Board Governance Series

VOLUME IX 2007

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS

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CORPORATE BOARD MEMBER® MAGAZINE | NASDAQ®

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CORPORATE
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
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MAGAZINE

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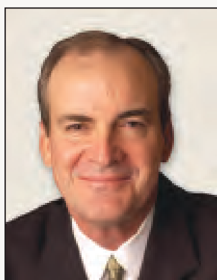
Dear Corporate Director,

The rules and laws pertaining to corporate governance have undergone many changes in the last year, and the responsibilities facing today's directors continue to increase in complexity, as well as number. Yet directors may take heart knowing they are not alone. The resources available to them are increasing as well, and today's boards and committees are more adept at implementing the best practices needed to ensure a responsible governance process as well as mitigate risk. Thus, while change often brings added scrutiny and risk, it also provides an opportunity for boards to anchor their organizations in sound principles that will help clarify the expectations facing them and build a solid foundation for the future.

Corporate Board Member magazine and The NASDAQ Stock Market proudly present volume 9 of the Board Governance Series—a collection of informative commentary from the nation's experts in corporate governance. Inside the pages of this special supplement you'll find discussions on best practices and topics of utmost interest to corporate directors, including information security risk, best practices for compensation committees and audit committees, and how to evaluate and manage personal and enterprise risk.

We invite you to visit our our website, as well as those of our series partners, to view online the webcasts highlighted in this publication as part of your own continuing education on today's most important corporate governance issues.



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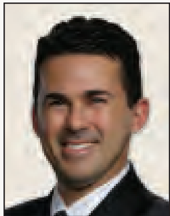

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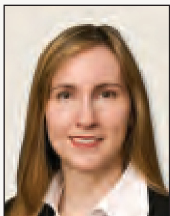

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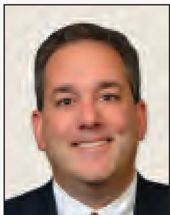

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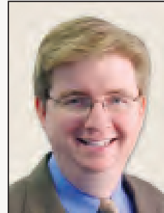

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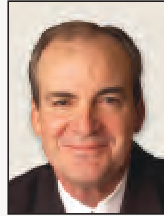

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Emerging Best Practices for Compensation Committees

Jane T. Romweber, principal, Hewitt Associates, outlines best practices compensation committees should embrace to increase their effectiveness, including practicing good meeting procedures and working with executive compensation consultants to ensure that expectations are clear and understood.

JANE T. ROMWEBER
Principal
Hewitt Associates

I'd like to talk about best practices for compensation committees, both established and emerging. This is taking on more importance in today's environment of negative media attention.

To start, let's talk about existing, established best practices. Several years ago, compensation committees wanted to take more control over the meeting process, which led to some processes that have served them well. I'm going to discuss four of those.

The first process calls for committee input into the agendas, which allows directors to determine what is covered during meetings. This is best done through a preset committee calendar established at the beginning of the year, so that all topics and dates are known in advance. Second, it's helpful if there is a single management liaison who meets with the committee chair before each meeting. This gives the chairperson a chance to suggest additional analysis that may be helpful prior to the meeting. Third, it's critical that the committee not be rushed. There should be at least two meetings held to discuss important or controversial topics, with the analysis presented at the first meeting and the decision taking place during the second meeting. Last, the committee should have a regular practice of holding executive sessions without management present; this provides a process for discussing sensitive issues without making a big deal of it.

Working Effectively with the Compensation Consultant

Additional best practices are emerging in today's environment and I am going to discuss three of them. To begin, let's talk about working effectively with the compensation consultant. The first point is that the compensation consultant should report directly to the committee. This is critical to ensure that the consultant knows where his or her final loyalties might lie if there is ever a question. Second, it's important that the committee establish what the consultant is responsible for and what the consultant is not responsible for. Because this can have budget implications, it's critical that this be set out as a shared understanding with the committee, management, and the consultant at the beginning of the year. Third, it's important that the committee, when it meets in executive session, has a regular practice of including the consultant in the first portion of each executive session. And this is important because processes may or may not be occurring the way they should to be sure that the consultant has enough lead time to provide adequate counsel to the committee. Last, if there is a report by the consultant, the consultant should be the one to present it to the committee directly, rather than management. This is particularly important in the area of market data, and it's true even when management has its own consultant.

Digging into Market Data

A second emerging best practice deals with understanding the choices and judgment calls that go into developing market data. I'll discuss a few of those now.

The first involves understanding the source of the data and the limitations that the source naturally brings to bear. For example, proxy data will reflect the most recent fiscal year of each company, and will only cover five executives. A consultant or proprietary database, however, will almost certainly include long-term incentive grants [made] in

the first three months of the most recent calendar year and will cover many more executives. Information from certain sources may be piecemeal, while others will provide comprehensive, total compensation data, and that should be understood by the committee.

Second, a great deal of judgment is involved in choosing a peer group for market data purposes, having to do with the company's industry, whether specific or general, and with the company's size. A common starting point for peer group selection is one-half to double the revenue size of the subject company, but, as I mentioned, that's only a starting point.

The third issue is that the committee should understand the statistical methodology that's been used. For example, we generally size-adjust our data to be specific to the revenue size of the company for which we're preparing the data. We could just use the raw median, which might be a little clearer, but that may or may not be appropriate, depending on how the company's size relates to the sizes of the peer companies.

"[Compensation committees] should add to their best practices by working with executive compensation consultants to ensure that expectations are clear and that there's a shared understanding of those expectations."

Challenge Employee Contracts

Another emerging best practice is to challenge the need for and design of comprehensive employment agreements. They have some issues. First, let's acknowledge that these agreements are essentially misnamed. They're not really about employment; they're about severance. They have other issues, as well. Their complex nature can mean that their impact is not immediately obvious. They tend to focus too much on the executive, and not enough on what the executive will do for the company in terms of performance. They tend to be constantly renewed and open-ended, which can lead to employment contracts that never end. They also tend to be multiplicative, meaning if one executive has one, other executives want one, too, and that just compounds the issue.

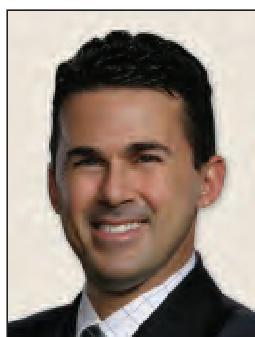
So what should companies do instead? There are ways to achieve the committee's goals without using comprehensive employment contracts. The committee probably wants noncompete clauses and other restrictive covenants. It also probably wants a rational severance program, but it can accomplish that through other means, including a broad-based, or at least executive, severance plan; special equity awards for retention, and sometimes severance as well; and equity award agreements that encompass some of the other key provisions, such as bad-boy clauses. If contracts must be used, it makes sense for the severance in them to wane over time to a lower level, and for contracts not to be renewed except perhaps for a single period, depending on what the committee might want.

Summary

In summary, compensation committees should continue practicing good meeting procedures, such as influencing agendas and holding executive sessions. They should add to their best practices by working with executive compensation consultants to ensure that expectations are clear and that there's a shared understanding of those expectations. They should dig into market data and make sure they understand the judgment calls and choices that went into it, and they should challenge complicated and comprehensive employment contracts by asking, "Could this be done another way?" Adhering to these established and emerging best practices will make compensation committees more effective.

What Every Director Must Know about Information Security

Although it's critical that directors have knowledge of their companies' sophisticated technologies, this doesn't require them to be technology experts. David M. Remnitz, senior managing director and segment leader for technology, FTI Consulting, discusses the accelerating issues surrounding information security risk.



DAVID M. REMNITZ
Senior Managing Director and
Segment Leader, Technology
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Today's topic addresses the issue of information security risk as it pertains to members of the board, as well as management's responsibility in assuring that an information security program is comprehensive, robust, and meets the requirements demanded by shareholders. This encompasses the ability to respond and stand strong in the face of increasing regulatory pressures, particularly in response to potential investigations or actions against the organization.

Information Safeguards

The first part of this webcast focuses on understanding the existing institutional assets that should be part of an information protection program–valuable components a director must be cognizant of and must ensure management is keeping a firm hand on. Those institutional assets represent knowledge, intelligence, business know-how, and business function within the enterprise. Being able to put together an information protection program around those assets is critical, and understanding who, within the management unit, is responsible for that oversight is also very important in terms of directors' understanding this issue and its potential problems.

In looking at an information protection program, traditionally you would want to protect all of the information in the enterprise. However, the model that many organizations today are much more interested in and attuned to is that of protecting the most valuable information–items that, if inappropriately controlled, could produce extreme harm to the organization. Examples include what's known as personally identifiable information–data regarding employees, individual health records, insurance, and financial transactions that could be tied to specific personnel in the organization. The protection of that information is most critical.

Building a security program that takes into consideration the overall enterprise value of information is very important, as is being able to pinpoint hot spots within the company where information is maintained. There may be specific silos of operating intelligence within the organization, especially if it is multinational. There may be other silos of knowledge that need to be protected as well. For example, in the research and development division of a major life sciences organization, the key ingredients [for a new product] may be contained in electronic information that could be subject to release or inappropriate disclosure. It is how you protect that information–ensuring management has its eye on it and can be questioned as to how it is putting in controls, technologies, and procedures that allow the organization to feel comfortable that the information is being safeguarded–that is most critical when you look at the information controls within the business.

The second point is the issue of being able to certify the validity, reliability, and integrity of information that you have within the businesses you help manage. In this aspect, it is most critical to understand the controls, the checks and balances, and the tests put in place by the management team, especially as they relate to the financial systems. If you are not comfortable that the controls surrounding the financial applications and processes within the business are fine tuned and robust, and that they run on a 24/7 basis and produce results that are as accurate as management can

provide, then you must be on top of this issue.

Being able to attest to the technological controls in a vast, multinational organization is no trivial event. Being able to understand the sophisticated technologies that are being put into place just in a single organization, one that is not involved in large-scale acquisition or M&A activity, is certainly critical. Doing so gets increasingly complex as organizations acquire, merge, and become larger and larger, simply because combining financial systems and technological infrastructures makes the task that much more challenging.

We're not asking you to be a technologist. We're not asking that you understand all the intricacies. We're just asking that you meet with the people in technology and risk management and in the office of the CIO who are responsible for implementing the technological underpinnings and applications within the business. It's most critical that you understand which controls, procedures, and enhancements are in place, as well as how management tests and audits specific results within the enterprise.

"Building a security program that takes into consideration the overall enterprise value of information is very important, as is being able to pinpoint hot spots within the company where information is maintained."

Action Steps

You should first sit down with the organization's CIO to gain a broader understanding of the information technology platform that the business operates under and to understand its applications, specifically in the business's core areas. So if it is a financial services organization, you will want to spend time not just on the financial systems that are controlling the accounts payable and the general ledger functions, but also on understanding the trading operations and how specific models are created that lead to an advantage in the markets.

As part of these discussions, you will also want to have a good understanding of the governance model for information risk control, as well as the specific areas of responsibility within the business line. Who is responsible for testing? Who is responsible for procedures? Who is responsible for installing specific business applications and ensuring that they are operating in a manner that gives you every confidence that they are producing reliable results?

On another note, as a takeaway, you should look to outside analysts who can provide insight into how the industry (or industries) is treating these types of issues. What are the best practices that should be impressed upon the organization's management? Are there other industries that are doing things better–that are more advanced, that might have experienced areas that you're just growing into from an information assurance and risk management perspective?

Another takeaway would be that management must continually report its progress to you. Where are the problem spots within the information technology platform? What corrective measures is management taking? Has it brought in outside advisers to help? Who are those outside advisers? Those are very important points.

The issues I've discussed are not going away. In fact, they will accelerate. As a board member, you will face these issues on a daily basis as you meet with company management. You must be cognizant of the reliance that each organization now places on the information assets it maintains. Getting a firm grasp of this will take time, but leveraging outside advisers, listening to management, and then combining that feedback with some of the notes I've covered in this discussion should be very helpful.

Audit Committee Evaluation Techniques: Challenges & Opportunities

Catherine L. Bromilow, partner and U.S. leader for corporate governance, PricewaterhouseCoopers LLP, outlines three approaches audit committees can take in performing their evaluations: discussion, questionnaires and checklists, and interviews and benchmarking.

While many audit committees are conducting performance evaluations on an annual basis, we find they aren't necessarily getting all the value they could from those evaluations. The New York Stock Exchange rules have, for a number of years, required audit committees to assess their performance. One challenge is that, having done such a self-assessment for a few years, some audit committees may look at it as a rote exercise–in effect, just another compliance function to fulfill. Given how busy audit committees are, as well as how much scrutiny directors are under, it just makes sense to get the most value possible from these evaluations. In this webcast, I will cover the three approaches audit committees could take in performing their evaluations and the advantages and drawbacks of each. Then I will provide ideas on how to improve the value you get from your assessments, whichever approach your committee takes.

Approach No. 1: Discussion

One way an audit committee might conduct an assessment is through discussion. Typically, as part of a regular meeting, the audit committee chair leads a discussion about the audit committee's effectiveness, or he or she may do so during an executive session. This is really the simplest way a committee can do its assessment–sitting together and discussing its effectiveness.

There are drawbacks, though. One is that not all chairs are equally skilled at facilitating a discussion about effectiveness. Another drawback is that, depending on the dynamics in the room, even if there are issues, you may not be able to surface them. For example, let's say the audit committee has a particular concern with the information it's getting from a specific manager. If the committee is having the discussion as part of a regular meeting, it will be difficult for members to single out for criticism any one manager who is sitting there with his or her peers. So certain issues may not be brought up. Or, to use another example, say the issue actually is with one of the audit committee members. Perhaps the person doesn't adequately prepare for meetings and so takes up too much meeting time asking questions that have already been answered in the premeeting materials. Even if the discussion is held during an executive session, it can be difficult to handle those kinds of delicate issues when other people are present.

With discussion, you get what you pay for. It's the simplest approach, but it's also the one that ultimately may provide the least value to audit committees.

Approach No. 2: Questionnaires and Checklists

A questionnaire is the most common way committees conduct evaluations. Very simply, a survey is distributed to all audit committee members. They complete it and submit it to someone who compiles the results and shares them with the audit committee chair so that he or she can discuss the results with the rest of the committee.

There are advantages to using a questionnaire. One is that it's relatively simple. Another is that it ensures you get feedback from every audit committee member, which is something that a discussion may or may not do.

There are, however, some drawbacks to using the survey approach. One is that people often hesitate to disclose issues or concerns if they have to put them down on paper. There may be liability concerns involved with this hesitation.

CATHERINE L. BROMILOW
Partner and U.S. Leader for
Corporate Governance
PricewaterhouseCoopers LLP

It's difficult to solicit solid information that will lead to improvement opportunities using just a questionnaire approach.

Another drawback to this approach is the law of diminishing returns. One audit committee chair told me that the first year his committee used a questionnaire, it identified a number of areas needing improvement, which the committee went ahead and made. However, two to three years out, the answers to that survey make things appear better than they are. "It looks like we're wonderful," he said, "but I know we're not wonderful. I know there are still things we can work on."

So while surveys have many advantages, audit committees may not be getting all the value out of those surveys they would wish.

Approach No. 3: Interviews and Benchmarking

The third way audit committees can assess their performance is through what we call the interview approach. Typically, a third party does one-on-one nonattribution interviews with each audit committee member as well as most, if not all, members of management who support or interact with the committee. After the facilitator conducts the interviews, he or she compiles the information, discusses it with management and the chair, and perhaps even facilitates an audit committee meeting where members can discuss results and develop an action plan.

This approach has a number of advantages. First, if you get the right type of facilitator–a skilled interviewer who also understands governance and what audit committees do–you can benchmark where your audit committee is in relation to others. Another core advantage is that a good interviewer who hears someone express a concern can ask follow-up questions to probe those issues. You just can't do that with a questionnaire.

What are the drawbacks? It's more expensive and it takes more of the audit committee's time.

"Using the interview process may require more resources, but typically you get a far better result..."

Again, you get what you pay for. Using the interview process may require more resources, but typically you get a far better result for your audit committee from this approach.

Maximizing the Value from Your Assessment

The discussion approach allows the chair to do some valuable preparation so the discussion is more productive. For example, instead of just asking, "Do you think we fulfilled everything our charter calls for?" the chair can craft questions that get more to the underlying processes that affect audit committee effectiveness. The chair also may want to have one-on-one discussions with fellow committee members prior to the meeting to get a better handle on what the issues and concerns are, thus ensuring those points get addressed as part of the broader discussion.

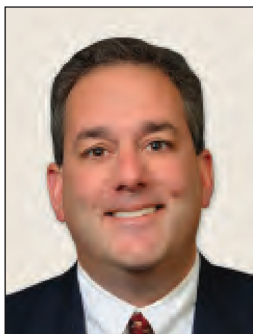
If you're using the questionnaire approach, stay away from yes or no answers. They're too simplistic and won't necessarily give you what you want. Also, consider changing your questions every few years–particularly if you've gotten to the stage where all the answers are positive, but you know things are not necessarily that great. In addition, if you get the sense you're not getting frank answers from people, take a closer look at the process. One potential concern is with the person who is compiling the information–could committee members fear that for some reason their responses will not be kept confidential? Are audit committee members concerned about where the information ultimately is going to end up–how long it's going to be retained and what type of confidentiality surrounds it? You may find you need to make some changes to the process that will reassure committee members that they can respond with candor and their responses won't come back to haunt them.

Finally, with either the questionnaire or the discussion approach, you may want to seriously consider bringing in an outside facilitator periodically–say, every three to five years–to conduct an assessment using the interview process. That will help your audit committee members understand what's going on around them and with other audit committees, and ultimately may provide the best value.

At the end of the day, if you're going to conduct an annual performance evaluation, you should try to get the most benefit you can from it for your audit committee.

Three New Developments That Cause Directors to Lose Sleep

David J. Berger, partner, Wilson Sonsini Goodrich & Rosati, reviews the most critical issues troubling today's directors. He covers such things as the unholy alliances between proxy advisory firms and investors, personal liability risk, and the lack of respect board members often experience today.



DAVID J. BERGER
Partner
Wilson Sonsini Goodrich & Rosati

Directors today are under a lot of pressure. You can't pick up a newspaper without reading about one attack or another on directors of public companies. Perhaps even more than litigation, directors today worry about the telephone call on a Thursday afternoon from a reporter like Gretchen Morgenstern saying, "We'd like to run a story on you in Sunday's *New York Times.*"

Historically, directors were only subject to legal standards, which were relatively stable and easy to explain. Today, directors are governed under a variety of standards, including not just legal liability, but attacks under the ever-evolving standards of "best corporate governance practices,"and the even more ephemeral notion of the "*Wall Street Journal*" test, or how directors may appear in the world of public opinion. Indeed, perhaps the greatest potential "liability" directors face is not legal liability, but reputational risk. The directors I've spoken with are continually coming to me and telling me that they're losing sleep over these issues.

The Short-Term "Unholy Alliance"
The first thing I often see is what I call the troubling, or even unholy, alliance between short-term investors and proxy advisory services, as well as institutional investors. Hedge funds and other short-term investors have really figured out the proxy system in such a way to make it very difficult for directors in any proxy contest. As part of this process, hedge funds and other shareholder activists have determined the key issues for the proxy advisory services that, in most public companies, either influence or direct the votes of the 20%, 30%, or even 40% of a company's shares that are controlled by institutional investors.

For example, one key issue that these proxy advisory services like to see is representation of minority investors on boards of directors, so a hedge fund or other short-term investor can rapidly acquire somewhere between 5% and 10% of a company's outstanding stock. Once that acquisition is announced, usually there will be two, three, or four other hedge funds or short-term investors that will also get into that company's stock, and as a group they'll quickly own between 10% to 20% of the company's stock. Once you combine that with the institutional investors' holdings, if there is a proxy contest, what's key is what the proxy advisory services, such as ISS or Glass Lewis, are going to do.

The hedge funds understand the issues that are important to the proxy advisory services–primarily governance issues and representation via a significant investor on the board. As a result, a hedge fund that owns a significant minority stake has a number of systematic advantages when running a proxy contest for less than a majority of the board. The best defense for a company when facing this type of situation is something that is actually quite difficult and unusual for companies to do–speaking with their shareholders on a more regular basis, instead of just when the company wants the shareholders' vote. It's important for directors and management to speak with shareholders not only when they need their vote, but also when they don't need their vote. So go out and talk to shareholders, and not just during proxy season.

The reason for this is really quite simple. Institutional investors typically own stock in dozens, if not hundreds, of companies, and as a result they have to cast dozens (if not hundreds) of votes

during proxy season. Because proxy season is relatively short, an investor owning shares in hundreds of companies may have a limited amount of time to make decisions about individual voting issues during proxy season, and will often not have time to focus on one particular company during this season. Because of this, if you make a point to speak with him or her during the off-season, you'll have a better chance of getting attention. And don't just speak with the person who makes the investment decisions. Oftentimes the person who makes the voting decisions for institutional investors is different from the person who makes the investment decisions. Make sure to speak with both of them.

Personal Liability

The next issue that might cause directors to lose sleep is the risk of personal liability. What directors are seeing is that every decision they make is likely to be challenged in court. At least they have the feeling that everything they do–whether it's in the context of a potential acquisition or merger, or what used to be considered routine decisions such as the promotion or hiring of new executives, the replacement of a management team, or even strategy selection–is being challenged in court. Directors are feeling vulnerable and under pressure both from the courts and fear of litigation, as well as from the public.

The unfortunate solution directors often follow to avoid such pressure is what I call the bunker mentality; that is, directors hunker down and try to leave no written record of what they do and keep things as plain vanilla as possible. In my experience this is the wrong thing to do. Instead, the solution I recommend is what I call transparency. Directors have to be prepared to defend their decisions, and the best way to do that is to have contemporaneous records documenting what they thought about and why they chose the path they did. This can include, for example, the board's reliance on the expertise of bankers or accountants. Directors should have written documentation from each consultant explaining the various options presented to the board. Transparency in this day and age is necessary, and the bunker mentality may do more harm than good.

Lack of Respect

The final issue I'd like to talk about has to do with the lack of respect directors receive in today's society. I'm old enough to remember the days when you could walk into court representing a director, and whether it was a judge or jury, that director's decision would get a lot of deference because directors were thought to be leaders of society. But that has largely changed. If you walk into court today with a director as a defendant, there is, particularly among juries but also among some judges, a certain skepticism that comes into play. And I think this skepticism extends to society at large. As I mentioned earlier, you need only to pick up a copy of the *New York Times* or *Wall Street Journal* to see a lot of skepticism over why directors made certain decisions. And here, I'm afraid, some of the blame has to go on the directors.

The reason I say this is because directors appear to have become unwilling to take on management, particularly with regard to executive compensation. The reality is, executive compensation has gone a little crazy in our system. Directors are being blamed for that, and unfortunately this criticism is not wholly unreasonable. Directors are responsible for selecting and deciding on executive pay packages. Until the executive compensation morass is taken care of, and directors are able to stand up and defend their actions, there's going to be a lot of cynicism about directors.

Across the board, directors are under tremendous pressure these days, and there are many understandable reasons why they are losing sleep. They're facing attacks from the media. They're facing attacks from shareholders. They're facing the risks of litigation. All of these areas contribute to directors feeling as if the world is spinning out of control. However, if directors assume control of their destinies and take a couple of steps that are a little different from what their traditional practices have been, as well as gain control over such critical issues as executive compensation, I think they can sleep easily at night and regain the status in society they previously held.

"Directors are feeling vulnerable and under pressure both from the courts and litigation, as well as from the public."

How Boards Can Manage Compliance & Regulation

Joseph C. Atkinson, U.S. operations leader, Governance, Risk & Compliance Practice, PricewaterhouseCoopers LLP, reviews ways boards can achieve a more effective, more consistent, and more manageable risk and compliance environment.

JOSEPH C. ATKINSON
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Board members recognize that the corporate operating environment has gotten much more complex over the last several years. As proof, we often cite the statistic that the Federal Register added more than 118,000 new regulations between 1981 and 2005. However, that figure only encompasses regulatory activity at the federal level. Add to that all the risk discussions managements have undertaken and the obligations they are under to discuss risk management practices with boards, as well as the weight board members feel on their shoulders as to where the next risk is coming from, and you have a very complex and rapidly changing environment.

The Power of Principles

Given that complexity, I want to discuss some ideas and principles boards can apply to help drive effectiveness in their organizations. There's a huge opportunity for boards to anchor organizations in principles that will help manage the complexity and clarify expectations, both for management and the board. But we often hear from boards that there's a lot of confusion. Which principle do they follow? Should they choose one over another? We're finding that, in both the regulatory and risk environment, with frameworks such as ERAM and COSO and the requirements the PCAOB and other organizations have placed on boards, there are commonalities among the issues.

Likewise, there are principles that, if applied, can help organizations and boards sort through the complexities. For example, our firm recently spent a good deal of time with an entertainment media company, and as it expanded operations, it had many more compliance obligations that applied at the operating level, the business-unit level, and all the way up to the corporate level. Management and the board found that the way those obligations were identified and dealt with varied, depending on where the activity was taking place within the organization.

We've seen that same challenge at financial services companies and banks. In fact, we've seen it across the entire spectrum of industries. And we're finding that companies of all types are responding to these compliance obligations and risk events by having management build a process, such as a new Sarbanes-Oxley process or a new compliance management process, to deal with them. We think there's an opportunity in that kind of environment to drive the discussion more toward principles. When you look at how a management team develops a process to deal with a specific compliance obligation, there's an opportunity at the outset to ask, "What are the elements of an effective response to that kind of obligation?"

For example, how do you define your objectives, both those that the compliance obligation or risk event put upon you and, more broadly, those related to what the business unit is about? How do you consistently define the policies and practices that should be employed? How do you define your risk appetite and tolerance level?

These are the types of frameworks that have been put before boards. There are common principles that provide some guideposts boards can use to anchor their discussions so that the complexity and amount of change doesn't become the driving force; instead, the commonality of process and practices becomes the foundation from which they can establish a program tailored

to their organization. This principles-based approach helps boards and management reach a better understanding of company expectations.

Let me give another example. We often find that members of management are responsible for identifying and assessing risks at an organizational model level. They may be dealing with operational risk. They may be dealing with financial risk, perhaps specifically with the financial control risks that Sarbanes-Oxley addresses. But the way they capture and report that risk could differ completely by geography, by business unit, or by risk category. The challenge is that as the information gets collected, the consistency with which one event is compared to another–such as the criteria applied to determine that an event is beyond the company's risk appetite–starts to waiver as it moves through the organization. Thus when they present a report to the board and ask the directors to make decisions or help management judge which issues require immediate attention, there's a complete lack of consistency, leaving the board in a difficult spot.

That capability needs to be defined at a very practical level–what does a certain policy or procedure accomplish? What does [the concept of] objective setting encompass in the management environment? What does risk appetite mean? How has the board communicated its risk appetite and tolerance? We think there's a very significant opportunity to drive a much more effective risk and compliance program by using common language and vocabulary.

Monitoring and Reporting

We talked a bit about monitoring and reporting when issues start to arise, but there is a broader context involving management itself. Large organizations that have grown through acquisition or are dealing with spread out geography may be seeing significant amounts of control issues, ethics hotline issues, and compliance issues, all of which are being tracked and captured by different executives. Following accepted principles for management discussion can help boards sort through the functional silos that often mask the fact that there's commonality in what happens behind the scenes. So if board members can get to that commonality, there's an opportunity to create a discussion that's much more meaningful to the board and allows directors to focus on the risks that are most important.

We've talked about the principles, now we can apply what we call the operating levers–things like process, people, technology, and information. This is the toolbox that's available, both to the executive leadership and to the board, to drive change and increase the effectiveness of these necessary practices. We think the technology, the process, the people, and the information tools are critical to how this all comes together.

Summary

To briefly recap, one, the situation for boards and management doesn't have to be as painful as it has been over the last several years. There is a path to a more effective, more consistent, and more manageable risk and compliance environment.

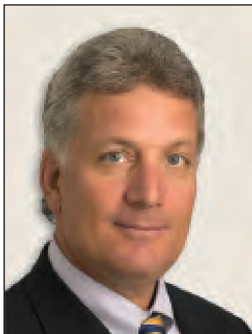
Two, the principles are key in providing a foundation. By principles I mean anchoring management and the board in a common vision of what can be accomplished. While the sea is churning around you, you will have a better ability to manage it if there is a common foundation and set of guidelines shared by management and the board. The language is the same. The principles are understood. The expectations are clarified.

Three, look very hard at the operating levers. They're the only available tools that can affect the kind of foundational view we're describing: the technology, the process, the people, and the information. How does management apply those levers and integrate them into a comprehensive plan? How does the board receive management's plan? How does the board act on that plan? Those are conversations, that, if initiated by the board, can be very helpful, both to the board in fulfilling its obligations and to management in its ability to execute those obligations.

"While the sea is churning around you, you will have a better ability to manage if there is a common foundation and set of guidelines shared by management and the board."

Understanding the Basics: Enterprise Risk 101

Neal Hochberg, senior managing director, FTI Consulting, discusses how important it is for boards to have an organized approach to understanding the risks their organization faces, as well as the need to develop plans to deal with each aspect of those risks.



NEAL HOCHBERG
Senior Managing Director
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I'm going to discuss some of the risks boards face, particularly what's referred to as enterprise risk, which comprises a vast array of possibilities directors should be aware of. As I finish the segment, I'll talk about some of the specifics boards need to think about, particularly those issues directors must ensure are addressed in their company's action plan.

Reputation

A company's reputation is its most treasured asset, and one can only value the impact of that reputation when something goes wrong. As we get into the specifics of some of the issues associated with controlling enterprise risk, we'll see how each individual component can impact a company's reputation, whether in the eyes of its public stakeholders, its own employees or potential employees, or within its own community. From an operational perspective, there are a number of critical factors that could impact the risk associated with the enterprise.

Protection of Assets and Operation

For example, as far as relationships with vendors and key suppliers, often there is extreme pressure to tighten the screws, so to speak–to get better terms and conditions and better timing of deliveries. That constant push and pull leads to vendors finding that the only way to meet those commitments is to possibly do something illegal. For example, offering kickbacks in some countries is not an unusual occurrence in exchange for getting deliveries on time or getting pricing to a certain point. But doing so is illegal. It is against customs and practices, and will ultimately cause tremendous pain in the country in which it occurs.

Another good example that's getting a lot of press is the Foreign Corrupt Practices Act, which has a number of requirements concerning anticorruption, antibribery, and books and records. Even the smallest or most minimal illegal payment can cause tremendous hardship to a company, both from an operational and reputational perspective. The U.S. government is on record for taking FCPA violations very seriously.

Control Environments

Yet another issue the board must consider in its overall control environment, and not just its internal control environment, is the company's process and procedure for legal compliance–compliance with both local customs and laws and its own code of conduct, including the ability for its own employees, who sense something may not be right, to report suspicious activity, whether it's through whistleblower channels via the audit committee or through some other method to report these types of issues. Clearly, tone at the top has been a topic of frequent discussion over the last couple of years, and it continues to be extremely critical in evaluating the integrity of the compliance program and the code of conduct for, and the related behavior of, employees. The worst-case scenario is when people who are pushing past the gray line, if you will, are rewarded financially. Although that information may never bubble up to the board level, it may be known among general managers and division presidents who see that behavior being rewarded and believe that, in essence, is the accepted code of conduct and conveys the tone at the top, which could prove very troublesome.

Financial Reporting

One last point I want to mention, though there are probably many other aspects of enterprise risk I haven't addressed, is the relationship among the internal control environment, internal audit function, and financial reporting and disclosure. We're talking about multinational companies that are publicly traded and are responsible for filing financial statements. Those financial statements need to be accurate; they need to offer full disclosure, and they need to comply with all the applicable listing laws and regulations. There are instances where, for example, a company might have a very broad and well-founded financial reporting system, but that system doesn't necessarily reach all reporting entities. It may emanate from a regional office and be carried up to headquarters. It may reach down to some of the key businesses that are operating in the region, but not to all the legal entities with books and records. So there's a lot of exposure to human interaction, which may lead to misreporting, fraud, or worse. Therefore, boards must be cognizant of the quality of their financial reporting system, as well as the system of controls. Policies and procedures in this area should be converted to all local languages, or at least to the predominant languages in the countries in which their companies operate.

> **"There seems to be an overwhelming amount of information [boards] need to be thinking about today, and this will continue to be an evolutionary process."**

Furthermore, with regard to a corporation's compliance officers, are they conducting training sessions in the local language so there's not a misunderstanding between the English word and local customs and language? I have found this to be an issue in many multinational corporations–disconnection and misinterpretation caused by not having the policies and procedures, the accounting manual, or the code of conduct translated into the local language. It's also important that the folks who work for you are trained in that local language.

When we think about what boards should be focusing on, there seems to be an overwhelming amount of information they need to be thinking about today, and this will continue to be an evolutionary process.

As we wrap up this segment, a couple of things come to mind. One is really understanding the tone at the top–how organizational leadership and management on a day-to-day basis communicate the values, the integrity, and what the organization stands for to all of its stakeholders, including its employees. That's critical. Part of understanding the tone at the top is the rewards system–what drives people's behavior, and is it consistent with the organization's overall mission, vision, and integrity?

Another aspect is the compliance program, and really understanding how the organization's compliance functions–legal compliance, regulatory compliance, financial reporting compliance, and operational compliance–filter down through the organization. Is it an independent function, or is it embedded somewhere where it can get lost in the shuffle?

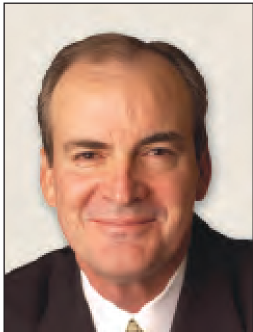
Last, boards need to understand corporate disaster recovery because that's a critical issue for the board. That includes insurance, technology, security, (both physical and information), and other major aspects for which the board needs to know how the corporation would respond in the face of a pandemic or other type of physical disaster.

Summary

In all, the responsibilities of being a board member, particularly at a multinational corporation, can at times feel overwhelming. In considering some of the challenges and related risks directors face, it is very important for boards to have an organized approach to understanding those challenges and to develop a plan to deal with each aspect of the related risk.

What Steps Can Boards Take Today to Make Them More Effective in the Future?

Our panel of board governance experts discuss key steps boards can take to ensure they are working as effectively as possible, including discussion of critical issues such as board succession, compensation, and satisfying shareholder concerns.



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What steps can boards take today to make them more effective in the future?

Catherine L. Bromilow: There are two key steps boards can take. One is to look at succession, and the second pertains to dealing with shareholders.

First, I want to take a closer look at board succession. While good nominating committees use a matrix to determine what skill sets they need on the board and who does and should fill those slots, that's typically done for the near term. They aren't necessarily looking longer term–say, three to five years out–with regard to board succession. Does the board have older directors who may be required to resign because of term limits or retirement ages? Does it have the right skills for the areas the company is moving into?

For example, in looking at the emergence of Brazil, Russia, India, and China, if those countries will have an important impact on your company, what are you doing to begin identifying people who understand how business works in those parts of the world and to recruit such people to your board? I realize it's difficult to identify those people and make the logistics work. For example, it can be challenging for a director in China to attend eight board meetings a year, plus committee meetings, considering the travel time and distance. But at some point there's going to be a real benefit to overcoming those challenges and getting the right people on your board. It would behoove boards to start thinking now about the steps they need to take from a broader perspective and over the long term to build a successful director succession plan.

The other key step relates to shareholders, and it involves the board ensuring it understands shareholder concerns and is satisfied that those concerns are being addressed appropriately. This past proxy season shareholders continued to demand action from companies on a variety of issues. It's particularly evident in the current attention to executive compensation. We don't expect that scrutiny to diminish, especially if you look at the combination of majority voting and broker nonvotes. We believe it's important for directors to stay close to shareholders and to make sure that management–despite conflicting views between the company and shareholders–doesn't build a wall. If there was ever a time to work for detente on shareholder/company relationships, it's now.

Roger Carlile: Boards should focus on enterprise risk management. Boards have come through a period of time in which they have been forced to be very reactive to risks, whether to financial reporting risks, such as in the Enron and WorldCom scenarios, or other kinds of risks. As a result of that reactive posture, studies indicate that boards have not spent as much time as they would like on strategy and operational issues. Enterprise risk management is a way to get back to the front end of risk from a proactive point of view–to look at risk in light of strategy considerations, operational considerations, and legal compliance reporting considerations and to really take control of the situation and not be purely reactive.

Going forward, enterprise risk management will become particularly important to boards for a variety of reasons. One is that it's becoming a lens through which boards are being evaluated. Standard & Poor's, for example, is now rating boards on their

enterprise risk management status and capabilities. Also, having a strong enterprise risk management program is another way in which boards may be able to diffuse or mitigate director liability. If they don't have an effective enterprise risk management process in place and some of those risks actualize, plaintiffs' attorneys, shareholders, and other stakeholders will be asking the board why it did not consider such risks in advance by having a process to identify them, assess how serious they could be as to the material and monetary risks to the company, and take action to mitigate those risks proactively. So boards are going to have to deal with this issue whether they want to or not, because increasingly, they're going to be graded after the fact on how well they assessed and managed risks inherent in their strategy and operations.

"Enterprise risk management is a way to get back to the front end of risk from a proactive point of view."
– Roger Carlile, FTI Consulting

David J. Berger: There are three steps a board should take to be more effective. First, a board should not neglect its role as strategic adviser to management. Boards have two primary functions. One is to monitor compliance with important regulations, but the other is strategic. Too much of a board's time these days is spent on compliance and regulatory regimes. Directors must also spend sufficient time reviewing and approving the company's business operations and strategic direction.

A second step boards can take to be more effective is to make sure they control their adviser, rather than having their adviser controlling them. It is critical that a board obtain advice from independent experts in areas where it lacks specific expertise. However, the board should never forget that it is in control. It sets the scope of the engagement, it requires a specific work product from its advisers, and it should be willing to question the information it receives. The board is responsible for making decisions, and advisers follow the board's direction.

The third step boards can take to be more effective is for individual directors to remember the important role they play in the board process. Boards like to act with unanimity, and the best boards are congenial, where the views of all directors are respected. If an individual director is not satisfied, either with the process or with the decision that a board is moving toward, they should feel sufficiently comfortable within the boardroom to ask questions and seek further information. That process, which should lead to more discussion and better information, is likely to produce a better result for the board and the corporation as a whole.

Jane T. Romweber: Every board and compensation committee would like to be confident that it's paying for performance, and yet every board grapples with how to set stretch goals and ensure that it's paying appropriately at each performance level. I'm going to suggest four things boards and compensation committees can do to give them confidence that they're indeed accomplishing that goal.

First, compensation committees should treat the issue of which performance measures should be used in the company's incentive plans as a separate project. While this is likely to have a direct tie to business strategy, it's also likely to encompass growth, returns, and total shareholder return in some form. Second, committees should conduct a historical analysis of how companies similar to theirs have performed over short and long periods, which will provide insight into the variability of performance over time and also what constitutes good or poor performance.

Third, compensation committees should look at what other companies are doing in terms of goal setting-information that is available for the first time through the expanded proxy disclosure rules. This will provide insight into short-term as well as long-term incentive goal setting.

Last, committees should continually reevaluate the use of time-based restricted stock, which has only a weak link to performance. Restricted stock that isn't sized-based on performance and doesn't vest based on performance really should be used only as needed for retention purposes.

Boards and committees that follow these procedures will have an excellent foundation for a strong pay for performance program.

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