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Our *What Directors Think* survey shows that, post-crisis, risk keeps directors awake at night more than any other concern. It's no surprise, then, that a majority of directors are now giving risk management a priority ranking.

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The focus on fraud, corruption, and misconduct is increasing not only at home, but also throughout the world. And the pace of enforcement is ramping up considerably, with implications for US companies and their directors.

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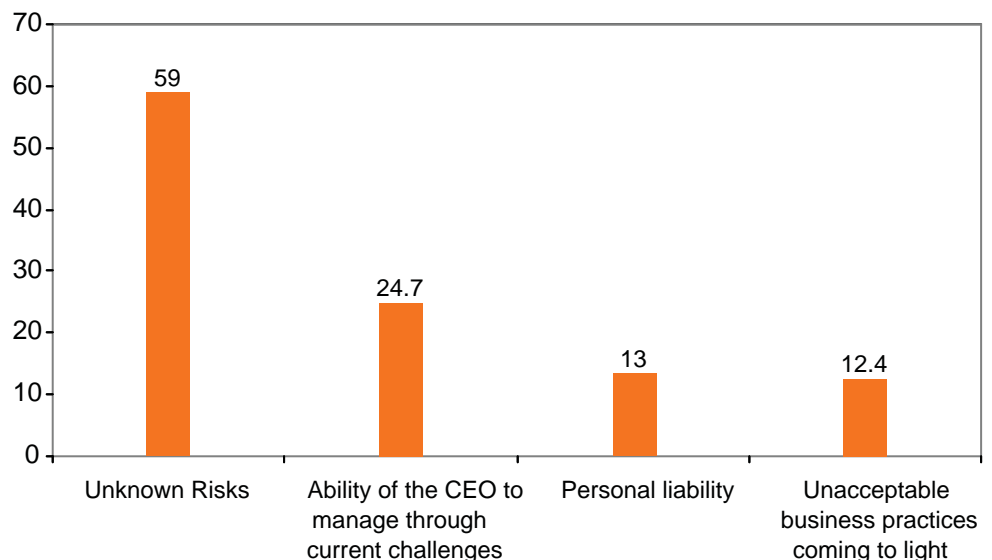
Recent changes in off-balance-sheet and consolidation rules will bring more entities and financial assets on to a company's balance sheet. The impact of these changes goes well beyond financial reporting. What should directors focus on?

## Directors and risk: Trying to avoid being blindsided

The aftereffects of the global economic crisis continue to reverberate through corporate boardrooms, bringing risk management into sharper focus. In the 2009 *What Directors Think* survey conducted by PricewaterhouseCoopers and *Corporate Board Member* magazine, risk management is clearly of primary concern to directors.

What keeps directors up at night? Some 60 percent of 1,021 respondents said unknown risks represent the greatest challenge they face as directors (see chart).

### Percent of directors responding to what keeps them up at night



Source: PricewaterhouseCoopers and *Corporate Board Member* magazine, 2009 *What Directors Think* Survey

It comes as no surprise then, that risk management merits the most attention from the board: Sixty-four percent of directors ranked it the highest priority after the board's core mission of profitability and shareholder value. And two-thirds indicated they would like to spend more time on risk management this year than in past years. Indeed, only

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## Spotlight on anticorruption

Scrutiny of fraud, corruption, and misconduct is increasing. More countries are signing on to anticorruption statutes, stepping up enforcement, and targeting companies and executives for investigation. Additionally, enforcement agencies from different countries are coordinating their investigative efforts, and these efforts show no signs of abating. As companies pursue growth by expanding into new markets and engaging in M&A activities, the risk of exposure to corrupt third parties increases. Boards should understand how management is vetting potential business partners and agents in foreign markets.

The legal anticorruption standard for US companies is the Foreign Corrupt Practices Act (FCPA), which deals primarily with bribery and fraud. Enforcement of the FCPA is handled by the Department of Justice, which often works with the SEC on these cases. The number of FCPA cases has increased significantly in recent years, with a total of 71 cases brought in 2007 and 2008, compared with only seven brought in 2003 and 2004. As of May 2009, there were 120 FCPA investigations pending.

In response, Fortune 1000 companies are developing processes and solutions to lower their risk exposure to fraud and corruption. Companies are ensuring that compliance programs are more rigorous and comprehensive, particularly when they buy companies, enter new countries, and develop new vendor relationships. Such measures will help protect companies from issues that could arise when dealing with agents and counterparties accustomed to different business practices.

### Reputational Risk

In a 2009 PwC survey, 55 percent of companies say the biggest corporate threat resulting from illegal behavior is damage to the company's reputation. This is greater than the combined total of those who say legal, financial, and regulatory impacts would be the most severe.

The economic crisis increases the risk of fraud and corruption for companies. Pressure to meet earnings targets in a difficult economy could lead to manipulation of financial results. Any downsizing that weakens internal control could open the door to asset misappropriation. And any employees who are personally in

financial difficulty could be more apt to participate in false vendor schemes or pad expenses.

So how might directors respond?

- Regularly discuss with management the company's possible exposure to corruption and fraud
- Understand the company's anti-corruption policies, processes, and controls, and discuss whether they are adequate in light of the company's risk profile, as well as being communicated throughout the company
- Be comfortable with management's response if a regulatory breach or fraud has been identified
- Be "investigation ready," which could include determining in advance which law and accounting firms would be used to conduct investigations, if necessary
- Ensure the internal audit team includes FCPA compliance and fraud detection and deterrence in its scope of work

Given the potential for reputational and monetary damage, directors increasingly understand the need to view fraud and corruption as critical business issues, not just legal and compliance matters.

## Off-balance-sheet arrangements—or maybe not

Many companies, in many sectors, use off-balance-sheet arrangements to manage risks, reduce borrowing costs, and collaborate with other companies. The recent economic downturn has highlighted perceived flaws in the accounting models for off-balance-sheet entities, calling into question the appropriateness of their off-balance-sheet treatment, especially in light of companies providing additional financial support to such entities.

Beginning in January 2010, two new accounting standards will change how companies determine whether to consolidate certain entities and financial assets. Many companies—including those that collaborate on long-term projects, manage or service pools of assets, or transfer financial assets in securitization transactions—will be significantly impacted.

One of the standards amends the accounting for transfers of financial assets by eliminating the concept of a qualifying special-purpose entity. (A QSPE is an entity that, for accounting purposes, enables certain assets

to be moved off a company's balance sheet, allowing the company sale accounting treatment.) As a result, transactions will have a harder time qualifying for off-balance-sheet treatment than in the past. The changes could affect many transaction types, including factoring arrangements, sales of trade receivables, and sales of auto and mortgage loans.

The other standard amends consolidation accounting for variable interest entities (entities where the controlling interest is not based on majority voting rights). The new guidance changes the determination of who should consolidate an entity and requires QSPEs to be consolidated—which will result in more entities being consolidated. Potential “parents” of such entities will have to determine which party has control over key operating activities and economic exposure. These determinations can be complex and often require significant judgment from management. The company that is determined to be “controlling” will include all of the affiliated entity's assets, liabilities, and results of operations on its balance sheet and income

statement. These determinations of “control” must be done continually, and the conclusions could change over time.

For calendar-year-end companies, these changes take effect in 2010, including for quarterly periods. These standards may change the way businesses form strategic partnerships, joint ventures, and other relationships, such as co-production arrangements.

As directors seek to understand the impact of these changes, here are some matters to focus on:

- How the new standards will impact existing off-balance-sheet transactions and relationships
- What remodeled financial statements may look like if new entities are included, and what the impact will be on financial ratios, debt covenants, and compensation arrangements
- The impact on planned acquisitions, financing arrangements, and strategic relationships
- The effect on communications to shareholders

## Directors and risk

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half believe they are effective at monitoring their companies' actual risk management. In fact, six in ten directors ranked the balancing act that is risk management oversight—ensuring that the company is not being so risk-averse as to miss key opportunities versus failing to conduct the appropriate due diligence in an effort to grow value—as among the most difficult of their responsibilities. This ranked second only to strategic planning oversight.

The study also provided some interesting insight relating to the information directors receive—45 percent of directors say the quality of risk information they receive from their companies has improved; meanwhile, 36 percent say it has been consistently satisfactory throughout. But

some directors—17 percent—say that even though management has begun addressing their concerns over the inadequacy of risk information, what they have received to date is inadequate.

It's clear the economic crisis has sharpened directors' focus on the risks their companies are taking—not only the nature and level of the risks, but also how well they are being managed. Plus, regulatory changes coming from the SEC may require new proxy disclosures about the relationship between the board and senior management regarding material risks. There is no doubt the focus on risk will continue among shareholders and regulators, reinforcing the need for directors to bring their best thinking on the topic to the boardroom.

### How PwC can help

To have a deeper discussion about how these subjects might affect your business, please contact:

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Tell us how you like **To the Point** and what topics you want to hear more about. Just send an email to [us.assurance@us.pwc.com](mailto:us.assurance@us.pwc.com).

### You may also want to see

*This Week in the Boardroom*: This weekly on-demand webcast series informs directors and C-suite executives of current governance issues impacting their strategic and operational decisions. The program features discussions with experts from PricewaterhouseCoopers and other organizations, who offer advice and concise analyses on regulatory changes, shareholder developments, management succession, board evaluations, proxy access, board elections, and other issues critical to boards.

*This Week in the Boardroom* and our corporate governance publications—including previous issues of *To the Point*—are available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

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