Board Governance Series

VOLUME VII 2006

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS

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CORPORATE BOARD MEMBER MAGAZINE

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BOARD MEMBER
MAGAZINE

Corporate Board Member is the leading information resource for senior officers and directors of publicly traded corporations, large private companies, and Global 1000 firms. The bimonthly publication provides readers with decision-making tools to deal with the corporate governance challenges confronting their boards.

Corporate Board Member further extends its governance leadership through an online resource center, conferences, roundtables, and timely research. The magazine maintains the most comprehensive, up-to-date database of directors and officers serving on boards of publicly traded companies listed with the New York Stock Exchange, NASDAQ Stock Market, and American Stock Exchange.

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CORPORATE
BOARD MEMBER
MAGAZINE

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To that end, *Corporate Board Member* and The NASDAQ Stock Market proudly present volume 7 of the Board Governance Series—a collection of commentary from leading experts on corporate governance. Inside the pages of this special supplement are discussions on best practices and research on pertinent topics for directors—navigating M&A transactions, preparing for audit committee meetings, mitigating risk in today's environment of increasing risk, understanding the new SEC disclosure proposals, and understanding enterprise risk management.

We invite you to visit our series contributors' websites and to view the webcasts.

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President
Corporate Board Member

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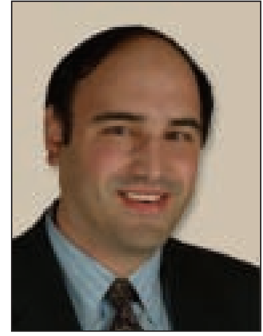
The Director's Role in M&A Transactions

Malcolm Landau, partner at Weil, Gotshal & Manges LLP, discusses what directors need to know concerning M&A transactions–from the realization that they are in charge to having independent people making the ultimate decisions.



Malcolm E. Landau
Partner
Weil, Gotshal & Manges LLP

I'm going to discuss some of the things board members should consider when they are presented with an M&A transaction, whether it be a transaction they want to embark upon independently or a transaction presented by someone outside the company. Specifically, what is a proper process for the board of the selling company to pursue, and what are some of the things that the board should consider as part of that process?

As a preliminary matter, boards should be familiar with the two types of potential buyers in the marketplace. There are strategic/industry buyers– buyers that are in the same industry as your company or want to get into the industry with the long-term view of synergies and building out the business by integrating or growing their business through the acquisition. Then there are financial buyers, the most common being private equity firms. These are buyers looking to acquire the business and turn it around. They often bring a lot of new ideas as well as a new vision for the business with the goal to improve it and grow it, but their objective is to at some point have a financial exit, either through a public offering or further sale.

Each of those buyer groups present different challenges for the board in evaluating the offers. Financial buyers pose some challenges because they build their transactions via third-party financing. They will often need to raise money, usually from banks, but frequently also from the more challenging capital markets, and that poses closing risks for the seller. There is always the risk that the financing cannot be raised due to market or other issues and the deal won't close. That's a bad result for the seller. Obviously the board wants to know when it signs the deal that it's as certain as it can be. There has been a trend lately where that risk has been shared with the financial buyers through reverse termination fees if the financing fails. But ultimately, financing is an issue when dealing with a financial buyer. For industry buyers, regulatory approval, particularly antitrust clearance, is often an issue because if both buyer and seller are dominant players in the same industry, the combination of two competitors into one business will impact competition in the market. This raises the risk that the transaction may not be approved by regulators.

When evaluating an offer price for a proposal that will take a long time to close due to a lengthy regulatory approval process, the board should consider whether to discount that price for time value, because $24 two years from now is worth less than $24 today when you look at it on a present value basis. So a competing offer that may be priced a little lower but that will close sooner may actually be more attractive. Similarly, if you risk adjust a $24 price for a proposal with a lot of attached risk, that may be less attractive than a $23 price for a proposal that has greater certainty. The board will need to think about all those things when it evaluates bids.

Validating the Right Price

A board does not have to sell a company, but once it decides that selling the company is the right thing to do and it receives an attractive offer price, a big issue is how does the board validate that price? Yes, the board will ask its investment bankers to opine as to whether the price is fair, but still, how does the board get comfortable that it followed a proper process to validate that price in the market? There are at least three ways to run the process from the board's perspective. The board could conduct a broad-based auction by hiring a financial adviser to draft an information memorandum and contact potential buyers to see what they are willing to do in terms of making a

proposal. This could be a public process, sometimes signaled by an announcement that the company is considering strategic alternatives. Alternatively, the board could conduct a more focused mini-auction and confidentially approach a limited number of most likely suspects, because sometimes you don't want to have a broad-based auction due to inherent risks, including risks associated with having an unsuccessful public auction. Or the board could identify one attractive proposal and pursue it to see if the two parties can come to an agreement. Once they reach an agreement, they announce it publicly and then there is an opportunity for others to overbid. Based on a number of cases over the past few years, people have become quite comfortable that, under the right circumstances, relying on this post-signing market check is a viable option for the board.

"The first thing that the board should understand is that it is in the driver's seat."

Independent and In Control

The first thing that the board should understand is that it is in the driver's seat. It is ultimately the board's decision, not senior management's, as to whether it will present the transaction for the stockholders' approval. And the board must be comfortable when it makes that decision. So how does the entire process play into that decision? Obviously management is key, and the board needs management to participate and cooperate in the process. The buyers will want to talk to management and be confident in what the board says about the business, and that information will often come from management. Ultimately, however, the board must keep the oversight role. That doesn't mean directors are at the table negotiating the minutia of the warranties line by line. What it does mean, however, is they must stay on top of and be comfortable with the key strategic decisions–the valuation, the price, the overbid clauses, how tightly the deal is locked up, and the conduct of the sales process. So that's the first realization for the board–it is in charge.

Second, you want people who are independent running the process. There is a lot of talk about special committees, but they aren't necessary in many contexts. You could have a board comprised of a majority of independent directors, as many boards today are, running the process, and that's fine. Sometimes you will want to have a special committee; there may be convenience involved or there may be other reasons that call for it, and that's perfectly fine, too, and we advocate that in many cases. But the key is to have people who are independent and without conflicts related to the process making the ultimate decisions. How does that pertain to management? Well, there are circumstances, particularly common when the buyer is a financial buyer such as a private equity firm, where management is key to the buyer's interest in the business. The buyer will frequently offer members of management something very lucrative to stay on with the business, such as equity in the surviving company or lucrative pay packages. How does the process not get tainted by the potential conflict of interest of someone getting something different from what the stockholders are getting, particularly if that someone is the person negotiating the contract? The board must take control of those issues, and well-advised boards know that it is much better for the process if management team members do not talk about their personal deals until the overall company transaction is settled. But there is always the chance that these issues will come up at some point in the process, so the key is for the independent directors to keep control, keep that supervisory role, and keep the process pristine for when it's looked at in hindsight, as these deals always are.

How do you identify the right thing to do? Even a very experienced director may go through this process only 10 times in his or her career. It is important to have a team of experienced advisers that helps you get the process right. And the board is entitled under the law to rely on those people for guidance in making the best decision. But ultimately, it will be up to the board to make the tough decisions, so directors should take the time they feel they need to get informed, ask questions, and deliberate, so that they are comfortable with the decisions they make.

In summary, an M&A transaction is not something directors should fear. It's a very exciting process. In fact, some directors find it's one of the most interesting aspects of being on a board. It's really the turning point for a company. Many skill sets come into play, and as long as the directors are prepared, advised well, and do the right thing, an M&A transaction is something they might actually enjoy going through.

Keys To Improving Audit Committee Efficiency

Catherine Bromilow, partner at PricewaterhouseCoopers LLP, outlines the key drivers of efficiency for audit committees—from meeting preparation to simply managing the sheer volume of materials they receive.

Catherine Bromilow
Partner
Corporate Governance Group
PricewaterhouseCoopers LLP

One of our areas of focus at PricewaterhouseCoopers is to support our clients' audit committees as they work to ensure they are effective in meeting their responsibilities. Those responsibilities have, of course, been added to substantially over the past few years. What we are seeing now is audit committees trying to determine how they can get their work done in less time and with less effort–in effect, more efficiently. One area in which audit committees can reap real benefits from operating more efficiently is meeting preparation. There are three key aspects of meeting preparation where audit committees can improve efficiency.

Chairs Must Prepare

The first is the audit chair's role in meeting preparation. He or she is responsible for driving each meeting and must be entirely comfortable with the agenda. One of the best ways to reach that comfort level is to make sure he or she has an in-depth and robust understanding of the issues–by holding one-on-one conversations with management, internal audit, external audit, and anyone else necessary, to develop that deep understanding. That level of understanding is critical because not only is the chair responsible for making sure the audit committee is addressing the necessary issues, but he or she can decide whether an issue merits establishing a subcommittee to investigate it, work with management and others on it, and then come back and report to the full committee. Once the audit committee chair has a robust understanding of the issues, he or she can decide how the committee can most efficiently carry out its oversight.

We are seeing many audit committee chairs holding such one-on-one meetings, and they report that they find them valuable. Ultimately, audit committee chairs are recognizing that they are responsible for driving the meetings and making sure the committee accomplishes its goals. And a key part of that is making sure the committee understands and addresses the issues it should.

Manage Advance Materials

The second key area for efficiency gains is the advance materials that are distributed before meetings. Audit committee members are drowning in paper; they receive huge volumes to read prior to every meeting. One committee chair told me that one attribute he looks for in a director joining the audit committee, in addition to the financial literacy, independence, and good business sense, is the brute strength necessary to carry the advance materials. In a similar vein, another audit committee chair told me they insist that every page be printed on both sides, so while the amount to read is the same, there is, at least, half the physical material to carry around.

Audit committees truly are concerned about the volume of information they are expected to digest, and they are dealing with it in several ways. The first is to make sure the elements in the briefing package are closely related to the agenda. For each individual report, committee members should have a clear understanding of why it's there and how it relates to the upcoming meeting. Many companies help that process along by indicating in the agenda exactly what the audit committee is supposed to do with the material. For example, if it is the draft minutes from the prior meeting, the committee members are expected to review them and come to the meeting ready to approve them. If it is some other information for which management is seeking the audit committee's advice and counsel, the committee members would need to look through the report, analyze it, and then come prepared to discuss it. There may be other reports that are simply there for the audit committee's information. So clearly linking the materials to the

agenda, and specifying what the committee is expected to do with each piece of information, is the first key.

A second way to improve materials is to standardize the format of the reports the committee receives. Most important here is to have a concise executive summary at the beginning of each individual report. That allows audit committee members to have a much better understanding of the issues as well as providing context before they read the entire report.

The third key way audit committees are managing the volume of information is to think through which of the detailed reports they are receiving could change to an exception report basis. This addresses one reason why audit committee materials have grown: Once the committee has requested a special detailed report, and it has been provided for a few meetings, there's a reluctance to remove it from the reporting package. Switching from a detailed to an exception report format can be a solution–ensuring the audit committee gets the information it needs without the level of detail it may not need.

While managing content is important, another critical aspect is the timing of receiving those materials. Audit committee members should get materials at least 10 days before the meeting because they need to be able to devote the time to read, understand, and analyze them. Now, we recognize that some of those materials–final versions of financial statements or the MD&A–are not going to be available 10 days before the meeting. That said, some committees are asking for pro forma statements–the basic information that may be available. That lets them go through it carefully and then, closer to the meeting, management can provide them with a final version that shows any changes from the version they reviewed in detail. That way, the audit committee has had the chance to review the material in depth, and then supplement it with any additional information.

Members Must Prepare

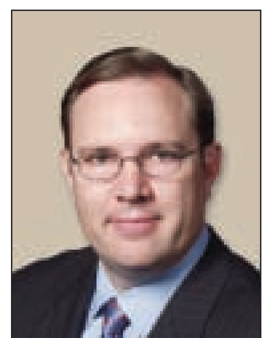
The third and final area supporting efficiency is what individual committee members themselves do. They play a key role in making sure there are no surprises. Audit committee members need to devote the time and preparation to come to meetings having reviewed and thought about the issues. How does the no-surprises concept fit? If they see something in the materials that they have questions about or that seems strange, they shouldn't wait until the meeting to bring it up. Instead, they should reach out to the chair and management to let them know about those concerns. That way, management can come to the meeting entirely prepared to discuss those things, thus using meeting time efficiently. This is key. We understand that audit committee members and chairs are busy people, but if you sign up for the role, you must be willing to make the time and devote the energy to fulfilling the responsibility. Otherwise, if not all members come prepared, those members who have prepared adequately end up wasting meeting time bringing those unprepared members up to a level of understanding of the issues. In effect, we like to think of proper preparation as a "no audit committee member left behind" situation. And that happens when audit committee members understand the issues up front and make the commitment to come to meetings prepared and ready to participate in discussions.

In conclusion, we see the key drivers of efficiency for audit committees being the chair discharging his or her role properly, and making sure the right issues are brought forward; the right advance materials, so the audit committee gets the right information at the right level of detail at the right time; and the role of the members themselves in making the commitment to come to the meeting prepared. Interestingly enough, although we've been focusing on efficiency, these actions also support the audit committee's effectiveness, because they allow the committee to focus on the issues that are most important.

"Ultimately, audit committee chairs are recognizing that they are responsible for driving the meetings and making sure the committee accomplishes its goals."

Using Outside Advisers to Help Manage Risks

FTI's Roger D. Carlile, senior managing director and Forensic and Litigation Consulting Segment Leader, offers a director's road map for mitigating the increasing risks facing them and for reducing their personal liability in today's environment.



Roger D. Carlile
Senior Managing Director
Forensic and Litigation Consulting
FTI

Recent corporate accounting improprieties have triggered shareholder mistrust of some corporate boards and a subsequent rash of liability claims against directors personally. In fact, the likelihood of a director being sued personally has increased by nearly one-third since 1995 and the average settlement of those claims has nearly doubled, from $8.4 million to $16.6 million, during that same period.

In addition to the rise in liability claims by shareholders, there also has been a steep increase in the number of SEC actions barring directors and officers from further service on the board or with the company. In 2000, 38 such actions were taken against directors; in 2004, 170 directors were barred from further service by the SEC.

I'm going to discuss the escalating risk directors face today and some ways it can be mitigated. In particular, I'd like to offer a director's road map for reducing personal liability by suggesting how working with independent advisers can be one of the best practices and best defense strategies available.

Mitigating Board Liability Proactively

Boards can work with advisers either proactively or reactively. In the proactive manner, a board might bring in an independent adviser to help in a number of situations. For example, if management and the independent auditor have a disagreement over how something should be treated, the board may want to seek independent advice on what is the proper accounting treatment. If the board has questions on an accounting or compliance issue, or perhaps if it is meeting with the SEC over certain accounting issues and wants an independent adviser to help conduct that meeting, it may engage an outside adviser for that as well. If the board is concerned about potential shortcomings in the company's risk controls and internal accounting controls and procedures, then it may want to work with an independent adviser or a professional team that is not related to the development and function of the controls, and have that adviser perform a high-level review of those controls. These are a few of the reasons why a board might want to work with an independent adviser in a proactive setting.

Mitigating Board Liability Reactively

Meanwhile, there are some common examples of reactive reasons for seeking counsel from an independent adviser. By law, all publicly traded companies must have a mechanism in place to permit employees to "blow the whistle" without repercussion. Boards can reactively engage independent advisers to help review these whistleblower claims by employees, vendors, and customers, or even third parties who may tip the board to some action that may have a material impact on the financial statements. There are also regulatory actions that may be undertaken by state insurance regulators, the SEC, or perhaps a stock exchange commission that would cause the board to want to work with an independent adviser. For example, federal prosecutors and state attorneys general have been very aggressive in their investigations of pharmaceutical and medical device companies. Those companies' boards are not immune to findings and discrepancies under the obligations imposed by the Office of Inspector General Guidance and the PhRMA and AdvaMed Codes. In addition, the NASD might find irregularities in the records of a member securities broker/dealer. And, of course, sudden shareholder claims are another serious example: Under most state laws, shareholders of a corporation have a right to request or demand that a company's directors take action to redress alleged harm caused to the

corporation by its officers or board members in any self-dealing transactions. Finally, the board may develop its own conclusion that there are specific issues it needs to better understand or investigate. In any case, once a potential enforcement problem rears its head, directors must act swiftly and decisively because time is of the essence if investigative or enforcement proceedings are to be less severe or averted altogether.

It's also important that outside advisers be reputable, experienced, and qualified. They need to know that the independent adviser is knowledgeable in the areas that it is being asked to assess, whether that be complex accounting treatments, the way certain internal controls operate or should operate, the way certain transactions are accounted for in the books, or the various dynamics associated with a given industry. To ensure that the board, independent auditors, and regulators can rely on the findings, it is essential that the independent adviser be highly experienced and sophisticated in the relevant issues being examined and be transparent in its conduct and processes.

"There has been a steep increase in the number of SEC actions barring directors and officers from further service on the board."

So what are the key issues to understand or consider when working with an adviser? First and foremost, it's important for your outside adviser to be independent. One reason outside auditors are looking for that level of independence when relying on the results of an investigation is to certify the financial statements' accuracy; auditors have become increasingly sensitive to any indication of irregularities or questionable accounting practices. Also, boards are feeling increased pressure to conduct independent investigations that are the least vulnerable to public scrutiny. Finally, the SEC also is looking for independence so that it may confidently rely on that work in its investigations and reviews.

The objectivity of an outside adviser is equally important to ensure that the effectiveness of the review or investigation is not compromised. Outside auditors and other interested parties will be scrutinizing the results of the investigation or other activities of the adviser to confirm that the results are, in fact, independent and were examined from a broad perspective, not one focused on any one set of issues.

What if you're not quite sure of the specific issues you are likely to face in an investigation? In this case, it's even more important to work with an outside adviser that has a broad range of skills and capabilities to ensure that when new issues or investigative avenues are uncovered, you don't have to change or bring another outside adviser on board. For example, it would be more efficient if the outside adviser had accounting capabilities, SEC investigation experience, computer forensic expertise, and former law enforcement professionals and certified fraud examiners all under the same roof. This breadth of expertise will enable your adviser to deal with any issue that might arise during the investigation, litigation, or arbitration.

Once the board has determined it is going to hire an independent adviser, there are a number of things it should do to ensure the right adviser is engaged. The most pressing is to get a sense of the scope of the investigation or work to be undertaken. Another factor is to reach an agreement up-front in your engagement letter that documents a full and complete description of that scope of work. This ensures the board that the adviser will not stop short of providing the accounting advice or other professional services needed to complete the assignment as described in the scope of work. It also provides confidence to the board that directors will be able to review the documentary evidence required to assess the situation, understand which professionals might need to be interviewed, and know what processes will be used to gather information and conduct interviews throughout the investigation.

Summary

Directors face an environment with an increasing number of personal risks. And as we've discussed, there are a number of steps they can take to mitigate that risk for themselves. One of those steps is to work with independent advisers in either a proactive manner or a reactive context and understand how they can work effectively with those advisers to limit their personal liability. In the end, it's up to the board to understand the scope, plan, and terms of engagement with the adviser to make sure the work is implemented in a way that achieves the board's objectives: a transparent process, reliable findings, independence, and objectivity. The final report should include any findings that the board can rely on to better understand the situation that drove it to take action in the first place.

Executive Compensation Part I
Dealing With SEC Compensation Disclosures

John D. England, managing principal for Towers Perrin, outlines how the new SEC disclosure proposals will clearly affect the time and energy compensation committees spend grappling with the issue of executive pay.

What are the new SEC disclosure proposals?

Earlier this year, the SEC proposed regulations that would revise the executive compensation disclosure rules for the first time since 1993. A lot has changed in executive compensation over the years, and shareholders believe there really isn't enough disclosure about pay programs, pension programs, and termination provisions. SEC Chairman Christopher Cox decided this would be one of his first initiatives and subsequently the rules were released. They were open for public comment through the end of April, and we hope that by the end of this summer they will be finalized.

The rules essentially broaden the definition of compensation. Believe it or not, there is no definition in the proxy rules for reporting total pay. You see salary, bonus, and, perhaps, the number of options or restricted stock shares granted, but there has been no picture of how much the top five executives were paid until now. The SEC has solved this problem by including that information in the summary compensation table. The first column, after the executives' names, shows the amount of total compensation, including salary, bonus, long-term incentives, pension values, which have not been well disclosed in the past, perquisites, and other elements of compensation. This level of detail will allow shareholders, for the first time, to know how much executives are really paid.

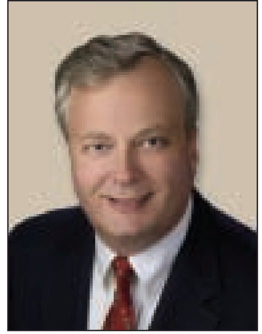
So that's the first change. Beyond that, there are two other major rule changes. The first clarifies the area of pensions and deferred compensation. There has always been a table in the proxy statement that defeats even some actuaries in terms of understanding the pension amounts an executive earns over his or her career or what he or she might have at retirement. Now it will be very clear what the annual accrual is and what an executive will have at career's end–numbers that people haven't really been able to understand before.

The other major change, prompted, in part, by the recent scandals, is how much someone receives when he or she leaves the company, whether through retirement, a change of control, or termination. Those numbers have not been publicly disclosed, or are buried in employment contracts. Now a section will lay this out very clearly so that shareholders see not just what people are paid, but what they will earn and receive post-employment.

How does a board prepare for the new SEC disclosure rules?

Boards have got to act soon in terms of getting ready for these rules. If they wait until next year–say January or February when their company has to start putting together its proxy statement–they are going to be far too late. We're advising most clients and companies to start this summer, even before the SEC finalizes the rules. You can be fairly sure that the summary compensation table, disclosures in pensions, and some of the other items that are clear, will be part of the final rules.

So this summer, most companies should take the proxy statement that they filed in 2006 and recast it so they have an idea of what it will look like next year if they simply had applied the new rules to the 2006 proxy. That will not allow them to do the comparative analysis–how they look against other people–but will show them what the shareholders will see next year. And that may cause companies and boards to question whether the programs that they developed in the 1990s, whether pension plans or change-of-control provisions, really fit today's governance environment. In fact, we believe many companies will start to revise their programs. One example that you're



John D. England
Managing Principal
Towers Perrin

already seeing relates to how the SEC changed the way that personal aircraft usage is accounted for in the proxy statement. There are some very big numbers, even in this year's proxies, that will be even greater next year. If you see very large numbers in an area that most shareholders won't fully appreciate or understand, well-disclosed companies may want to revise those policies. Another example is what's counted in pension programs. Usually it's salary and bonus. Some companies have artifacts of the past where they include long-term incentive amounts, and those numbers make pensions seem very high. It's better to see in advance the detail that the shareholders will see a year from now than to be caught off guard. So our advice is to absolutely prepare this summer by recasting those proxy statements that you just filed. It's a lot of work, but you'd be better off to do the work now than wait until next year.

A number of people have heard the term tally sheets, though it is not something that's a generally accepted accounting principle. A tally sheet has many different meanings. One meaning can be simply the figure in the summary compensation table that represents the total amount of an executive's earnings for that year. But when a group of institutional investors coined the term tally sheet, they were actually referring to a larger bushel basket of pay arrangements. They wanted to see not only how much somebody earns in a particular year, but also issues such as what happens in the event someone is terminated without cause. Does a severance package kick in, and if so, how much? What happens to the value of equity compensation? Do stock options accelerate? Do restricted stock shares vest? What happens to the pension? What happens to perquisites? Those numbers aren't really known. In fact, if committees have approved packages with those programs in the past, which many of them did either in employment contracts or just program by program, it's surprising how many committees haven't actually thought about what their total value would be. So a tally sheet gets to that point. What happens in the event of a change in control? Most people understand that it's a multiple of pay, but again, are pension credits added? If somebody is treated as if they're older and given credit for more years of service, when they're terminated, does that go into a pension amount that then affects the total package value? If somebody signs an employment contract, say up-front in the case of a new CEO, the focus is on the salary and bonus and the long-term incentives or stock option grants, but rarely on the total value. So tally sheets are a very important item for companies to see.

"All these new rules are clearly going to affect the time and energy compensation committees need to spend on the issue of executive pay."

Summary

All these new rules are clearly going to affect the time and energy compensation committees need to spend on the issue of executive pay. The days of a compensation committee meeting lasting only half an hour or 45 minutes have been over for 20 years, so we're certainly not seeing that. But there will be much more time spent, more critical thought given, and more engagement with external advisers and company management as committee members grapple with these new issues. In part two of this webcast, we'll talk about how boards should approach the process of managing a compensation committee going forward.

Executive Compensation Part II
Compensation Committees: Best Practices

From communicating with the full board and shareholders to adequately preparing the meeting agenda, John D. England, managing principal for Towers Perrin, discusses the significant change the compensation committee has undergone over the past 20 years.

Committee Guidelines

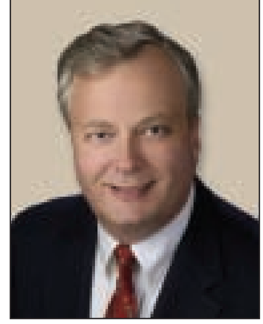
When I started in this business 25 years ago, compensation committees often received their committee book when they walked in the room. It was on the table, they opened it, management would discuss the items they wanted the committee to approve, and 45 minutes later, perhaps five to nine sections were approved and everyone went on their way. Those days have been gone for a while, but it's still surprising how many companies don't follow two fundamental rules–no surprises and "two bites of the apple." No surprises means don't put something in front of the compensation committee the members haven't had adequate time to think about, understand, and potentially ask management questions about. You cannot put board members in an awkward situation, asking them to approve something without understanding it fully. And the two bites of the apple theory really gets at that. Best practices of compensation committee governance dictate management present an idea or proposal in one meeting, and then bring the final recommendation in a second meeting. Sometimes that can be in a follow-up call, sometimes it's simply waiting the three months between meetings, but two bites of the apple allows for better understanding, a better process, and absolutely better questions.

Pre-meeting Agenda and Materials

Building on these tactics, I'd like to talk for a minute about best practice in terms of developing the committee book, which eventually will be in front of the committee members in the room when proposals are pushed forward. That process should actually start two or three weeks before the meeting during agenda development with the committee chairman and by making sure committee members understand the items that will be brought forth. This doesn't mean having the full materials, but approving an agenda and developing materials that go beyond spreadsheets or legal treatises, to include memos and letters explaining why you're asking for approval of particular items. All this should be done a good two weeks before the actual committee meeting. Then you meet with the committee chairman with the book and review it to make sure he or she understands its contents, and make final revisions a week before the meeting. I insist to clients that the book should be mailed a week before the committee meeting with an invitation for committee members to speak with the head of HR, the chief executive, or the independent consultant. The day before the mailing, the independent consultant should provide each committee member with a confidential memo outlining his or her observations about the materials and questions for management so when the meeting day finally arrives–management can go about the process of requesting approvals and the committee can ask informed questions and work without surprises. Thus begins the process of two bites of the apple.

Communicating with the Full Board

Board committees were established so the board itself doesn't have to be involved in all the minutia of governance. Responsibilities were given to an audit committee, a corporate governance committee, and a compensation committee to act on the board's behalf. A best practice now, though, is to bring the board into these decisions. That doesn't mean simply a quick, five-minute report by the committee chairman to the full board about the decisions the committee has made, particularly as they affect CEO pay or CEO hiring. Most compensation committees will make a decision that's then either ratified by the full board or the full board discussed with before the committee actually votes on it. The days of a compensation committee acting on



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its own are largely over, not surprisingly. If there is an issue, or if something later comes out that the external advisers, the press, or governance groups think was untoward or incorrect, the full board takes the heat, not just the compensation committee. So now the best practice is to continue to have the committee structure, but be sure the board is brought in on those decisions. Sometimes that means inviting the board into the committee meeting. They can't vote, but if all board members can sit in on a committee meeting so they have the texture of the full discussion, most boards are allowing that. That was verboten in the past. In fact there would be a negative reaction if someone who was not on the compensation committee invited himself or herself to a meeting. Now it's a normal process because committees know the board is fully responsible for the actions of the committee; it's not just the committee itself that's on the line.

"The board is fully responsible for the actions of the committee, it's not just the committee itself that's on the line."

Communicating with Shareholders

In many proxy statements, boards will ask shareholders for approval on matters related to executive compensation. Often that entails going to shareholders to replenish reserves for a stock incentive plan or to put a new incentive plan in place. In the past, many companies were nervous about proxy solicitation rules that said you can't formally solicit the votes of shareholders. Often that meant you wouldn't talk to shareholder groups at all about these proposals. But with the advent of shareholder advisory groups–ISS, Glass, Lewis & Co., and many of the major pension fund corporate governance groups such as CalPERS, TIAA-Creff, and others–we've seen a change. It's very common now for a committee chairman, often accompanied by the chief executive, to visit these groups. They hold immense power over pension funds and other groups, particularly ISS and Glass, Lewis, and are amenable to hearing the story. In fact, they actually like the idea that there's somebody real behind these proposals of whom they can ask questions, and generally inform themselves to make better decisions about whether or not to support certain objectives.

Summary

The compensation process has changed fairly dramatically from what it was 20 or so years ago for committee chairmen, compensation committees, and for boards. Overall, the area of compensation, which used to be a governance issue affecting a few people that didn't garner much shareholder comment, has received an inordinate amount of attention of late. Shareholder groups think it's important, the press and the media think it's important, and external bodies that opine on executive compensation look at these programs with great scrutiny. That means committee chairmen, committees, and boards need to spend more time on these issues and be prepared to answer questions, and management needs to be far more open and engaging of committees in terms of providing material in advance and making sure the process works so there are no surprises, and everyone has taken two bites of the apple. All these things need to happen in a way that wasn't necessary in the past, but now just makes common sense. If you were on a board, you'd want to go through the same process so that you'd be able to make good decisions as well.

Why Successful Boards Value Enterprise Risk Management

Miles Everson, partner at PricewaterhouseCoopers LLP, provides an overview of why enterprise risk management is an increasingly important aspect of strategic planning for organizations.

Miles Everson
Partner
Advisory Services
PricewaterhouseCoopers LLP

I am frequently asked why enterprise risk management is so important. Why is it such a hot topic? There are some fundamental reasons why ERM is more important today than it was five or 10 years ago and why we think it will continue to be at the forefront of business leaders' minds. The first reason involves the ever-increasing rate of change. Technology has advanced rapidly over the last 50 to 100 years. As that momentum continues, the need to be predictive and anticipatory becomes even more important. Indeed, the fundamental underpinnings of enterprise risk management call for organizations to be more predictive and capable of determining how change might affect them.

The second related issue is complexity. With the desire to be more flexible due to this accelerating rate of change, an element of complexity has arisen–there are extended business models, companies are doing business in more countries than ever before, and competitors are coming out of nowhere. So the varying responses to this environment have caused an inherent degree of complexity to be put into those models, therefore making it more difficult to understand and manage the business.

The third item driving the demand for ERM is simply the transparency of the situation when you have a hiccup. If an organization has an unmanaged risk that manifests itself, everyone knows almost instantaneously. It wasn't that way 15 or 20 years ago–you had time to prepare the message, and time to plan actions to remedy potential impact to your customers, vendors, and investors before they are aware of the issue. That's no longer the case, so an organization equipped to identify and manage risk is more important today than it was before, and we think it will continue to be of increasing importance.

The next topic for consideration is what makes those companies that are the best at identifying and managing their risks so successful? We've spent the last four or five years extensively researching the common elements of organizations that are good at managing risk. And while there are a number of elements we could look at, a few of them really stand out. The first, which will be no surprise to most, is there clearly needs to be a commitment from the top–the CEO and the board. However, going beyond that, the question is what do you look for in terms of evidence that there is such a commitment? One of the clear signals is that the fundamental principles and disciplines of identifying and measuring risks have been imbedded into the company's strategic planning process. So if you think about it, the point at which you most significantly influence the risk profile of your organization is when you choose the strategies and allocate resources to deploy against those risks. If you don't understand the risk you are taking at that stage of the business cycle, your likelihood of being able to identify and manage enterprise risks effectively has gone down dramatically. Organizations benefiting from ERM carry such traits as the CEO having clear decision-making authority and feeling that he or she can act with innovation and entrepreneurialism. Those types of benefits come forth when you've imbedded ERM principles into the strategic planning process.

Starting an ERM Program

Once you've assessed why ERM is important and moved on to determining what the key considerations are in order to put legs on enterprise risk management, the question for many companies is, "Where do we start?" To begin, most companies undergo a risk assessment to identify risks. And that's a step every organization should take. The challenge is how do you change an episodic risk assessment into a more

sustainable process? That is where the integration of the strategic planning becomes important.

Second, companies often overlook the need to determine how capable their organization is at identifying and managing risk. There are key principles that exist to qualify a company as being effective at risk management. For example, there should be a specified risk appetite that can be articulated across the organization to help guide decision making. And the organization should measure risk using the same unit of

"If an organization has an unmanaged risk that manifests itself, everyone knows almost instantaneously."

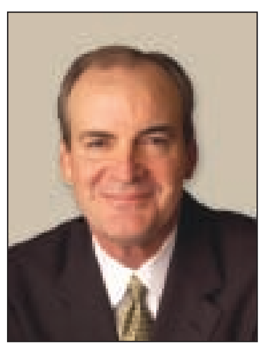
measures it's used to measure its objectives. These are basic tenets that are often overlooked. There is often a tendency to jump to an answer too quickly without understanding what it takes to effectively manage risks (i.e., fundamental principles). Therefore, we encourage organizations to take the time to understand the fundamental principles and then look at how they apply those principles to their facts and circumstances so they can yield the best results.

Summary

I'd like to close with three takeaways. The first is that the rate of change will continue to accelerate, which will require every organization to be better equipped to identify and manage risks. Second, don't jump too quickly in responding to how you want to approach enterprise risk management; take the time to understand the principles. And third, make sure you don't overlook the need to understand how you are managing risk today. What are your capabilities? Make sure you are leveraging your current investment in a way that is most beneficial for your company.

What Critical Issue Should Boards Be Addressing? (That They Currently Aren't)

Our corporate governance experts weigh in on the critical board issues that are not receiving adequate board attention and focus.



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We brought together our Board Governance Series partners to ask their viewpoints on an important question: What critical issue should boards be addressing that they currently aren't?

Holly Gregory: Directors have a lot on their plates these days. Although I'm hesitant to give them one more thing to put on their plates, given all their specific tasks, I'm concerned they may not be taking the opportunity to step back and think about how their decisions fit together. They may miss the forest for the trees or create incentives for unintended outcomes. For example, directors clearly know they are responsible for setting the tone at the top of the company, for formulating the corporate strategy with management, for setting the executive compensation and incentive schemes, and for providing oversight of accounting and disclosure and audit, but unless they sit back and think about how their decisions in those areas fit together, there may be unintended consequences. That's the danger we saw at the end of the 1990s and into 2000 when the scandals around accounting policies and revenue recognition and the whole bubble economy took place. It requires a board to really understand the organization's culture and, therefore, understand how the strategic goals will be impacted by the incentive programs it establishes and what that means for accounting policies. It's a challenge for boards to find the time to step back and take this kind of broader view of their decisions, but this is one of those areas where if they take the time, there is a huge significant payoff in preventing problems down the road and in extracting the full value of the decisions they do intend.

Neal Hochberg: Board members serving companies with diverse businesses around the globe are faced more and more with the challenge of ensuring that their accounting systems and the quality of financial reporting through those systems are accurate, complete, and fully compliant with both the Sarbanes-Oxley and Foreign Corrupt Practices acts. Most multinational companies I'm aware of and have worked with are organized into regions around the world, with some companies having as many as 18 or 20 regions, with multiple countries reporting to each of those regions. And each one of those countries may have one or more legal entities. Board members need to be aware that while these systems are in place on an international basis, many times the patchwork that occurs among the legal entities, companies, and regions requires a large number of adjustments–both manual and what we call "top-side adjustments." In these cases there are many Excel spreadsheets involved, and any time there is that much human interaction, there is a lot of opportunity for manipulation. And so that is an area of increasing concern for board members. We've been involved in a number of significant issues in which corporate headquarters felt comfortable, the board had all the reason to believe it should be comfortable, and yet problems occurred below the regional level in what I would call these patchwork accounting systems.

John England: In my opinion, not spending enough time on leadership development and management succession is a critical board issue. Now that doesn't mean a board isn't thinking from time to time about who might replace the CEO in the next couple of years–that much, most boards do. But many boards are not getting rich information about how talent is developed in the company and what creates future leaders among those who are 30 or 40 years old. How is that process handled? What assignments are made? What training is given? Is the company offering advanced education? Boards need to be keenly aware of not

just the shareholder value that's being created today and who might create that shareholder value in the next few years, but how is that next generation of talent being groomed to take over key company positions? There's too much focus on the chief executive when there's a large group of people, whether they're the functional heads–the CFO, the head of HR, the general counsel or the operating unit head–who actually run a company in a very different manner than the CEO, who's focusing more on strategic issues. Boards need to be much more involved in that process and not just delegate it to a committee, or worse, not focus on it at all. So in my mind, management development, career planning, and leadership development are all key areas boards must focus on today.

"Directors have a lot on their plates these days."
– Holly J. Gregory, Weil, Gotshal & Manges LLP

Catherine Bromilow: We've seen heightened M&A activity over the past year and many expect it to continue. Boards, by and large, are not prepared in the event they receive an unsolicited offer for their company, and that lack of preparedness is like trying to navigate through a storm if you don't know how to sail. So directors really need to think about preparing for the possibility of an unsolicited offer. There are many things you could do to prepare, but the top five considerations begin with understanding the vulnerabilities: Are there aspects of your company's strategy or balance sheet or the way it compares against peer groups that make it particularly vulnerable? Second, engage the services of a great lawyer to advise you on this issue, including reviewing any plans you may want to put in place. Third, identify a good investment banker. Fourth, know your shareholders and their concerns. If your shareholding mix is changing, are hedge funds playing a greater role, and what does that mean? And fifth, as with any kind of crisis plan, appoint a leader, define your communication strategy, and identify who will keep an eye on the rest of the business while you deal with this issue.

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