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From the Field: Weeding
by Eleanor Bloxham

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I am in Ohio and it is proxy season so I've been reading.

In proxies, as in some boardrooms, it seems politeness and reserve continue to trump frank and plain speaking.

Dandelions in the Fields of Financial, Strategic and Risk Oversight

"To be frank, we (directors) simply don't know enough about what's going on in the company." (NACD Directors Daily, March 26, 2010; *Comment from a director attendee,* Highlights from the 6th Annual Audit Committee Issues Conference: Setting the 2010 Agenda, KPMG, February 2010)

Is this true on the board on which you sit – or invest in? *How well do boards understand the information they receive? Can a board make excellent decisions with information that is less than excellent? Can management make worthwhile recommendations? Can the board meet its disclosure obligations with less than excellent information?*

And yet… it's springtime … and love is in the air according to a recent article, *Relax, Your Board Loves You* (CFO Magazine, March 1, 2010) which presents the results of a survey conducted by CFO Research Services on behalf of accounting and consulting firm Crowe Horwath.

According to the survey**, 1 out of 2 senior finance executives *do not* believe the Board understands the business performance information** that finance provides to the board. And almost 1 in 6 board members surveyed serve on boards where they don't believe the Board understands the business performance information it receives.

That means, if senior finance executives are right, and are in agreement with board members, then on **1/3 of all boards**, board members *don't* understand the business performance information they receive from Finance – but **don't know that they don't understand**. (1/2-1/6 = 1/3)

Can the numbers be this high? Is there other evidence from the survey that boards ***may not*** *understand the business performance information provided?*

One piece of evidence: **On every dimension rated, Board members believe the information they receive from finance is better than Finance believes it to be.**

This suggests that boards are not aware of the validity of what they are reviewing.

My concern for directors is noted in the title of the article: if finance executives *relax* because the board *loves* them, who will rush to disabuse the board of false optimism concerning (a) the quality of their understanding and (b) the quality of the information they are receiving?

Directors must step into the breach.

What some directors may not recognize from a liability and good governance perspective? As a director, you can rely on information provided on which it is reasonable to rely – but *not on information on which it is not reasonable to rely.* After all, how reasonable is it to rely on something on which it is not reasonable to rely? *Not very*.

Board members have a positive responsibility to do all they can to ensure that that on which they rely is reasonable to rely upon. How reasonable is it to rely on certain information? Here are highlights from the study.

GAAP reporting: According to the survey, *almost one in five - 19% of board members do not think the GAAP reporting provided by finance is "excellent" and* ***almost one in three -- 32% of financial executives*** *do not rate GAAP reporting as excellent.*

Information that drives strategy: Can the board rely on the information that drives strategy decisions? 80% of board members (and 84% of financial executives) do not believe the competitive analysis and benchmarking information the board receives from finance is excellent. Business performance forecasts not excellent? 63% of board members and 79% of finance executives rated them not excellent.

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Risk in the spotlight: Comprehensive risk tolerance and exposure reporting not excellent? 77% of board members and 87% of finance executives say so. Risk assessment and related reporting not excellent? 71% of board members and 84% of finance executives say so.

Investor and litigation hot buttons: M&A and divestment analyses not excellent? 57% of directors and 77% of finance executives say so. Compensation reporting provided by finance not excellent? 56% of directors and 74% of finance executives say so.

Board solutions to these dandelions? Review the morale issues and hiring needs of finance. Are they overworked and understaffed? (See the March 9 digest, STRATEGY AND RISK: The Underemployed, Unemployed and Overemployed: Employee, Customer and Community Impacts p. 1 - 2. http://www.thevaluealliance.com/PDF/CGADigest030910.pdf)

Hold the CEO, CFO, Independent Chair or Lead Director, and Audit Committee Chair accountable for getting GAAP reporting and critical decision making information to the level of excellent.

Snapshot *	**Senior Finance Executives**	**Board Members**
Do not believe board understands business performance information	1/2	1/6
Reporting/Information Is **Not** Excellent:		
GAAP	1/3	1/5
Compensation	75%	55%
Strategic and M&A, divestment	75–85%	55–80%
Risk	85%	70–75%

* Numbers are approximate or rounded to nearest 5%

Every director should be asking: with this level of less than excellent information, can management really be making the right recommendations on strategy and tactics in this competitive environment? Can we as a board truly evaluate management's recommendations appropriately with this less than excellent information? Are we having frank and direct conversations about the adequacy of our understanding as a board and about the information we all rely on?

Perhaps, the less than excellent strategic, risk, M&A and divestment information boards appear to be receiving helps to explain why, based on the research, shareholder activists are able to create significant value in these areas when they engage with companies. (See the March 9 digest, STRATEGY AND RISK: Lessons for Boards from Successful Shareholder Activists p. 2 - 3. http://www.thevaluealliance.com/PDF/CGADigest030910.pdf)

Engage in stronger reviews with tougher questions on current reporting. Have frank and direct discussions that eschew a self-defeating reserve. Until they can be improved, weed out bad reports or portions of reports where the results are unreliable – and may provide a dangerous, false sense of security.

Make the expectations for membership on your board clear, including the requirement that members understand the business performance issues and reports. Include this as a dimension on your annual self-evaluation.

Encourage regular feedback from executives on the board's understanding and consider engaging in an anonymous 360 review from executives and finance staff on their perception of the board's understanding of the various reports and subject areas. (We like boards to do these in the independent evaluations we provide.)

If board members lack a thorough understanding in certain areas, look for some new approaches. Try new independent, outside parties for director education to help the board close gaps in understanding. Revitalize director succession planning and exit strategies as needed to shore up skills and beef up the number of analytical personalities and those willing to engage in frank, plain speaking.

Also, be aware of the way in which information is presented to the audit committee -- and to internal and external auditors -- and the issues that could impair judgment as a result.

Here are some interesting findings from recent research.

One recent study showed that "when auditors are initially exposed [to] more ambiguous information, they are less likely to ultimately identify the error". (http://ssrn.com/abstract=1113496 , The Impact of Initial Information Ambiguity on the Accuracy of Analytical Review Judgments, Luippold, Kida)

Another study showed that a management diversion to look at error free accounts causes auditors to miss earnings management issues elsewhere. In fact, this study showed that with no management interference, *surprisingly,* over *2/3 of the time, auditors were unable to uncover earnings management issues – and over 90% of the time auditors were unable to uncover the error* if they were diverted by management to look at reliable accounts. (*Now You Don't See It*, Sarah Johnson, CFO Magazine, March 1, 2010; http://ssrn.com/abstract=1424004 Managing Audits to Manage Earnings: The Impact of Baiting Tactics on an Auditor's Ability to Uncover Earnings Management Errors, Luippold, Kida, Piercy, Smith)

Manage the presentation of content rather than be managed by it. Make sure internal and external auditors are properly trained, and weed out and replace ineffective internal and external auditors with more effective ones: the top 5% *who will* spot the issues.

Why wait for a case to be brought to find out the board didn't really understand -- and perhaps management knew it all along? Start weeding now.

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As discussed in the April 2004 digest, p.3 http://www.thevaluealliance.com/PDF/CGADigest%20041104.pdf , the July 2006 digest, p.3 http://www.thevaluealliance.com/PDF/CGADigest072406.pdf, the December 2008 digest, p.4 http://www.thevaluealliance.com/PDF/CGADigest122908.pdf and most recently by James McRitchie, CEO of corpgov.net in a report issued March 2010 by Corporate Secretaries International Association http://www.csiaorg.com/pdf/research_paper.pdf, directors have a duty to ensure disclosures "fairly present" the business -- not just invoke "don't ask, don't tell". (http://tcbblogs.org/governance/2010/03/25/tricker-led-corporate-secretaries-group-issues-20-ways-to-fix-governance/, Conference Board Blog, Larkin, March 25, 2010)

Is your board discussion reserved – or frank – related to this issue of fulsome disclosure? To make strategy decisions -- and to *fairly present*, it is imperative that boards understand the business performance of the companies they oversee.

Weeding through the Disclosure Requirements on the Riskiness of Compensation and the Board's Role in Risk Oversight

Based on my discussions with directors over the past couple of months, questions seem to remain on how to handle the new disclosure responsibilities of the US SEC, especially and including the requirements with respect to compensation and risk – and risk oversight by the board. And in my review of some recent proxies, it is clear that on some boards, less diligence is occurring than is warranted given the board's responsibilities for oversight of public disclosures.

The January digest on pages 1-2, http://www.thevaluealliance.com/PDF/CGADigest010510.pdf provides a thorough review of what *must* be disclosed and some questions savvy boards would want to ask and answer for shareholders.

Compensation and Risk. This is an important area for boards to understand.

The top D&O insurers look strongly at the risks that arise from the company's compensation programs as part of their overall risk reviews. They recognize that compensation programs *can* be a red flag to other issues and a red flag in front of the charging bull of shareholders and plaintiffs.

Thus, at least to top D&O insurers, compensation programs do indeed have the potential to create material adverse risk.

In reviewing prospective clients today, top D&O insurers ask questions such as: If a board is ineffective in holding down the level of compensation, how effective is it in other areas of oversight? If a company is willing to ignore shareholders on pay issues, what are the implications in terms of other important areas of shareholder relations? Where else may they "care less" than they should?

Clearly, compensation programs can adversely impact a company's reputation with the public, its internal culture and decision making, its relationship with investors and regulators, and the likelihood that the company will face major litigation or regulatory action.

The salient questions are to what extent do these relationships matter to the company -- and to what extent are the compensation programs likely to create material adverse risks in these areas? Is your board discussion polite and reserved – or direct and plain spoken – related to the impacts of its compensation programs?

Here are some concrete examples based on past evidence and research studies.

Does your compensation program contain high levels of equity components? "There are several problems, of course, with tying pay to stock price… The stock price ... is forward looking. It represents the market's beliefs of what the company will be able to achieve in the future." (Economic Value Management: Applications and Techniques, Bloxham, 2002, Wiley, p. 35) "Stock based compensation is an incentive to increase expectations not performance." (*The Wrong Incentive*, Martin, Barron's, December 22, 2003) "Experts and evidence now place a large part of the blame for financial scandals on the excessive use of stock options and **stock-based compensation**." (Emphasis added, *Three Myths of Management*, Pfeiffer and Sutton, March 27, 2006, Harvard Business Working Knowledge http://hbswk.hbs.edu/archive/5270.html which was excerpted by permission of Harvard Business School Press from *Hard Facts, Dangerous Half-Truths, and Total Nonsense: Profiting from Evidence-Based Management.* Copyright 2006 Jeffrey Pfeffer and Robert I. Sutton)

Does your compensation program use earnings based measures like EPS, which have been shown to increase the chances of earnings manipulation in cases of the last decade? Just type in "earnings per share" and fraud into Google to see the plentiful examples and search on "earnings per share" and manipulation to see the warnings to investors.

How frank and direct are your board's discussions on the evidence related to both these ubiquitous approaches to compensation? Equity based compensation and measures like EPS are just two examples of ways in which common compensation structures and metrics can adversely impact, in a material way, the risks that managers may be willing to take.

The SEC has suggestions also related to compensation, risk and behavior. Material adverse risks could arise (1) **if the time horizon for the incentive is less** than the time horizon for the full costs and benefits of the employee actions to be realized (because this might incent short sighted risk taking) (2) **if pay is high vis–a-vis revenues** (because it might provide too great an incentive to do risky business) and (3) **in business units that are risky** and may carry a lot of the company's risk (the MD&A can be a clue here) (because if a business unit is risky and pay is rewarding employees for that business, it may be incenting employees to increase the risk of the firm).

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Boards need to seriously consider how to disclose the risks in the compensation programs in a way that accurately reflects the potential for material adverse risks. How much time has your board given to open and clear thinking discussion on these topics? Clearly, it is an area of importance and a discussion worth having in-depth.

The Board's Role in Risk Oversight. The new SEC guidelines require disclosure concerning the board's role in risk oversight. Based on my reviews of the proxies, in their disclosures, many boards may not be adequately considering the material *risks that arise from the board's own activities.*

The activities reserved for the board itself (related to M&A decision making, succession planning, financial reporting and audit oversight, strategic oversight, executive and director compensation, etc.) raise the potential for serious risks to the organization.

Has your board engaged in a straightforward discussion of these risks?

Who provides oversight with respect to these? What is the role of the board or its committees in oversight of risks created not by management or employees or external circumstance but the *potential material risks to the organization created by actions (or inactions) of the board itself*?

For example, what are the roles of the individual committees in oversight (self-policing) and of the governance committee more broadly related to material decisions by the board? Does the board ensure its members are educated and fully informed? How so?

As part of the annual evaluation of the board, does the board do what we recommend our clients do and seek to identify the risks it may be creating by soliciting the anonymous opinions of management and outside advisors (auditors, consultants) on board effectiveness and the potential risks created by its decision making processes?

Does the board engage in *independent* evaluations of the board and its activities? Do the charters and job descriptions spell out directors' responsibilities in overseeing potentially material risks of board activities? Does the board encourage the views of regulators, of independent analysts or investors?

On an ongoing basis, how does the board monitor its own risk taking? Does it request feedback and follow-up on the risks created by the decisions it makes, etc.?

What is the board's contribution to risk – and understanding its own role in creating and ameliorating risks? Given the importance of board decisions, these are important areas of risk oversight for the board to address.

In an upcoming digest, we will tackle some of the detailed steps boards need to take to address the issues covered in this edition. In the meantime, do not be silent, but speak frankly and plainly, weeding through the fields with a clear understanding of the importance of your role in the economic eco-system.

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