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New disclosures will impact directors

New proxy disclosure rules will provide shareholders more information about how the board operates—bringing even more focus to what you do. Directors should understand these changes and their possible impact.

Several forces at play in director elections

Changes in some long-standing governance practices like broker-voting will change the dynamics of director elections. A decline in voting due to the “notice and access” rule is also having an impact. Directors should take an active role in working through these issues.

What's up with segment reporting?

While there have been no specific changes to the literature on segment reporting, it continues to be an area of SEC focus. The goal is to allow financial-statement users to see the company as management sees it, so reported segments may need to change periodically as management's thinking changes.

New disclosures will impact directors

In December the SEC finalized rules on new proxy disclosures, which take effect in the 2010 proxy season. Preparing the new disclosures may take more time than anticipated. Given that some of the disclosures concern individual directors and the way the board fulfills its responsibilities, we expect directors will want—and need—to be involved well before the disclosures are finalized.

The new disclosures include

- An assessment of the relationship between compensation and risk across the entire business (not just within the C-suite)
- Changes in the compensation and equity awards disclosure tables
- Directors' and nominees' experience, qualifications, past directorships, and skills and attributes, as well as an expanded discussion of any legal proceedings involving those individuals
- Board leadership structure
- Board role in risk oversight
- Compensation consultant fees
- Diversity considerations in identifying directors and nominees

Among the new disclosures that will have a particular impact on directors:

Enhanced disclosures about directors and nominees: These disclosures can create reputational risk for directors, as well as for the companies they represent, affecting how shareholders perceive board members' fitness to serve. Companies may want to first describe the collective skill set required for the board to be effective. This approach can provide context for the discussion about the specific skills and experience individual directors bring to the board and how those fit into the broader picture.

In addition, directors sitting on multiple public company boards should actively coordinate these disclosures among the companies they serve, so that the information is consistent across various proxy statements.

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Several forces at play in director elections

A number of converging forces could change the dynamics in director elections. Directors should be aware of these forces and consider their impact.

One of those forces is the new rule prohibiting NYSE registered brokers from voting uninstructed shares in uncontested director elections. Why should you care? Because brokers typically vote uninstructed shares in support of the company's recommendation.

Those shares are not insubstantial. One study found that during the 2009 voting season, broker votes averaged 19 percent of total votes cast. The new rule could significantly reduce the number of shares being voted in support of a company's recommendation.

Another force affecting director elections is the impending SEC rule on proxy access. Although the SEC is expected to consider this issue in early 2010, a final rule is unlikely to take effect in time for the 2010 proxy season. Directors should nonetheless begin contemplating how proxy access will affect future elections.

With proxy access, shareholders will be able (within certain guidelines) to place director nominees in the company's proxy statement—in opposition to the board's nominees *and* at the company's expense. Currently, shareholders that wish to nominate their own candidates must engage

in an expensive proxy battle, which has limited the number of shareholders who've been willing to undertake such an effort.

The SEC's "notice and access" rule (issued in 2007) also affects proxy access. It allows companies to reduce their printing and distribution costs by posting their proxy statements electronically via their corporate websites and then mailing a notice to shareholders to inform them of the proxy statements' availability (giving shareholders the option of requesting a paper copy).

The savings come at a price: lower voter turnout in director elections—especially among retail shareholders. In fact, among retail investors, eligible shares voted dropped from 20 percent to 5 percent since the rule took effect.

The bottom line is that certain shareholders may now have even greater influence in director elections than before. How might boards address this and other election challenges?

First, by understanding whether any shareholders want to change board composition or nominate alternative directors. Second, boards should determine whether any directors or nominees are potential targets of a "withhold vote" campaign by an activist shareholder group.

It is also useful to discuss with management ways to encourage

retail shareholders to vote—perhaps by mailing physical proxies to shareholders owning more than a *de minimis* number of shares.

Other actions:

- Ask management to give the board more information about the shareholder base, which may include the voting breakdown of institutional and retail investors, what their concerns are, and the impact of discretionary broker voting on director elections. Discuss strategies for engaging with shareholders, encouraging them to vote and clearly explaining why the board's nominees are the right individuals.
- Discuss whether the company should engage a proxy solicitation firm to help secure votes on its proposals. Such firms can advise on developing a "non-objecting beneficial owner" list (which could facilitate communicating with retail shareholders) and on devising a strategy and budget for an effective campaign geared towards such shareholders.
- Understand the causes and rationale for any "withhold vote" recommendation by major proxy advisory groups. Consider whether management—or even certain directors—should meet with these firms to explain the board's position and views.

What's up with segment reporting?

Segment reporting continues to be an area of SEC focus. So what's changed? Technically, nothing, from a rule perspective. Nevertheless, the SEC continues to emphasize that segment reporting must look at the company through management's eyes.

The SEC is particularly concerned that ongoing economic conditions or business restructuring at companies may have changed how management analyzes and evaluates operations. Each year, management should consider how it assesses and talks about the company, tying that to how it defines and aggregates segments in its financial reporting.

When the SEC reviews a company's filings, it looks for inconsistencies between the text in the filings and the segment disclosures in the company's financial statements. But the SEC is looking at more than just formal filings—it's also looking at other information, including what is presented to analysts, covered in press releases, and available on the Internet.

If the SEC's review raises questions about the appropriateness of the company's segments, it may ask for copies of the complete monthly reporting package used by the chief operating decision maker (who often is the CEO or COO, though sometimes operating decisions may be made by a

senior management committee). The SEC then uses this reporting package to understand how the company is deciding resource allocations and hence whether the financial-statement disclosures are sufficiently consistent that investors and other financial-statement users can see the company through management's eyes. So, as management's view of the company evolves, chances are that the reported segments will need to evolve, too.

The identification of segments can also affect financial reporting. Each year, companies need to test the valuation of goodwill at the appropriate operating level of the business, unless there's a "triggering event" necessitating an immediate evaluation. (A triggering event is a change that, *more likely than not*, would reduce the fair value of an operating business below its carrying amount.)

The SEC may question whether an impairment charge should be recognized. It might also look at whether a company that recognized a goodwill impairment advised readers in a previous filing that such an impairment might be necessary. Companies recognizing a goodwill impairment charge would be judicious in also disclosing how the future of the business may be affected by the conditions that caused the impairment.

Key questions directors should be asking:

- Is the company satisfied that the reportable segments in the financial statements are consistent with the information management uses for decision-making?
- Are the company's disclosed segments consistent with the way management discusses the company's operations and results with the board, in the financial statements, and via other public information?
- Has the company said there's a possibility it will need to write off goodwill for certain segment(s) reported in the filings? If not, does it need to consider that possibility?
- If the company is recognizing a goodwill impairment in the current period, has it disclosed the underlying prospects for that operating business unit?

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Board leadership structure:

The question of whether to separate the roles of board chair and CEO has been debated for many years. Companies now will have to disclose the reasons for their chosen leadership structure. The SEC says that in requiring this disclosure, it is not trying to influence a company's decision about whether to separate the roles; rather, it's seeking a clear picture of how the board operates.

The new requirement is also likely to prompt some boards to reconsider which structure is best for the company. In doing so, they will probably want to take into account the skills necessary for the chair role, the company's maturity stage, the CEO's tenure, the skills of directors filling certain key roles, and the role played by the lead director (if there is one), among other factors. Companies might also choose to define what events (e.g., the CEO's departure) would

trigger the board's re-examination of its leadership structure.

Board role in risk oversight:

This is an area where some directors may be thoughtfully reconsidering their roles. In making the new disclosures about its oversight of risk, the board should discuss not only the risks it oversees, but also its process for reviewing those risks and the adequacy of the information it receives.

The board also might consider formalizing which risks should be overseen by the full board, on the one hand, and by individual board committees, on the other, with a clear process for how those committees report back to the full board on the major risks under their purview.

Further, the new SEC rule says that companies may want to either consider disclosing whether the individuals who manage risk report directly to the board or a

board committee or, alternatively, consider describing how the board or committees receive information from those individuals.

Director diversity: Companies will have to disclose whether the nominating committee considers diversity in potential director nominees and, if it does, how it goes about that. If the company has a diversity policy, it must disclose how it's implemented and assessed for effectiveness.

The rule allows each board to define "diversity" as it sees fit, whether it be on the basis of gender, ethnicity, knowledge, experience, education, geography, skills and abilities, or other characteristics that are meaningful to the company. Ultimately, boards may find that defining diversity and including it among the skills and attributes used to assess director nominees could bring additional perspectives to the board.

How PwC can help

To have a deeper discussion about how these subjects might affect your business, please contact:

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You may also want to read

The 2010 edition of *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. Key areas of focus in the current edition include the economy, governance changes, global tax issues, financial reporting, and regulatory developments, as well as a special focus on government involvement in business.

The current issue of *Year-End Questions Audit Committee Members Should Be Asking* is now available, covering topics of particular importance for the 2009 reporting cycle. The questions are intended to be in addition to the more comprehensive questions the audit committee routinely asks management and the auditors.

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