Winning in a different world

2009 Energy Board Symposium Viewpoints

PRICEWATERHOUSECOOPERS

Energy Board Network

On May 20, PricewaterhouseCoopers held the second day-long Energy Board Symposium and were pleased to see many returning directors and to welcome new attendees to the Energy Board Network.

Ian Bremmer, President of Eurasia Group, began the event by discussing geo-political risk and sharing insights from his many travels and meetings with world leaders. T. Boone Pickens gave the keynote luncheon address and provided his insights on where the energy industry is going. The rest of the day was filled with discussions on regulatory and financial risk management, sustainability and carbon emissions, SEC reserves reporting changes, corporate governance, and regulatory and legislative policy.

The following articles provide a recap of the discussions that the directors engaged in with each other during the day. At PricewaterhouseCoopers, we are committed to providing opportunities to connect and discuss the issues that directors must address and to bringing directors together to share their insights and best practices.

Please enjoy this summary of the Energy Board Symposium. I look forward to seeing you at our upcoming Energy Board Network events and to continuing the dialogue on the pressing industry issues.

Sincerely,

Rich Paterson
Global Energy Leader

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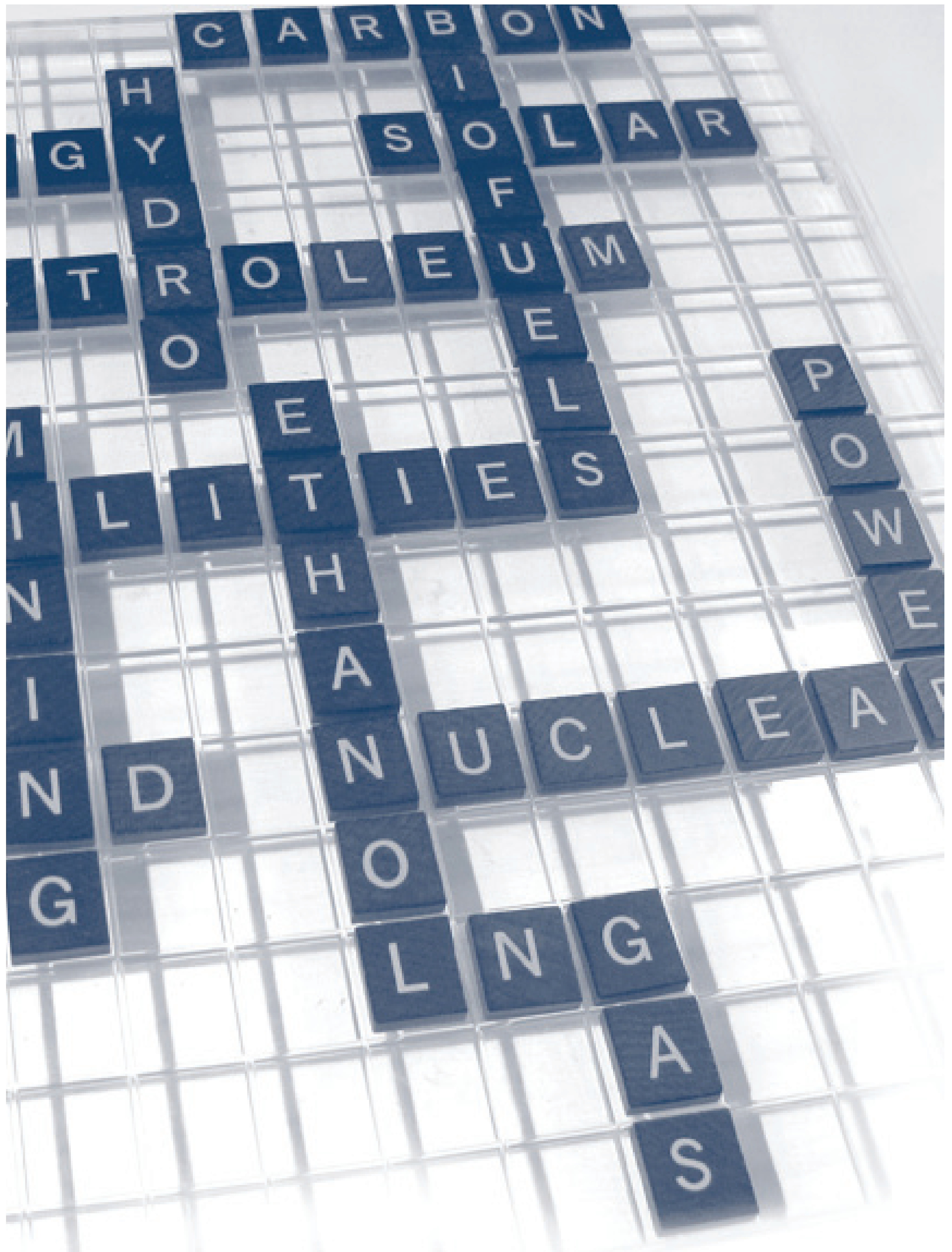
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Ian Bremmer
President and Founder-
Eurasia Group

Prospects for U.S. business

U.S. business leaders searching for clues to the future must recognize the dramatic shift in thinking that has taken place since the global economic crisis that began in late 2008, Dr. Ian Bremmer told members of the PricewaterhouseCoopers 2009 Energy Board Symposium.

The president and founder of Eurasia Group–the leading political risk consulting firm–said that the crisis gave politicians and regulators a unique opportunity to concentrate power at the federal level, and that U.S. corporations can expect the government to continue expanding its influence over businesses in the coming years.

“Government–not markets–will decide who wins and who loses,” Bremmer said. “Globalization is being increasingly challenged by state capitalism.”

The result is a distinctly changed landscape for American businesses. Detailing the sharp contrast between 2008 and 2009, Bremmer told Symposium participants: “New York used to be the financial capital of the world. Today, it’s not even the financial capital of the United States … Washington, D.C., is.”

Who will fill the vacuum?

The shift away from individual capitalism is happening at the same time the U.S. is losing its ability to influence world political and economic events, Bremmer said. For example, the Chinese government is working to increasingly decouple itself from the U.S., he said, and as American power wanes, few countries are willing to step into the vacuum to take the lead on important issues such as nuclear proliferation or climate change.

These trends portend a somewhat diminished future for American companies, Bremmer said, with less efficient growth due to government regulations and tax policies, more frequent and complex international crises that roil global markets, and an overall decline in globalization and its resulting opportunities. In addition, U.S. companies will find it more difficult to recruit and retain talent as other countries catch up–and even surpass–the United States in terms of educational

and professional opportunities. Bremmer pointed out that foreign banks were already taking advantage of the U.S. government's cap on salaries in the banking industry to recruit away the best and most experienced employees.

Bremmer pointed to a major airline manufacturer as an example of how unprepared many U.S.-based companies are for this new world. "This company's long-term strategic plan estimates that 65 percent of new plane orders will come from China by 2025," he said. "Do they not see the massive growth in education and the resulting pool of talent that China is building? The Chinese will not be buying all their planes from U.S. companies. They want to build their own planes."

Global winners and losers

Changes in domestic economic policy aren't the only obstacles for American businesses. Bremmer said the world is becoming more volatile and more complicated, with several nations facing rapidly deteriorating social and political conditions. While Iraq is improving–to the point where investors will soon return–the situations in Pakistan and Afghanistan are worse than ever, he said. And Russia is struggling with numerous economic issues and will be a more difficult business environment in the coming years, he predicted.

The same is true for Venezuela, Bremmer said. While relations with Venezuela may appear improved, it will not lead to better business opportunities for U.S. companies. And the forecast for foreign investment in Mexico looks weak as the government continues its struggle against drug-related violence.

"In today's world, economic and political stability is impossible to predict on a five-to-10-year timeframe," Bremmer said. "Given global economic conditions, discontinuity is more possible than ever before. More unemployment and more social dissent will distract governments, and some will collapse. That will create risks for companies that do business there."

Still, there do appear to be a number of resilient economies around the world. Bremmer pointed to Brazil, Saudi Arabia, India and Indonesia as markets that are focused on steady growth, centrist policies and infrastructure investment.

"A key component of resilience is the government's political capital and ability to focus on economic issues to ensure stability," Bremmer said. "For example, there is enormous support in China for the Beijing government. There is a strong nationalist sentiment throughout China and that supports the country's economic growth."

Government overreach

Despite the dramatic changes taking place at home and abroad, Bremmer told Symposium participants that the pendulum will always swing back.

"There is no doubt that we are seeing growing interest in and support for a state-controlled financial system here in the U.S.," he said. "And yes, it's a clear shift away from individual capitalism toward state capitalism. But the U.S. is not becoming a socialist country. In fact, there is little doubt that government will overreach with too much regulation and tax rates that are too high, and that will lead to decreased productivity and a return to a more business-friendly environment in the future."

CARBON
HYDRO
ENERGY
BIOFUELS
PETROLEUM
ETHANOL
MINING
UTILITIES
WIND
WAVE

Laura Cox-Kaplan
US Government & Regulatory Affairs Leader-
PricewaterhouseCoopers

Vincent P. Colman
National Professional Services Group Leader -
PricewaterhouseCoopers

Ed McClellan
National Tax Services Principal-
PricewaterhouseCoopers

Competitiveness may be at risk

"The Obama Administration has charted a particularly ambitious course, and is hoping to leverage the economic crisis to enact key policy reforms in the areas of health care and energy independence," Laura Cox Kaplan of PricewaterhouseCoopers said during a panel discussion titled "Regulatory and Legislative Policy: A View from Washington, D.C." at the 2009 Energy Board Symposium.

Mrs. Kaplan, Partner-in-Charge of U.S. Government and Regulatory Affairs for PwC, said, "The President's top priorities come with a very hefty price tag making tax increases a likely reality. It is safe to assume that you'll see much discussion about U.S. business' ability to remain competitive in this environment, especially as you consider the fact that the U.S. already has one of the highest corporate tax rates in the world."

Battling emissions

Mrs. Kaplan said cap-and-trade legislation faces a difficult road.

"The Administration is pitching cap-and-trade as a job creation engine, but estimates show that it could increase substantially the costs on individuals and families. It could also significantly impact individual state economies in coal, oil, natural gas, and timber producing states," she said. "While the President's party occupies a majority of seats in both the U.S. Senate and House, local economic interests are likely to drive the debate on climate change and cap-and-trade in a manner that makes geography even more important than party affiliation."

Regardless of the cap-and-trade debate in Congress, Mrs. Kaplan said the Administration is likely to pursue environmental goals, including emissions reductions, on a separate track by using regulatory authorities of the Environmental Protection Agency, Department of Energy, and other authorities allowed for under the Clean Air Act.

Regulatory reforms in response to the financial crisis

Mrs. Kaplan also described potentially significant changes to the regulatory architecture for the financial services industry, and to the way many financial products and services are regulated.

“We are likely to see a very different regulatory regime following this financial crisis, with potentially the most sweeping changes enacted since the U.S. securities laws were written in the 1930s. While it is too soon to predict what precise changes will be made, it is safe to assume that financial services companies will not be the only ones impacted by these changes,” she said.

Mrs. Kaplan said two key themes being echoed around Washington include the need to create a systemic risk regulator and the need to provide the government with the authority to wind down troubled depository institutions not already regulated by the FDIC. She said the most significant debate is around how to structure such reforms and whether to consolidate existing financial services regulators—like the Securities and Exchange Commission and the Commodity Futures Trading Commission—under a single regulatory umbrella.

She also mentioned an increased emphasis on consumer protection. “We are also going to see enforcement efforts stepped up and regulatory loopholes closed, along with calls for increased transparency for products and players across the financial sector,” she said. “The SEC—along with some in Congress—is particularly focused on ways to increase shareholder input especially related to the election of company directors, and in determining executive compensation,” Mrs. Kaplan said.

New focus on financial reporting

Vin Colman, U.S. Assurance Managing Partner and National Professional Services Group Leader for PricewaterhouseCoopers echoed Mrs. Kaplan’s view on the SEC, saying that the agency has undergone substantial changes in recent months, with a more deliberate and dedicated approach to reviewing registrants’ accounting and reporting judgments. In dealing with the SEC, companies should ensure that they have followed best practices for applying professional judgment and contemporaneously documenting the basis for their conclusions as well as alternatives that were considered. With regard to disclosure, “companies should carefully consider whether they are providing sufficient information to investors,” Mr. Colman said. “The depth and level of transparency should be consistent in each filing and communication to investors, including what is reported on the company website.”

In response to the financial crisis, the US-based Financial Accounting Standards Board (FASB) and the London-based International Accounting Standards Board (IASB) independently issued additional guidance on fair value accounting to help preparer companies to apply accounting standards to financial instruments. Political forces in the U.S. and abroad certainly played a part in the FASB's and IASB's response.

However, there is still a level of concern over the burdensome nature of applying the fair value guidelines beyond financial instruments into non-financial assets and liabilities. "Some constituents are beginning to push back," Mr. Colman said. "They think that the FASB is going too far, too fast with respect to fair value accounting for non-financial assets and liabilities."

Colman wrapped up his portion of the panel noting that the specific timing of a U.S. transition to International Financial Reporting Standards (IFRS) will remain uncertain for some time, due to other priorities at the SEC.

Energy firms targeted

Ed McClellan, Principal, National Tax Services, Legislative & Regulatory Group, echoed Ms. Kaplan's views that taxes were likely to rise–as he put it, "at home and at work"–as the Administration and Congress look for ways to increase revenues.

Mr. McClellan pointed to a number of initiatives that are currently under consideration, including:

- Limit foreign entity "check the box" rules
- Defer domestic expense deductions allocable to deferred foreign earnings
- Limit foreign tax credits to the amount of total foreign tax paid and deny credit for foreign taxes not subject to U.S. tax
- Modify rules for dual capacity taxpayers

In addition, he said, the Administration is planning several new tax proposals designed to encourage alternative fuels at the expense of traditional hydrocarbons.

“The Administration’s claim is that our current tax system distorts markets and encourages investment in oil and gas production,” Mr. McClellan said. These planned energy tax-related revenue measures include the repeal of the manufacturing deduction; repeal of the percentage depletion; the levying of an excise tax on Gulf of Mexico production; repeal of the expensing of intangible drilling costs; and many other policy changes designed to reduce energy company profitability.

“These tax laws will have a profoundly adverse impact on independent domestic oil and gas drilling companies,” Mr. McClellan said.

However, Mr. McClellan pointed out that there are few congressional districts across the U.S. without some form of the oil and gas industry in operation. Fighting these proposed tax laws will require the energy industry and its trade associations to communicate the very real impact increased energy taxes will have on local U.S. jobs.

“In many ways, energy transcends political affiliation … it’s regional,” Mr. McClellan said. “The industry needs to make the argument that these measures will eliminate jobs and reduce production at a time when we need affordable energy more than ever. These tax proposals will hurt local activity, local economies and will undermine our national goal of achieving domestic energy independence. I see nothing on the horizon which indicates we will no longer need domestically produced oil and gas.”

“If the energy industry can communicate these important issues to Congress–especially to the Senate–they can impact the debate. But the clock is ticking.”

Catherine Bromilow
Corporate Governance Partner-
PricewaterhouseCoopers

Pat Gray
Corporate Governance
Group Leader -
PricewaterhouseCoopers

Executive compensation once again a high-profile issue

Lawmakers are expected to step up efforts to address executive compensation in response to public concern over high-profile corporate rescues, Catherine Bromilow and Pat Gray of PricewaterhouseCoopers told Energy Board Symposium attendees during a panel discussion on trends in governance.

Congress has already instituted a number of compensation regulations that impact companies involved in the Troubled Asset Relief Plan and the American Recovery and Relief Act, including a ban on bonuses to top employees and a $500,000 limit on the tax deductibility of compensation. Additional proposed legislation would impose other measures on public companies across all sectors, including giving shareholders a “say on pay” vote on executive compensation.

“There is a lot of outrage among voters right now, and Congress will respond because executive compensation is such a hot issue,” said Catherine Bromilow, a partner in the Corporate Governance Group at PwC.

Past attempts to control pay

Ms. Bromilow stressed that this is not the first time executive compensation has been seen as an area in need of reform. In the 1980s and 1990s, there was a great deal of focus on pay-for-performance, and on increasing the proportion of equity compensation to more closely align pay with stock performance. More recently, there have been more shareholder proposals on pay and demands that executive compensation take into account the full range of shareholder interests.

Despite these attempts, the gap between what senior executives and rank-and-file employees earn has continued to grow, Ms. Bromilow said.

“Every effort to limit executive compensation over the past three decades has actually had the opposite effect,” she explained. “For example, the required disclosure of salaries in company filings–designed to shine a spotlight on what was considered excessive compensation –led to pay increases when executives found out what others earned.”

The challenge for directors

The current environment creates a number of challenges for members of executive compensation committees, said Pat Gray, partner and National Leader of the PwC Corporate Governance Group. The question for boards of directors has always been "how can we structure compensation to drive performance?" and there is no easy answer.

In fact, Mr. Gray said, performance measures for U.S. corporations run the gamut of financial and non-financial measures, but compensation programs do not always match those metrics.

"Boards need to understand how the entire management team is evaluated and incented–down to the line manager position–in order to align compensation plans with the metrics that are important," Mr. Gray said. "Rethink your entire compensation structure to ensure you are rewarding people for the full range of measures that you want to achieve, not just a single target, such as sales volume."

Another important factor to consider is the inclusion of risk into the compensation program, Mr. Gray said. Executive compensation reform should be viewed as part of an integrated approach to enterprise-wide risk management by first defining the company's risk strategy, and then aligning compensation processes with that approach.

"Compensation policies are increasingly being seen as a proxy for good corporate governance," Mr. Gray said. "Boards need to have greater involvement in compensation matters–with some coordination or overlapping membership between the audit committee and the compensation committee–and ensure that there are sufficient controls over business unit metrics."

Mr. Gray acknowledged that boards are struggling to determine how best to handle compensation in a rapidly changing environment.

"Executives are working harder than they ever have and it is tough for directors to roll back pay under those circumstances," he said. "There is increased pressure on boards to implement incentive plans that reward long-term planning and performance, but investors are troubled during downturns in the market if senior leadership is being compensated for non-financial metrics such as safety, customer satisfaction or achievements in sustainability."

"In the meantime, there is a tremendous effort under way to control executive pay and it will likely continue for some time. Compensation committees need to ensure they get sound, objective advice on executive pay, and that they are communicating compensation objectives and issues appropriately with shareholders."

Mark Smith
Western Region
Risk & Compliance Leader-
PricewaterhouseCoopers

Make risk assessment a priority

Boards of directors must be prepared to handle the full range of regulatory and financial risks that threaten companies today, Mark Smith of PricewaterhouseCoopers informed participants at the 2009 Energy Board Symposium.

The current volatile marketplace makes it necessary for directors to ensure that their organizations have effective, ongoing processes to identify regulatory and financial risks, measure their potential impacts and proactively manage them, said Smith, leader of PricewaterhouseCoopers' Western Region Risk and Compliance Advisory Services.

"Just as important, boards must be certain they are apprised regularly of the most significant risks, and determine for themselves whether the right actions are being taken," Smith said.

Regulatory issues are complex

The Federal Energy Regulatory Commission and the Commodity Futures Trading Commission are actively looking for compliance issues with an eye to those that can damage the industry's market reputation, Smith said. Both FERC and CFTC have a number of enforcement actions pending, with the potential for millions of dollars in fines to companies if they are found in non-compliance.

The complexity of this issue is underscored by FERC's more than 700 individual compliance guidelines that companies must monitor. "These standards are always evolving," Smith said, "and companies must stay on top of them. It is vital that boards ensure their organizations are following the proper jurisdictional agencies, staying aware of evolving standards and implementing new guidelines into the corporate code of conduct and standards and procedures documentation, as well as providing information and training to all impacted employees."

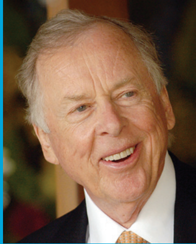
Financial risks typically revolve around measurement, reporting and limits and these, too, should be actively monitored for both market conditions and changing regulations. For example, Smith said the liquidity risks and guidelines related to commodity prices are still not well understood throughout the energy industry.

Accountability is key

The biggest obstacle for companies in enterprise risk assessment and management is developing and communicating clear roles and accountabilities throughout the organization. Once that is accomplished, however, the compliance framework must be supported by appropriate management information that ensures key managers are getting the data they need to make accurate decisions.

In closing, Smith said the board of directors should instill a culture of compliance throughout the organization that ensures managers view risk management as an integral component of their jobs–regardless of the economic issues they face.

“Risk and compliance functions should not been seen as adversaries to the business, but as partners,” Smith explained. “And incentives and metrics should include risk reduction to ensure that they are not forgotten when management moves to reduce costs.”



T. Boone Pickens

Natural gas: "Bridge fuel" to the future

The U.S. should take full advantage of abundant natural gas reserves to help reduce its dependence on foreign oil until renewable resources are more readily available and reliable, energy pioneer T. Boone Pickens told guests during his keynote address at the 2009 PricewaterhouseCoopers Energy Board Symposium.

Policymakers and the public all want clean energy, Pickens said, but few Americans really understand the size and scale of the nation's energy demand nor the limitations of highly touted alternatives.

"People hear something that sounds good and they make up their minds without looking any deeper at the issue," he said. "They don't want to know the reality."

Recalling his conversations with recent presidential candidates, Pickens said he had to explain that heavy-duty trucks–the backbone of the country's distribution system–can't run on electric batteries. "I told them that there's only one resource besides oil–today and in the future–that can move an 18-wheeler, and that's natural gas," he said. "It's relatively inexpensive, widely available and cleaner-burning than oil. And we can produce our own supplies without depending on foreign governments that are not always our friend."

Energy policy requires leadership

Pickens said the U.S. needs leadership that is willing to step up and address the serious economic and security issues related to the annual outflow of hundreds of billions of dollars to overseas petro-states. The answer, he explained, can be easily found by expanding the production and use of domestic natural gas.

"Right now, we represent just 4 percent of the world's population but we consume 25 percent of global oil production," Pickens said. "For the past 40 years, we've been saying 'send us your oil, never mind the price,' and our imports have continued to rise.

“Drilling for oil domestically won’t solve our problem. It will help, but it’s not the solution. We can import more from Canada, but at the same time, production in Mexico is falling dramatically and that will impact us. And Venezuela will soon be sending most of its oil to China as soon as the refineries are in place to process their heavy crude.”

What that means, Pickens says, is higher prices and a greater reliance on imports from geo-political hotspots.

“If you look ahead 10 years, it is not that difficult to see the U.S. importing as much as 75 percent of its oil at a cost of $300 a barrel,” he said. “And at that price, we’re not going to have the money to do anything else in this country.”

Today in the U.S., Pickens said, there are more than 250 million light-passenger vehicles and 6.5 million heavy-duty trucks in service. Yet just a few thousand of those are powered by natural gas, which is a common transportation fuel in other parts of the world.

“If you are buying a new car in Europe or Latin America, you have plenty of choices of models that use compressed or liquid natural gas,” he said. “But you cannot buy a natural gas-powered vehicle in the U.S.; they have to be retrofitted. People say, ‘well, we don’t have the refueling infrastructure.’ But I guarantee you that we could build the infrastructure quickly if the cars were on the market. We don’t need Washington to do that for us; we just need someone to lead the way. And that’s why I’m going around the country talking about this issue.”

Teaming up to transition

Pickens pointed to a successful conversion program in California as an example of how government can work with private industry to encourage the shift to natural gas as a transportation fuel. That effort provided grants to solid waste companies to replace high-polluting, diesel-fueled trash trucks to CNG-powered

trucks with substantial reductions in emissions. That same type of program could work with 18-wheelers, he said.

"We could easily transition 350,000 heavy-duty trucks to natural gas in three or four years," he said. "And this is a non-partisan issue. We have the resources. With the right leadership, we can reduce our oil imports and restore energy security."

In addition to repurposing natural gas as a transportation fuel, the "Pickens Plan" touts the use of clean coal and nuclear for the nation's electricity needs, supported by continued investments in wind and solar. For example, a more efficient and updated national power grid would strengthen the contributions that renewables such as wind can deliver.

"If you look at a map of global wind patterns, you can see that the U.S. has the best wind in the world," he said. "I believe that wind power can revitalize rural America, especially in the Great Plains region, by bringing jobs and stronger economies. It's something that people want."

The time is now

Pickens says the U.S. must start making these changes now if we want to positively impact our long-term energy outlook.

"Someone once told me that the best time to plant a tree was 20 years ago," he laughed. "But just in case you didn't back then, the next best time is today."

"We've spent 40 years getting into this situation, and we won't solve it overnight. But we need to get started."

Matt Arnold
Climate Change and Sustainability Principal
PricewaterhouseCoopers

Jonathan Lash
President
World Resources Institute

Preparing for a carbon-constrained world

American industry must accept the fact that carbon constraints are inevitable, panelists Matt Arnold of PricewaterhouseCoopers and Jonathan Lash of the World Resources Institute told a 2009 Energy Board Symposium audience.

Either through legislative action or regulatory control, the federal government will control greenhouse-gas admissions sooner rather than later, said Matt Arnold, Principal in the Climate Change and Sustainability group of PricewaterhouseCoopers. In fact, he said, momentum has been gaining for some time.

"We already have an unofficial moratorium on coal-fired power plants," Mr. Arnold explained. "And multiple jurisdictions around the country are setting up greenhouse gas reduction programs. In New England and California, companies are trading emissions credits. There are 900 U.S. cities with climate change programs in place and 27 states that have renewable portfolio standards for utilities."

Even more telling is the fact that U.S. businesses are actively seeking to implement more stringent restrictions on carbon emissions, said Jonathan Lash, President of the World Resources Institute, a research and analysis organization involved in environmental issues and sustainability.

"The U.S. Climate Action Partnership, for example, is a consortium of 27 major U.S. companies and several non-governmental organizations that is involved in emissions policy development," he said. "These companies knew Congress was poised to take action on greenhouse-gas emissions and they wanted a seat at the table."

Introducing uncertainty

Interestingly, the new administration's desire to implement a cap-and-trade program has slowed progress, Mr. Lash said.

"Cap-and-trade means uncertainty and that has delayed investment in renewables as companies wait to see what will happen next," he explained. "On the other hand, companies that have products or services that they believe will be valuable in a carbon-constrained world are eager for cap-and-trade. So there is no consensus."

"In addition, the dynamics of the cap-and-trade debate are different than they were in any other earlier environmental issue. The public isn't interested in the issue –as they were with clean air and water regulations–and the proposed legislation is very partisan." In addition, he said, regional differences will make cap-and-trade legislation difficult to pass because coal- and oil-producing states will be more heavily penalized.

However, if legislation bogs down, the EPA will begin regulating CO2 emissions under the Clean Air Act, Mr. Lash predicted. "It will be the largest regulatory program in the history of the United States," he said.

Preparing for the future

Energy companies and utilities are both heavily exposed to carbon price risk, but regulation will not hit companies in the same way, Mr. Arnold said. Factors such as carbon intensity of the fuel mix used, energy intensiveness of production processes, transportation needs and more will all play a role in determining a company's carbon risk.

Regardless, Mr. Arnold said energy companies should prepare now for an increased cost of carbon. While there are still uncertainties about the structure and detail of carbon regulation, it makes sense to begin analyzing how constraints will impact the bottom line.

Step one, Mr. Arnold said, is determining a baseline emissions figure, including inventorying all sources of emissions and instituting systems, controls, monitoring, verification and reporting processes.

Step two is creating abatement project profiles and developing marginal abatement cost curves to better understand the cost/benefit of reduction efforts.

Step three is determining the impact that carbon regulations will have on asset values, and developing an overall carbon strategy in response.

"It is important for energy companies to accept this change and begin transforming their culture accordingly," Mr. Arnold said. "It is difficult to think creatively when you see change as a problem, and you resent having to deal with it. Companies need to recognize that carbon constraints are coming down the road; smart management teams will adapt and learn and even make their carbon strategy a competitive advantage."

Catherine Bromilow
Corporate Governance
Partner-
PricewaterhouseCoopers

Pat Gray
Corporate Governance
Group Leader -
PricewaterhouseCoopers

Risk, compensation are serious issues for directors

Risk management and executive compensation are the top corporate governance challenges today, PricewaterhouseCoopers experts told a breakout session for board members at the 2009 Energy Board Symposium.

Risk presents a wide range of structural and policy questions that can be difficult for directors to respond to–everything from how the board is organized to how members stay current in a rapidly changing business climate.

The traditional view of many boards is that there is no need for a separate risk committee, said Pat Gray, Partner and National Leader in the PwC Corporate Governance group. Some boards require their audit committees to handle risk issues; yet others are taking a more detailed, systematic approach, involving the entire board.

Still, there is no consensus on the right approach, Mr. Gray said.

“Directors are not managing the day-to-day activities of the business, but they are still accountable,” he explained. “There is a nagging question of ‘How far do we go?’ in managing risk.”

Anticipating risk

Mr. Gray cited a recent pet food poisoning incident to illustrate how deeply companies must consider risk in today’s environment. A major pet store chain had diversified its suppliers to reduce potential risks, without realizing that all six vendors that were chosen received raw materials from the same supplier in China. The point of origin of the poisoning was the raw material supplier, and the pet store didn’t realize there was no true diversification in its supply chain until the very public incident.

“Identifying new problems before they arise is a common theme among boards today,” he said. “Too often, boards are blindsided by issues that arise out of the blue–problems that no one anticipated.”

Some boards are taking unique approaches to meet this need, Mr. Gray said. For example, one company's board established a "committee of committee chairs" that meets regularly to discuss potential situations and options for avoiding them.

Noting that no company can predict all possible scenarios, Mr. Gray said a company's culture plays a key role in managing risk. Directors should work with management to ensure that there is clear accountability throughout the organization, effective communication up and down and an atmosphere that allows dissent.

"Directors should maintain a healthy level of skepticism regarding management's risk assessment," he said. "And there should be agreement on acceptable levels of risk."

Compensation presents risk, too

Another issue that is challenging directors is the risk associated with compensation. Programs that encourage employees to act in extreme ways to earn bonuses or additional levels of pay can have serious consequences for companies, said Catherine Bromilow, a Partner in the Corporate Governance group.

Given the current political climate and the public scrutiny that executive pay is receiving, compensation has quickly become a full board issue at many companies.

"The broader board is asking questions and putting pressure on compensation committees," she said. "There is no more 'rubber-stamping' of the compensation committee's recommendations."

There has also been a shift away from compensation design to process, where the compensation committee sets executive pay and the principles to be applied throughout the organization. But the board must be comfortable that those principles are being applied appropriately.

"Directors need to ask management–are we driving long-term excellence with our compensation program, or just short-term results?" she said.

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