend among management and compensation committees to scrutinize and determine what's appropriate in terms of pay packages. So while say on pay is certainly an important corporate governance milestone and will undoubtedly influence compensation committees, particularly during this, its first year, it remains to be seen whether it will cause a sea change in the deliberations of compensation committees.

While say on pay is certainly an important corporate governance milestone and will undoubtedly influence compensation committees, particularly during this its first year, it remains to be seen whether it will cause a sea change. — **Don Kalfen**, Meridian Compensation Partners, LLC

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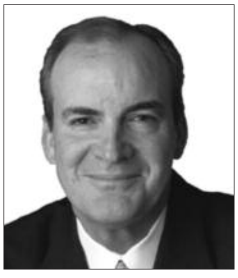

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