

# to the *point*

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## Current issues for boards of directors

**pwc**

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Compensation continues to be under the microscope. How can companies avoid raising concerns on compensation issues for the 2011 proxy season?

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The interplay of pressure, opportunity and rationalization could create an environment ripe for fraud. This article looks at the director's role in fraud deterrence and detection.

#### *And the survey says... PwC's Annual Corporate Directors Survey*

The results of the survey are in. What are directors saying about executive compensation, risk management, board composition, influencers, and where they want to spend their time?

### The 2011 proxy season: say on pay

Shareholders have more decisions to make in the 2011 proxy season as the new say on pay votes—which are mandated by the Dodd-Frank Act—start at all public companies. Making informed voting choices will require significant research by shareholders as they study the Compensation Discussion and Analysis (CD&A) section in proxies, compare information to peer companies, and analyze pay compared to corporate performance. And given the volume of information in CD&As, it's not surprising that many shareholders will likely be guided in their voting decisions by proxy advisory firms, such as Institutional Shareholder Services (ISS). At a governance event in the fall of 2010, Patrick S. McGurn, SVP and chief counsel at ISS Governance Services, provided some insight into how ISS will craft its voting recommendations given the new say on pay vote.

ISS recognizes that its volume of work increases substantially with the adoption of say on pay. Historically, ISS reviewed compensation disclosures in a company's proxy largely to make its recommendations about the election of directors, particularly those who serve on the compensation committee. Now, ISS will have to study the pay package in light of the company's performance, its peers, and executive compensation practices, which will take significantly more time. McGurn envisions that ISS's review for the 2011 proxy season will focus on analyzing CD&A to separate companies with compensation practices that trigger concern from those that don't. The goal for many companies will be to avoid raising unnecessary concern.

So how does a company avoid triggering concern about its executive compensation practices? By:

- Using clear, plain-English to disclose the overall compensation plans—preferably in an executive summary format
- Providing an overview of how the compensation plan aligns with company performance and shareholder value
- Disclosing whether or not the company has SERPs, perquisites, or other benefits which could be outside the range some consider to be “normal”

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## Deterring and detecting fraud in financial reporting—A director’s perspective

The monumental financial reporting frauds that occurred in the early 2000s had a significant impact on business culture. Whereas once fraud was something polite people didn’t talk about, it became a matter that responsible directors had an obligation to address. This happened not only because fraud became headline news, but also because regulation around fraud prevention and detection ramped up.

The Center for Audit Quality, whose aim is to enhance investor confidence and public trust in capital markets, published a report, *Deterring and Detecting Financial Reporting Fraud—A Platform for Action*, in October 2010.

The report is based on discussions with executives, directors, audit committee members, external auditors, and others. It provides a number of ideas for mitigating the risk of financial reporting fraud, as well as suggestions for action by stakeholder groups.

What makes an environment conducive to fraud?

The report discusses three elements, that combined, increase the likelihood that people will commit fraud:

- **Pressure** occurs when people are under pressure to attain unrealistic goals, putting their career advancement, compensation and continued employment at risk. Pressure could also come from personal issues—like a sick family member or an unemployed spouse putting strain on the family budget.
- **Opportunity** exists when conditions at the company allow fraud to happen; for example, a poorly designed or weakened internal control system. Corporate downsizing in recent years may have

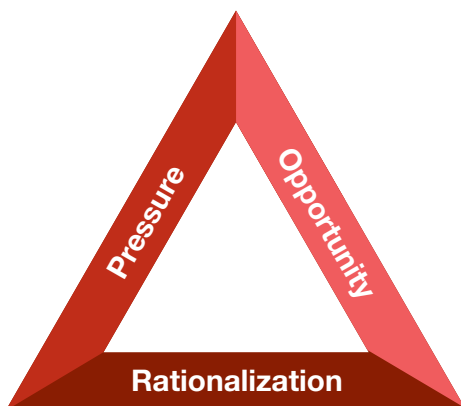
exacerbated the strain on companies’ internal control systems.

- **Rationalization** happens when people justify or excuse their fraudulent actions, which could be for personal (“I deserve this”) or business (“I did it to save the company”) reasons.

So, what is the director’s role in fraud deterrence and detection?

- Provide oversight of tone at the top. Reinforce that ethical conduct is an overriding priority. A strong tone at the top may reduce potential fraudsters’ ability to rationalize away their activity.
- Have solid knowledge of the industry/business. Understand key strategies, the business plan and performance targets, and consider their achievability in the context of current conditions, to mitigate against undue pressure.
- Understand fraud risks. Consider the extent to which executive compensation programs may have moved beyond motivating executives and employees to asserting inappropriate pressure. Downsizing that has affected key controls could also provide more opportunity for fraud.
- Maintain a healthy level of skepticism. Ask probing questions and observe “uncomfortable” behavior. Expect appropriate representations in response to questions and seek corroboration of those representations.
- Understand how any management overrides of controls are reviewed. Discuss with internal audit its procedures for identifying and reviewing such occurrences.
- Balance short-term and long-term goals. Understand how these goals are being set in the company to mitigate pressure.

Combined, these elements increase the likelihood that people will commit fraud.



## And the survey says... PwC's Annual Corporate Directors Survey on key governance issues

Over half of responding directors say that US company boards are having trouble effectively controlling CEO compensation.

Who in the governance community is not talking about executive compensation? Comparable to the impact of the Sarbanes-Oxley Act of 2002 on audit committees, the Dodd-Frank Act will have an impact on compensation committees and executive compensation practices. Results of PwC's *Annual Corporate Directors Survey* provide insights as to directors' views of sound compensation practices. The more than 1100 directors that responded to the survey ranked the following as the most important factors that compensation committees should consider to improve CEO pay policies:

- Ensure peer group companies are realistic (83%)
- Re-evaluate compensation benchmarks (82%)
- Set minimum stock ownership guidelines and/or holding periods (65%)

None of these items were included in the Dodd-Frank Act. Meanwhile, the Act includes provisions on clawbacks and compensation consultant independence, both of which were in the bottom-half of director rankings of importance. At the same time, over half (58%) of the responding directors say that, generally, US company boards are having trouble effectively controlling CEO compensation.

Other key findings from the survey:

- **Risk management:** 68 percent of directors believe their boards are effective in monitoring their companies' risk management plan, and 73% do not believe their boards should have a separate risk committee.

- **Board composition:** More than three-quarters of directors (76%) see no need to rethink the current mix of directors on their boards in light of the new proxy disclosures about director experience and skills. Further, 74% believe their nominating committee is effective at creating a board with a balance of needed skills and diversity. Sixty-four percent think racial diversity is the most difficult attribute to add to boards, followed by gender diversity (53%). However, 86% say their boards rely on existing board contacts to recruit new directors, indicating they may not be tapping more diverse resource pools.
- **Board influencers:** More than a third of directors (36%) identify institutional investors as the group most influential to their board. With say on pay effective in the 2011 proxy season, and proxy access anticipated shortly thereafter, institutional investors are poised to have increasing influence in the boardroom. It's prudent for directors to ensure management is appropriately engaging with these shareholders.
- **Board time:** Strategic planning (59%), risk management (57%) and succession planning (50%) are areas where most directors indicate they want to spend more time. This is consistent with prior survey results.

The full survey results may be found at [www.pwc.com/us/centerforboardgovernance](http://www.pwc.com/us/centerforboardgovernance).

# The 2011 proxy season: say on pay

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- Describing why the identified peer group makes sense for the company
- Discussing the independence of the compensation committee

In addition, shareholders will need to vote on the frequency of the say on pay votes. Shareholders will be asked whether they want to have a say on pay vote annually, biennially or triennially, or they can abstain from voting on frequency. While the company can make a recommendation on frequency in the proxy, it isn't required to, and indeed, some companies indicate they will make no recommendation. For its part, in its 2011 proxy voting policy update, ISS recommends annual say on pay votes.

Remember that while these votes are only "advisory," ignoring results of the shareholder vote could have implications in the future. Companies are required to disclose in the next year's proxy how they dealt with the say on pay vote in the current year. Failure to take some action after a failed pay vote could lead to shareholders withholding support in the subsequent director election.

Finally, ISS is changing another one of its policies relating to compensation. Even if a company makes a prospective commitment to change a pay practice that ISS considers problematic, ISS may still proceed with a negative vote recommendation. This could be another challenge for directors on the compensation committee.

## How PwC can help

To have a deeper discussion of how these subjects might affect your company or board, please contact:

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## You may also want to read

**2011 Current Developments for Directors** is now available to help directors understand important developments and their impact on your companies and what you do in the boardroom. This edition addresses significant corporate governance developments and includes a special focus section on building competitive advantage in a global economy.

The current issue of **Year-End Questions Audit Committees Should be Asking** is now available. The questions address the active regulatory environment and fragile economy and cover accounting and disclosure, internal control, risk management, compliance, and ongoing standard setting and regulation.

For these and other PwC corporate governance publications, visit the Center for Board Governance at <http://www.pwc.com/us/centerforboardgovernance>.