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Board Governance Series

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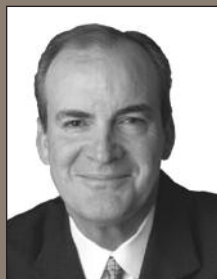
Dear Corporate Director:

The financial services crisis, TARP bailouts, and global economic turmoil have generated unprecedented interest in the compensation of corporate America's c-suite executives. Companies, their shareholders, advisory groups, and the media have always had a watchful eye on compensation in the past, but now that the ire of the general public has been stirred, the headlines and finger pointing have gravitated toward the boardroom.

This year's proxy season will be an especially complex one. Add to the corporate governance pressure cooker the potential impact of IFRS, which will necessitate that directors and management prepare for change and learn to mitigate risk, rather than merely take a reactionary stance.

Corporate Board Member magazine and The Nasdaq OMX Group proudly present the 14th volume of the Board Governance Series—a collection of informative commentary by experts in corporate governance from the nation's top business advisory, consulting, and law firms. Inside you'll find discussions on how proactive boards are preparing for the impact of IFRS, how to avoid a Madoff-type fraud, the challenges facing compensation committees as they select metrics and measure pay for performance, and what boards need to know about political contributions. In addition, we feature commentary from a panel discussion revolving around the question, "Are compensation plans providing incentives for the appropriate corporate behavior?"

We invite you to visit each of our series contributors' websites, as well as to view online the webcasts highlighted in this printed publication. Together, we hope these will become part of your continuing education efforts to stay apprised of the most pressing corporate governance developments for today's boards of directors.



A handwritten signature in black ink, appearing to read "TK Kerstetter".

TK KERSTETTER
President and CEO
Corporate Board Member



A handwritten signature in black ink, appearing to read "Bruce Aust".

BRUCE AUST
Executive Vice President
Global Corporate Client Group
The NASDAQ OMX Group Inc.

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VOLUME 14, 2009

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Principal, Senior Consultant, and member of Hewitt's Leadership Group

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Richard Harris

Principal and Senior Consultant

Hewitt Associates

Amy N. Moore

Chair, Employee Benefits and Executive Compensation Practice

Covington & Burling LLP

Philip H. Stern

Senior Managing Director

FTI Consulting

Our corporate governance experts discuss the importance of boards of directors taking on a more proactive role and having a long-term vision for their company.

Compensation: Preparing for Proxy Season

Mary Ann, compensation is certainly on everybody's radar screen, and there's a good chance that bright light is going to get even brighter. If you could just take a moment and describe what you currently see in the marketplace, that would be a great place for us to start.

In 2009, we saw an unprecedented level of interest in executive compensation. The decline in the economy and the related financial consequences for so many meant that there were a lot more parties involved in the executive pay debate than historically has been the case. In addition to corporations and their shareholders and the advisory groups and the media, this year we had the general public involved, as well as the government and Congress in its various forms and committees. Everyone had a view on what was right or wrong about executive compensation, and everyone wanted to be heard. This played out in two ways during proxy season. The first was in connection with shareholder proposals and the second was with the level of shareholder advisory group activity.

First, I'll discuss the shareholder proposal process. What we saw this year was in contrast to prior years where we might have seen a handful of proposals focusing on specific compensation-related topics, such as golden parachutes or abolishing stock options. This year, say on pay was the proposal of the year. It is amazing to think about the fact that as early as 2006, there were only a handful of proposals on say on pay that made it into proxy statements. This year we had more than a hundred, and many of them received either passing votes or very high favorable votes. We also saw a number of companies voluntarily include say-on-pay proposals in their proxy

statements, and those also generally received very high favorable votes.

In the future, we expect to see say-on-pay proposals mandated—everyone will have to include them in their proxy statements. So we do not expect to see the same level of shareholder proposals in the future because everyone will be including them on a management basis. We're not quite sure what form those proposals will take. There are several formats out there—one focuses on practices and policies, while another asks simply for approval of the amounts of compensation paid. There has been no mandate yet in terms of what any required say-on-pay proposal might have to include, so that is an open item. We are waiting to see what will come out of the government on that particular point.

Can you give us some examples where companies and their boards have found themselves in conflict with the policies of the proxy advisory firms?

One aspect of the proxy advisory firms and their ratings seems to be a surprise to companies—the fact that seemingly innocent, well-meant decisions can in fact lead to a recommendation from a proxy firm to withhold or vote against the election of directors. For example, a company might make a retention grant to an executive for very sound business reasons. If the grant is made in the form of equity and results in an increase in pay from the prior year, and the company also was in the bottom half of a peer performance group, there would not necessarily be any special dispensation or recognition given to the factors that led the company to make that decision. Another example is when an executive agrees not to take a grant one year but is given one the next year—those kinds of decisions also are not necessarily reflected in the advisory group recommendations. Doing away with defined benefit SERPs, which seems to be the trend for many companies, and replacing that with an equity grant considered more shareholder-friendly (limited to accrued benefits, rather than new benefits)—those decisions also do not seem to get any special dispensation from the advisory groups. The nature of what can seem, at times, to be subjective, perhaps arbitrary, decisions on the

Mary Ann Polk
Principal and Senior Consultant
Hewitt Associates



advisory groups' part in terms of how they decide to evaluate companies and their pay programs against their own guidelines—that is what has resulted in surprises for some companies.

What advice would you offer boards and their compensation committees to prepare for the next proxy season?

One key step they can take is to make sure they understand what the current proxy voting guidelines of the various advisory groups include. For example, you can find guidelines for RiskMetrics and Glass Lewis, to some degree, published on their websites, and those should give a good hint in terms of the types of designs advisory groups would be looking at to see whether or not they are

their GICS [Global Industry Classification System] code classification—whether that should be the bottom 50% that was their standard for this year, or whether it should be only the bottom 20%, or the bottom 10%, or perhaps even the bottom 5%.

A third area they are asking about is what types of factors should be considered when management say-on-pay proposals are evaluated, and their survey includes a laundry list of items for comment.

Mary Ann, we've only been able to scratch the surface on what is a very critical topic for boards today. If you had to offer just one takeaway on preparing for the next proxy season, what would that be?

»»» It is important to remember that last year's status quo won't necessarily be next year's status quo, and that what is considered an acceptable program design is a dynamic area and continually changing.

— Mary Ann Polk, Hewitt Associates »»»

included in someone's program. The other thing to recognize, though, is that last year's voting guidelines may not necessarily be next year's voting guidelines. In fact, RiskMetrics is in the process of soliciting input from its institutional advisors and the companies it evaluates on very specific topics related to these matters. For example, in the compensation arena, one of the areas that they are questioning is whether the change in ownership for determining whether or not a change in control has occurred should remain at 20%, which is a very common level for major companies these days, or whether it should be increased to 30%, 40%, or even 50%. That might be a surprise to companies that have long thought they were squarely in the mainstream by having a 20% level.

A second item they are asking about is what percentage of companies should be considered as underperforming in

As noted earlier, it is important to remember that last year's status quo won't necessarily be next year's status quo, and that what is considered an acceptable program design is a dynamic area and constantly changing. If companies are careful about making sure their programs are sound from a strategic perspective and monitor the developments on all fronts, then they should be well positioned as they enter the upcoming proxy season.

Political Contributions Part 1: Pay to Play

Let's start out with some basics. What are pay-to-play laws?

Pay-to-play laws are a relatively recent development. These are laws at the state and city level that essentially say if a company, or its executives, or, in some cases, its directors, make political contributions to state or local candidates, the company may be subject to severe penalties, including being barred from doing business with those state and local governments. For some large national companies, this is a direct threat to their business model. Manufacturing and service companies do a lot of business with state governments. They may be selling goods to the state prison system. They may be providing the computers that the state government uses. They may be providing food for all the state facilities and so on. All those business models are directly threatened by these pay-to-play laws.

At the state and local level, what we're seeing across the country now is 15 to 20 states that have very recently adopted laws that many companies are not fully aware of yet, or perhaps not aware of at all. These laws state that a contribution by even a single person at the company, even a single executive, or the spouse of that executive, or the child of that executive, or a director making a political contribution—just one contribution—could bar that company from doing business with the state for a period of years and could terminate existing contracts and trigger fines.

In addition, there is a new Securities and Exchange Commission initiative at the federal level to establish a federal pay-to-play law. This was attempted years ago but didn't survive the regulatory process, but it is very likely to survive this time around. And that pay-to-play rule will

affect a different category of people, specifically, investment advisors. Any firm that provides investment advisor services, such as managing state pension funds or city pension funds, would be subject to a new federal pay-to-play rule. And if an individual at that company made a political contribution to certain candidates, that company could be barred from doing business with that state or local government for a period of time and face Securities and Exchange Commission penalties. So this is a really big deal. It's developing very, very quickly and, I think, catching a lot of companies by surprise.

How do pay-to-play laws work?

They vary from state to state, but in general, pay-to-play laws require a company to identify its senior executives, as well as sometimes its board members and others within the company, who are paid contingency fees when they bring business into the company. They also require companies to register with the state government as to whether any of those people make contributions, or the company makes a contribution, to certain candidates for political office, at which point these restrictions on doing business with the state or city government kick in.

For example, Illinois introduced its first pay-to-play statute in early 2009 that essentially says that if you have a contract to do business with the state to the tune of \$50,000 or more, you must register with the state and list your senior executives and identify anyone who is paid a contingency fee for bringing in business from the State of Illinois. You must also continually update that list in real time as new people come into the company and as people leave. And then there will be very close supervision of contributions that are made by any of the people listed on that registration. If somebody on that list slips up and makes a contribution, or if the company makes a contribution, or the company's political action committee makes a contribution in that state, it will bar the company from doing business with the state government and will subject the company to penalties. Directors, in particular, are covered by some of these statutes. In Connecticut, for example, a contribution by a company director could trigger the pay-to-play penalties and bar the company

Robert K. Kelner
Partner and Head of the Election
and Political Law Practice Group
Covington & Burling LLP



from doing business with the State of Connecticut. So this isn't just an issue for executives or their family members, but also for members of the board in a very direct and personal way. A director might make a contribution totally unrelated to the company for personal, political, or ideological reasons. Nonetheless, under Connecticut law it could bar that company from doing business with the state.

executives to submit for preapproval their political contributions. So the board should be sure that that's been reviewed, that there's a formal compliance policy in place, and that there's a training program around that policy. After that, I would say boards, in particular, need to be worried about pay-to-play laws—laws that could bar contracts for the company as a result of political contributions. Any large national company whose business

»»» Any large national company whose business model includes doing business with state and local governments, at least in part, needs to have a pay-to-play compliance policy in place.

— Robert K. Kelner, Covington & Burling LLP »»»

How should boards address political contribution risk?

You know, years ago board members didn't really have to worry about a company's political activity because management dealt with that. But what's happened just in the last five years is that the legal and public relations risks associated with lobbying and political contributions have become so significant for companies that it is now something boards need to pay attention to because the fate of the company could turn on an inappropriate political contribution or a news story in the *Wall Street Journal* or *New York Times* resulting from that contribution. There have been numerous political contribution scandals in Washington in just the last few years, so board members need to be sure that their company has appropriate compliance programs in place for political and lobbying activity. That would include, for example, a policy on political contributions.

So, you might ask, under what circumstances might executives be barred from making political contributions? Under what circumstances might the company be similarly barred? Should contributions be preapproved by the general counsel's office? Increasingly, companies require

model includes doing business with state and local governments, at least in part, needs to have a pay-to-play

compliance policy in place. This is particularly true because board members personally are sometimes covered by those pay-to-play laws, and thus, they really need to be paying attention to whether management has adopted proper political activity and lobbying activity compliance policies. My colleague Bob Lenhard, former chairman of the Federal Election Commission, will speak to a related topic in part two of this segment, which addresses the rules that apply when executives want to raise money for candidates and become active themselves in political campaigns.

Political Contributions Part 2: Executive Fundraising

Why are executive fundraising initiatives now a risk?

Board members and senior executives of companies are increasingly being asked to help raise funds for politicians. In part, this is a product of ever-increasing campaign costs and the need for politicians to spend a growing part of their work day raising money. This is also because companies are increasingly recognizing that changes in regulations, statutes, and government spending patterns are having an increasing effect, either in terms of creating opportunities or risks, on their very business models. For senior executives or board members who have decided they'd like to help candidates raise funds, it's important to understand there are a set of complex, and sometimes counterintuitive, rules that regulate activity in this area. What I'd like to do is to talk a little bit about the structure of those rules so that people can understand the rough terrain in this area of the law. This is important because if there is a violation, liability in this area of the law can rest both with the corporation and also with the individual board member or executive that participates in the fundraising activity. Therefore, it's important for executives and board members who want to participate to have at least some understanding of the rough contours of the rules in this area.

I'd like to begin by pointing to two different distinctions. The first is that there is a variation in the rules between those governing federal races, that is, candidates for the House of Representatives, the United States Senate, and the White House, and candidates running for state or local office, be it governor or mayor in the town in which you live. For simplicity's sake I'm just going to discuss the federal rules, but you should be aware that there may be

some variation in these rules to the degree that you want to assist someone trying to become governor or mayor.

The second distinction I'd like to draw is between events in which the individuals invited are only senior managers within your own company, for which there is one set of rules, and events in which the invitations are more broadly spread among friends, people in other businesses, and customers, for which a very different set of rules apply.

What types of events are areas of concern?

As I mentioned, there are two types of events and the law treats both somewhat differently. The first type is one in which the fundraising invitations only go to company senior managers. In this context, the law allows the company to pay almost all of the fundraising event costs, which means that corporate staff can send out the invitations, manage the RSVPs, arrange for the venue (either inside or outside of the corporation), and pay for any incidental costs, such as food or beverages, served at the event. Most frequently, the way these events present themselves is that the company will host a breakfast or a coffee or a lunch for senior executives and a candidate who almost invariably is a member of Congress. So the great advantage of these events is while the pool of people invited is small, the corporation can bear the costs, and this is especially important because it means that staff, administrative assistants, or legislative affairs staff, can be involved in the event's preparation and planning, and the corporation can pay those costs.

There is one thing companies need to be very careful of in this area, which is that corporate staff cannot handle the checks themselves. It is illegal, to use the terms in the law, for the company to facilitate contributions, which means to pay for the forwarding of the checks to the campaign, either before or after the event occurs. So it's a best practice for corporate staff not to handle the checks at all. In most cases, this isn't a problem because the campaign will almost invariably bring a staff person responsible for collecting the checks at the event. To the degree that an executive wishes to make a contribution, and they aren't

Robert Lenhard
Of Counsel, Election and Political
Law Practice Group
Covington & Burling LLP



able to attend the event, the company can tell the executive where to mail the check, but they're not allowed to use corporate resources, whether it be a stamp and an envelope or a FedEx envelope, to send that contribution to the campaign. The executive needs to use his or her own resources to make that contribution.

events held at the homes of senior executives or board members, for campaigns to pick up many of the costs associated with an event like this, particularly catering and some of the out-of-pocket expenses. It's important as a practical matter to make sure those bills end up getting paid before the event, not so much as a question of law,

>>> For senior executives or board members who decide they'd like to help candidates raise funds, it's important to understand there are a set of complex, and sometimes counterintuitive, rules that regulate activity in this area. — Robert Lenhard, Covington & Burling LLP >>>

The second type of event are those in which the invitations go outside of the pool of people who are senior executives in the company you're associated with or where you work. In this context, the rules are very, very different because the corporation is not allowed to pay for any of the costs for that type of fundraising event. Most frequently, these events present themselves either as a reception in the home of an executive or a board member or sometimes as an event inside the corporate headquarters itself in a very large room. The advantage of this kind of event is it allows you to solicit contributions from a broader pool of people, but the corporation can't pay any of the costs, either in terms of out-of-pocket costs for beverages or food or in terms of staff time in preparing for the event.

There are three groups of people who can pay for these kinds of events. The first is the company's PAC (political action committee), although it's very important, if the PAC is going to pay for it, to make sure those payments are made in advance of the event and also that you make sure all the costs are being captured. For the PAC it will be an in-kind contribution to the campaign, which means you need to be careful that the event's costs stays within the contribution limits.

The second group that can pay for this kind of event is the campaign itself. The campaign can treat it as an expenditure, and it's increasingly common, especially for

although it is important if the corporation has made an expenditure for them to be paid in advance of the event, but because some campaigns aren't very good about paying their bills or pay them very late. And the law can punish corporations in certain circumstances if a bill was never paid.

The third group that can pay for this kind of event is the host of the event— the board member or senior executive. These costs would be considered an in-kind contribution to the campaign. There's an important exemption, though, in the law, that says that if you host the event in your home, the first \$1,000 of costs are exempt from being treated as a contribution. And if the event is hosted by both you and your spouse, the first \$2,000 of the event's costs are exempt from treatment as a contribution. And so very often, the costs of these events end up not being an in-kind contribution at all because they remain below that \$1,000 or \$2,000 limit.

What should directors do?

In the end, board members are allowed to engage in these kinds of activities, and there are many good reasons to participate in helping candidates raise money. It's simply important to be aware that there are rules you need to be attentive to, and it's worth checking with the general counsel to make sure your event will fully comply with the law.

Are You Susceptible to a Madoff-type Fraud?

We have heard a lot about the Madoff fraud this past year and more recently with the issuance of the SEC's report, "Investigation of Failure of the SEC to Uncover Bernard Madoff's Ponzi Scheme." Clearly not all companies are susceptible to a Madoff-type fraud. But in the current environment, many companies are susceptible to some type of a fraud, including a financial reporting fraud.

The financial crisis has put a spotlight on financial reporting, in particular, financial reporting by companies in the financial services sector. Many companies in that sector hold financial assets (for example, mortgage-related assets) subject to fair value (mark-to-market) accounting that have been especially hard hit. Massive impairment write-downs, reported as charges to earnings, have raised concerns about the fair value valuations used in the reporting.

In fact, the fair value valuations have been at the forefront of the debates surrounding the financial crisis, prompting calls for action. In response, the SEC has conducted a study on mark-to-market accounting, Congress has held hearings on mark-to-market accounting, the standard setters have issued new guidance to improve mark-to-market accounting, and recently proposed financial regulatory reforms call on the standard setters to do more to improve mark-to-market accounting in the coming year.

Notwithstanding those actions, the fact remains that the fair value valuations have been and will continue to be subject to varying degrees of judgment and estimation, which make the fair value valuations likely candidates for increased scrutiny going forward. Key areas of focus include the valuation models, inputs, and judgments as well as the timing and amount of any resulting impairments.

We are seeing increased scrutiny of financial reporting by the SEC, law enforcement agencies, and others, including private litigants. Some key indicators suggest that there is more to come, principally in the financial services sector.

In particular, the SEC has reinvigorated its enforcement program. The SEC is making sweeping changes in the wake of the Madoff fraud so that it can bring high-impact cases more quickly. A significant change is newly instituted specialized investigation units. The units are designed to get at possible frauds arising out of the financial crisis and span a wide range of markets, products, transactions, and practices. While Madoff-type frauds remain a priority, they are not the only priority. Subprime and other financial frauds also are a priority.

At the same time, the FBI and other law enforcement agencies are working with the SEC on many subprime and other financial fraud investigations. Recent reports indicate that the FBI has literally hundreds of mortgage and mortgage-related investigations in process currently. To help them get at the frauds, the President signed into law the Fraud Enforcement and Recovery Act of 2009 (FERA). FERA expands the scope of liability for fraudulent and criminal activity by financial institutions, authorizes millions in funding to add more law enforcement resources, and establishes the Financial Crisis Inquiry Commission. The Commission is charged with investigating the causes of the financial crisis, as well as the causes of the collapse of financial institutions that failed, that were acquired to prevent them from failing, or that would have failed but for government intervention.

Finally, a recent study shows that shareholder class-action filings involving companies in the financial services sector are on the rise. Many are a direct result of the financial crisis and more than half name a financial institution as a primary defendant or co-defendant.

While many investigations remain in process, we have seen some recent actions that provide some "lessons learned" for financial reporting going forward.

Linda MacDonald
Senior Managing Director
FTI Consulting



In one case, the SEC alleged that from 2007 to 2008, a mutual fund inflated the fair value valuations of mortgage-backed securities for which market prices were not available by ignoring market information, including market indices and rising defaults and delinquencies. Although an alleged fraud, this case is instructive as a means of highlighting the need to consider all available market information in the fair value valuations performed in the normal course.

»»» In the current environment, governance alone is not enough.
— **Linda MacDonald, FTI Consulting** »»»

In another case, the SEC alleged that from 2006 to 2007, a bank trader colluded with an outside pricing vendor to inflate the fair value valuation of a commodity derivatives trading portfolio by mismarking positions for which market prices were not available. This case is instructive as a means of highlighting a company's exposure to fraud triggered by an economic downturn. At first, the trader inflated the fair value valuations to boost his own incentive compensation. Later, however, he had to keep the scheme going to hide actual trading losses.

Clearly, it is important for boards and audit committees to have in place governance processes, policies, and procedures covering financial reporting. But in the current environment, governance alone is not enough. It is equally important for boards and audit committees to make sure they know their regulator and are prepared to respond as questions about the reporting (or other matters) come up. The best defense is a good offense.

IFRS Is Alive and Well—Are You Prepared?

IFRS has had a rather interesting journey over the last couple of years in the United States. There was a great deal of activity 12 months ago, and it appeared the IFRS train was moving forward at a good pace. Then economic events took over and we had a change in administration. At her confirmation hearing, [SEC Chair] Mary Shapiro testified that she wanted to be very thoughtful in her approach to IFRS, and many interpreted that as a message that IFRS was not going to move forward. We actually haven't seen that to be the case. The commission issued its recommendation, known as the Roadmap Proposal, last November, solicited comments on it, and appears to be acting, as Shapiro indicated, in a thoughtful manner. Recently, there has been some talk in the marketplace that the SEC is continuing to evaluate comments and will be bringing IFRS up for discussion and debate, putting it back on the agenda, if you will, possibly as early as this fall. So there is a good chance come October or November the discussion will reemerge, and we will get some vision as to how the SEC sees IFRS moving forward in the United States.

What do board members need to understand about the impact of IFRS?

There are a couple of things board members should focus on regarding the impact of IFRS. First, while the United States continues to debate the direction it should take—whether it should move to IFRS and if so, whether it should convert to IFRS on a specified date, or whether there should be a discussion on continuation of the convergence efforts of the two boards, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), to create one set of global standards that the vast majority of people believe

is ultimately the right answer—the rest of the world continues to move forward. There are fixed deadlines for the conversion to IFRS in countries such as Canada, Mexico, Brazil, and Korea. We understand Japan is about to propose an optional use of IFRS by publicly listed companies, possibly as early as 2011, despite continued debate in that country as to the ultimate adoption date of IFRS. So the world is moving on, and, for multinational companies with outposts all over the world, IFRS will have a greater influence because of the change in local reporting in many jurisdictions in which they operate.

Another thing to understand is that the IASB has recently issued a standard IFRS for small and medium enterprises (SME). This was sought for many years to try to deal with some of the complexity and challenge of disclosure that small and medium enterprises, private companies, and subsidiaries felt would be imposed upon them if they made the move to IFRS. The IFRS standard of SME has been a long time in the making, but we expect that with its issuance, many of the European countries will look at whether they should adopt this IFRS standard and replace other national standards for statutory reporting and non-public company reporting, which again would impact foreign subsidiaries of U.S. multinationals.

I also think it's important for boards to understand the issue of convergence. Right now there is a plan that both the IASB and the FASB are working on very diligently to converge their two standards to create, as close as possible, one standard in some very significant areas of accounting such as revenues, leasing, and financial instruments accounting. That work plan is active and under way, and the standards are expected to be issued over the next three years. So that will have a significant impact not only on IFRS but, frankly, on U.S. GAAP, and it will bring IFRS and U.S. GAAP much closer together. So the influence of IFRS on U.S. GAAP and vice versa is real and will impact companies very significantly over the near term.

Richard A. Fuchs
Partner and IFRS Leader
PricewaterhouseCoopers LLP



What should boards be doing today?

The first thing I would recommend is that boards ensure that the companies understand what is happening and how all of this change is going to impact them and then to plan for managing that change. Don't let the change manage you, but manage the change. Clients are taking moderate steps and are beginning to think about and build plans for different scenarios. They're taking control of what's happening to their subsidiaries as a result of IFRS adoptions in countries around the world. They're asking questions: If we do make an accounting change, are there tax implications? One of the big things for U.S. companies, and we're seeing it already in the Canadian implementations, is that lack of statutory reporting means that changes in accounting standards and the impact

make sure that it's doing it rigorously, that it's controlled, that it's able to be tested and verified, and that the changes in systems and processes and controls are appropriate. It must also make sure that it's repeatable before it goes live, because to do so after it goes live runs the risk of a material weakness or some control deficiencies that have come about from all of this change. So it's really very critical that companies get in front of the change, understand it, and then build a plan to manage it.

In summary, if you asked about the one thing we should really focus on, I'd say it's to be prepared. There is a lot of change coming, and we know it's coming. We know the accounting standards that are moving. We know the foreign countries that are making the move to IFRS. So

»»» Make sure the organizations you're a part of recognize the changes and have begun to plan how they're going to deal with them.

— Richard A. Fuchs, PricewaterhouseCoopers LLP »»»

thereof potentially flow right through into tax reporting, and that could have real tax costs to a company. It could impact the tax strategies companies have put into place. So are they preparing for that? Do they understand what that means? Will they have the opportunity to modify those strategies, or do they need to think about those now as they implement new strategies? Even though these changes may not occur for a couple of years, many of these strategies are being built for long-term sustainability.

Boards looking at these plans also need to evaluate issues such as 404. When we adopted IFRS and worked with companies adopting IFRS in Europe and Asia, we did it without a 404 overlay. We didn't have to worry about 404 because that came later. Canada, again an example for the U.S. to learn by, is going through a change from Canadian GAAP to IFRS in a 404 environment, so it's having to

many people have said, "Well, there's a lot of uncertainty, and we're not going to do anything until things become clearer." We actually believe that things are very clear. We sit down with most of our clients and go through all these changes, and by the end the client's conclusion is, "Yes, it is clear, we've got to do something." So if I can suggest anything to board members, it would be to make sure the organizations you're a part of recognize the changes and have begun to plan how they're going to deal with them. If you take these steps, if your organizations begin to move forward, you'll realize that IFRS isn't dead. It's real, it's impacting you today, and its impact is only going to grow tomorrow. So be ready for it and lead the change instead of having it lead you.

Annual Incentive Measures: Paying for the Right Performance

Richard, incentive compensation and pay for performance have always been important issues for boards and public companies, but there's no question that there is a much brighter light on them today.

TK, what we're finding is that first of all, compensation committees want to make sure we're aligning incentives with long-term value creation. As you said, this has always been important. However, the pressure on directors to do the right thing is even higher today than just a few years ago. In addition to that, there's been a flurry of proposed executive compensation legislation and regulation over the last 12 months. This includes everything from further disclosure requirements by the SEC on incentive design, performance metrics, and how they motivate risk taking, to proposed legislation that's leading to the acceleration of say-on-pay becoming the law of the land. We believe the best way to be prepared for a shareholder vote on your programs is to make sure your incentive plans are measuring the right things.

Could you talk a little about the challenges compensation committees have in selecting metrics that measure performance?

In selecting metrics, the place to start is with the long term, which is what we really want to focus on, right? Companies want long-term, sustainable improvements to shareholder value. Yet we tend to pay people in discrete periods. While there are some three-year, long-term incentive plans, annual incentive plans are the most common by far—and often they are what executives and committees focus on the most. So compensation committees should focus on really understanding the

value equation for their company and their industry, and then think about the long-term metrics.

However, when it comes to compensation design for the majority of companies' long-term pay, share price is usually the only metric. And what I mean by that is they're using stock options and perhaps restricted stock as their total long-term pay package. There has been an increase in mid-term, three-year incentive plans, but again, the majority of companies are just using stock. If a company is just using stock price to measure long-term performance, then assessing the financial metrics on a 12-month basis becomes critically important.

So what companies need to do is understand the long-term goal and then determine which metrics in the current 12-month period are going to drive sustainable performance. Now, that may seem like something easily done, but the first thing to think about is what is it that the executive team can affect in the long term that can influence performance over the next 12 months? First, balance-sheet items are mostly a long-term kind of measure. So when you think of return on invested capital, which is a very important metric for lots of firms, it's difficult to implement and move that denominator too much in a 12-month period. Companies, therefore, focus most of their time and attention on measures of earnings in the 12-month period for annual incentives.

With the downturn in late 2008 and in 2009, we're seeing many more companies add some measure of cash management to the annual incentive plans in order to touch on the balance sheet items that you actually can impact during a 12-month period. When compensation committees look at annual performance metrics and they start with earnings, they need to understand the quality of earnings, because that's been one of the issues. We don't want to pay for things that are transient. Additionally, they should ask if there is still revenue growth, because companies can cut expenses, but they can't shrink their way to greatness. Finally, they should look at whether their profit margins are continuing to be strong, as well. So that gets at the quality of earnings. Take that and add the cash management piece and you'll have a very well rounded starting point for incentive plan metrics.

Richard Harris
Principal and Senior Consultant
Hewitt Associates



The Treasury Department established compensation principles for public companies in 2009. The first principle was that compensation plans should properly measure and reward performance. How can compensation committees accomplish that first principle today?

Taking the right steps is very important to getting to the right answers. It used to be that we could just do correlations of financial metrics to measures of shareholder values, often TSR, sometimes market-to-book ratios, and pick the metrics with the highest correlations. Unfortunately, over the last several years the volatility in stock markets and stock price has brought those correlations down to pretty low levels. It's hard to tell just from the pure quantitative correlations whether or not we're really getting the right metrics.

»» We believe the best way to be prepared for a shareholder vote on your programs is to make sure your incentive plans are measuring the right things.— **Richard Harris**, Hewitt Associates »»

So what should compensation committees do? Well, I think they should still understand the correlations. That's a nice starting point. The next step is, from a quantitative standpoint, to really understand how the company is performing on certain key metrics relative to the industry. That often points out for a company where they're weak or where they're strong, so they can either build on the strengths or improve the weaknesses. But finally, we think it's really important to also look at metrics qualitatively. We do what we call a value tree, which is really just taking the core value equation of growth in earnings and return on investment, and breaking it down into its core components—earnings, margins, revenues, all pieces of that core value equation. And by doing that on a qualitative basis, combined with the quantitative information, we really get a sense of what the key metrics should be.

There's a second step, though. There are some nuances to this that are not obvious when you just say we're going to measure earnings as the integral part of our annual incentive plan, because you have to determine what level of earnings. I've seen this more in discussions with compensation committees in 2008 and 2009 than I ever have before. Compensation committees have to decide whether to go with net income (or earnings per share, which is really that bottom-line number the shareholders receive) or whether to go higher up the scale. Should they go to an operating earnings, or an EBITDA—an earnings before interest, taxes, depreciation, and amortization, a very common incentive metric? You really want to choose a metric that will build value but is also one that the executive team can identify with, have an impact on, and can drive forward.

Richard, this is a very important topic for both boards and shareholders that we've only had a chance to touch on today. If you could leave boards with one important thought, what would it be?

If I'm sitting on a compensation committee, I may or may not feel like a financial expert. Don't worry. Consider two things. First, either the finance committee or the audit committee is actually being used as a consultant around financial metrics if the compensation committee doesn't have people serving on it that feel like they can do the job. But second, a compensation committee needs to demand from the management team and their outside advisers the right levels of quantitative and qualitative analyses that demonstrate that the metrics that they are paying incentives on are going to drive value, so that when the executives win, the shareholders win. If the shareholders aren't winning, the executives aren't getting paid.

Are Compensation Plans Providing Incentives for the Appropriate Corporate Behavior?

TK Kerstetter

President and CEO

Corporate Board Member, moderator

Catherine L. Bromilow

Partner, Corporate Governance Group

PricewaterhouseCoopers LLP

Richard Harris

Principal and Senior Consultant

Executive Compensation

Hewitt Associates

Amy N. Moore

Chair, Employee Benefits and Executive

Compensation Practice

Covington & Burling LLP

Philip H. Stern

Senior Managing Director

FTI Consulting

In each edition of the Board Governance Series we ask a common question of our partners that will be helpful to our readers. In this edition we asked, “Are compensation plans providing incentives for the appropriate corporate behavior?” Our panel had mixed reviews on this issue.

Amy Moore: Unfortunately, quite a few of them are not. I see three basic problems. The first is that incentive programs are almost always designed to measure things that are quantifiable, such as total shareholder return or earnings per share, whereas many of the most important characteristics of a successful executive are subjective—things like leadership, ethical behavior, and mentoring. Those characteristics are not measured well by many of these programs. Second, an important focus of Congress and regulators has been on programs that encourage excessive risk taking, and many programs are designed in a way that do encourage too much risk taking. They set the bar too high. They have cliff objectives where, if you don’t reach the target, you get nothing. They have payouts that are based on a stock price, so that the price on a particular day is all-important. The third problem is with programs that don’t encourage risk taking but that nevertheless are designed in a way that encourages short-term strategic behavior that is not in the company’s long-term interest. A lot of performance objectives can be achieved by what some executives call “financial engineering,” so that you can goose up your numbers and reach your target, but you haven’t achieved anything of long-term benefit to the company. So all too often, compensation committees need to do a better job of looking at the incentives they provide and making sure they’re appropriate.

Richard Harris: When we talk about appropriate behaviors today, for the most part we’re talking about making sure executives don’t take unnecessary and excessive risk. We want to make sure they’re driving the right kinds of behaviors for the long-term. Are incentive plans doing the job? Most compensation committees are making sure they’re dealing with the three big things that would address those issues. One, they’re making sure they

TK Kerstetter

President and CEO

Corporate Board Member



have the right metrics and goals in place to drive long-term behaviors. Goal-setting in an uncertain environment is challenging, but it's happening. Two, we're seeing severance come down, both in terms of regular severance and CIC. Why is severance important? Because if there's too much of a cushion for poor performance, it leads to more risk taking. Finally, compensation committees are going through a formal review of company risks and how their incentive plans link to those risks. That process really started in 2009. In summary, I'm not sure they're all the way there, but they're moving strongly in the right direction.

Catherine Bromilow: First of all, let's think about the parameters of what we mean by appropriate corporate behavior. One way to think about it is whether or not the behaviors that are being incented are those that are not going to sacrifice long-term company performance, as well as the company's viability for short-term results. So if we use that definition, then we do see some companies that have established programs with policies around compensation and incentive compensation that allow them to achieve those goals.

»»» Compensation committees need to do a better job of looking at the incentives they provide and making sure they're appropriate.

— **Amy N. Moore**, Covington & Burling LLP »»»

Philip Stern: As we sit here today in 2009, I believe compensation plans generally are not providing the right incentives but are being reviewed. I think, long-term, boards and board members are looking at compensation and addressing those issues. Certainly the federal government and various regulatory agencies are requiring that people look at compensation and linking it to risk and rewards. When they're putting a product out to the public in the financial sector, they're very concerned about how compensation is linked to those risks. FTI and *Corporate Board Member* recently conducted a survey of major corporations and general counsel and found that 43% of the general counsel at those major corporations are reviewing compensation. Boards are getting the message. And ultimately, conduct will have to change so we don't have meltdowns in the economy, such as we've seen in the financial, investment banking, automotive, and various other sectors that have taken large risks that have resulted in severe damage to the public and to the system and our economy. So I think, yes, generally speaking, there will be a link between compensation and the management of those corporations, but I don't think it's there yet.

I'd like to share two things with you today. One focuses on how shareholder value gets created from an operational performance perspective. The companies that embrace that approach tend to make sure there is a fairly meaningful portion of total compensation that executives can earn that is tied to the company's operating results. That's one way to look at it. Another way is to have a significant amount of executives' net worth in the company represented by long-term shareholdings. That helps orient their decision making toward a longer time horizon and gets away from some of the short-term views. Companies that do that not only require significant amounts of share ownership in the company, but also require those shares to be held at least until the executive leaves the company, and in some cases, even a little beyond.

The whole issue of how incentives work and impact corporate behavior—and whether it's the appropriate behavior—is much more in the focus and spotlight these days. In particular, the SEC is looking at rules that would have companies explain whether or not incentive and compensation policies are helping drive inappropriate levels of risk taking, so this is definitely a hot area board members will want to pay attention to.

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Compensation Committee Checklist for Assessing Incentives and Risk
The Center on Executive Compensation has created the following checklist to help guide compensation committees on these issues.

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Director of Publications **Deborah Scally**

Editor **Jamie Reeves**

Copy Editor **Kimberly Crowe**

Art Director **Alli Lankford**

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contact Board Member Inc., 5110 Maryland Way, Suite 250,
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5110 Maryland Way, Suite 250
Brentwood, Tennessee 37027
(615) 309-3200
www.boardmember.com