THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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Many thanks to all the people and for all the articles that inspired this edition of the Digest.

Published by Eleanor Bloxham, CEO of The Value Alliance and Corporate Governance Alliance, a board and executive education, information and advisory firm, and John M. Nash, President Emeritus of the National Association of Corporate Directors, below are complimentary summaries of up to date news, information, insights and perspectives on issues in value and corporate governance.

THE CHALLENGES IN A DOWN ECONOMY by Eleanor Bloxham

For Boards, Policymakers, Institutional Investors and Everyone

Prelude

The opportunity of this down economy has been to tangibly demonstrate (in the financial services sector and elsewhere) that responsively accepting what everyone else is doing as best practice (in oversight, in strategy, and in compensation) is not the best practice -- and to reassert the opportunity to instead make the choice to wake up to new possibilities.

En masse, "we should experience 'the current crisis' as 'a gigantic wake-up call.'" (Wall Street Journal, Noonan, 12/19/08) It should awaken our curiosity; it should cause us to ask better questions and find different answers. It's a call for reflection and a call to action -- for everyone --to do their parts and to accept their responsibility, with compassion for others and themselves.

What we see now in the current crisis, we have seen before. As in the childhood game, the music has paused and the scramble for chairs makes it clear, once more, how much we need to ensure strong, sturdy chairs and a seat at the table for all stakeholders.

For members of boards of directors, for policy makers and institutional investors, for everyone, it's time to pause and ask: *What lilting music, what siren's song (may have earlier) distracted me? And most importantly, how can I now contribute in ways that will help rebuild and restore the world economy?*

The July 24, 2006 issue of the Digest http://www.thevaluealliance.com/PDF/CGADigest072406.pdf discussed renewed efforts over the last decade to re-emphasize the long term because of the persistence of the siren's short term song which sings in good times *let's just keep this momentum going*.

Michael Useem states that the U.S. needs "a cultural shift to better emphasize long-term issues" and that "rebuilding the national culture [is] absolutely vital." (Knowledge at Wharton, 12/10/08)

He's right.

A recent article on our brains and how they work seems fitting to describe the challenge we face in re-wiring our orientation: "We are easily distracted … because we vastly overvalue what happens to us *right now compared with what comes in the future* and because novelty is intrinsically rewarding." (italics added) (Wall Street Journal, Chabris (Klinberg), 12/15/08)

"We live in the age of distraction. Yet one of life's sharpest paradoxes is that your brightest future hinges on your ability to *pay attention* to the present… *We become mindless*, Langer explains, *because once we think we know something, we stop paying attention to it*." (italics added) (Psychology Today, Dixit, Nov/Dec 2008)

Paying attention creates the best possibility for conserving time in the long run *and* creating the future we want.

Despite the challenges, we can re-wire. Rather than create the chance to see this all again, we have the opportunity in our intentions and choices in each moment to set the course for real long term success.

The Challenge for Boards

Martin Lipton has discussed a "board-centric" vs. "shareholder-centric" model of governance and states 'At its core, the board-centric model of governance is premised on the notion that boards merit the vote of confidence of shareholders and the public markets.' Jim Kristie asks: "Now, the big question: Will this financial crisis doom the appeal of maintaining the board-centric model?"…"What conclusion can one draw other than that shareholders must push for a more shareholder-centric model of governance? The human organism does what it has to do to survive…" (Directors and Boards, Kristie, 9/30/08)

The challenges for boards in this down economy are to awaken to the central roles they play and to become curious about *the limits of standard "best practice"* and about finding more effective ways of:

- Choosing board members and holding them accountable
- Hiring, motivating, compensating and holding executives accountable
- Increasing executive and board competency
- Improving the understanding of shareholder and stakeholder concerns
- Reviewing the numbers, strategies and risks, and adding value to corporate performance

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Reviewing best *principles* (not "best practices") will help engaged boards shape, innovate, re-energize, and re-vitalize their practices in ways that move beyond checklists -- to support stronger companies and economies. Reviews of the OECD principles are a great place to start to get back to first principles. http://www.oecd.org/dataoecd/32/18/31557724.pdf

Because the effectiveness of the board is critical to the efficacy of management oversight and to positively influencing a future orientation, seeing unlikely opportunities and encouraging sustainable innovation, the challenges for boards in a down economy are innovation and enhancements in *their own* competencies and processes which will translate into better run firms.

To accomplish these goals requires an inquiring re-look at both technical issues -- and human behavioral issues.

On the issue of human behavior, in a down economy, *understanding human behavior*, emotion and motivation (our own as a board – and that of others) and *how that modulates in good times and bad* is key.

The challenge that boards face in a down economy (and always) is that boards need to find ways to confront issues *early on* (when they feel that first tug or question) with a calm, rational approach. Curious boards will be asking:

- Do we feel that first tug or question early enough?
- If not, does lack of technical knowledge or information hold us back?
- What do we need in order to see the early signals?
- Does our boardroom culture give us an irrational confidence in the group's wisdom?
- Are our analytical, skeptical, curious brains fired up or powered down by our board service?
- Do we have the right people in the room to make it happen?
- Is the boardroom culture supportive of the innocent question – the vital one - which can stop the dominos from falling – and create better outcomes?

Disclosure and transparency will be important in restoring trust in the capital markets. *

Curious boards will:

- Review disclosures to make sure they contain detailed information on how accruals or estimations have been calculated and provide answers that explain:
  - (a) How the estimations and calculations have been determined: what algorithms have been used
  - (b) How the estimations and calculations may have changed over time
  - (c) What range of estimations or calculations might also have been used and what results would be on that basis
  - (d) Why the financials use the estimations and calculations they use rather than other ones
  - (e) What the financials would look like without a change in the accrual or estimation amount period to period and how that would impact investors' read of the financials: in other words, what unwinding the changes would do to the financial results of the firm

- Ensure they provide the information to be able to compare results period to period in order to explain the impact of financing and M&A decisions on reported earnings. including
  - (a) How earnings would have compared period to period before the financing or government cash infusion, before a merger, purchase or sale
  - (b) What risks have increased or decreased from the decisions that were made
  - (c) What have been the income and balance sheet impacts of these decisions

Compensation will continue to be a hot button issue.

A wide majority of most groups (including directors) agree executive compensation is too high. 94% of attendees at the 2008 NACD Corporate Governance Conference in October generally believe the level of compensation for CEOs of major U.S. corporations, relative to performance, is too high. (Financial Week, Rummell,10/22/08; NACDFocalPoint, 12/17/08) "The Corporate Library…found that only six of last year's 30 highest paid chief executives [i.e. only one-fifth] had a better five-year track record than their peers when it came to delivering shareholder returns." (Washington Post, Landy, 12/21/08) **

The challenge for boards will be to develop a curiosity about pay for *performance* far beyond current levels. Equilar reports that *less than 5%* (specifically 4.3%) of its custom research inquiries last month were on *performance* metrics. (Compensation Insights, December 2008)

The challenge for boards will also be to develop a curiosity about the motivational impacts of highly differentiated pay structures -- on employees and executives alike – and the behaviors these pay structures create. Equilar reports that *less than 5%* (specifically 2.2%) of its custom research inquiries last month were on internal pay equity. (Compensation Insights, December 2008)

Beyond simply responding to the *level of pay* in a down economy, the challenge for boards is to take this opportunity to go deeper:

- To develop much more curiosity about compensation -- and *how and why* it motivates
- *To identify the type of executives* motivated intrinsically rather than those that *require* high pay to be motivated.

The challenge will be to curiously re-examine executive compensation from the eyes of stakeholders <u>and</u> to understand the motivational impacts of different pay programs, more deeply and beyond the current level of discourse.

Curious boards will be asking:

- What can we change about our committee and our current compensation consultant relationship to create a more effective partnership in controlling costs and incenting the performance we want in a way that aligns pay with performance?

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- If we were to be able to find candidates for our executive positions who value our mission more than money, what motivators would work best for them?
- What metrics tied to pay would reinforce the values we espouse?

The next frontier: a real relationship between pay and values.

Besides the standard reasons, i.e. unfairness and misalignment, for conflagrations over executive compensation payments and perks, if we dig deeper, compensation is also a torch point because at its core, compensation is a public statement about what is important.

Compensation defines the character of the company by defining its values in tangible terms: what it is willing to pay for. Unfortunately, up until now, the reality is that most U.S. practices regarding what companies are willing to pay for are like most every other U.S. practice.

The economic crisis has raised louder questions about pay and its impacts on motivation and behavior. (For example one question commonly raised is w*hy were excessive risks taken*?) The economic crisis has brought to the forefront the reality, however, that in defining their pay philosophies, most boards have been about as thoughtful as the board next door – and most stakeholders – as exemplified by 94% of the NACD Conference attendees - agree that level of oversight and insight must be improved.

Although powerful government and investor intervention in the area of executive compensation is more than likely, insights into business context and human nature, influencers, and character will be critically important to shape compensation regimes that do their job in both the public and private interest. And the level of insight required necessitates new thought and introspection.

For any board considering its pay practices in value and performance terms, the character of its company and what it is willing to pay for, here are some uncomfortable (but necessary) questions to address.

Under our current system, would executives receive pay for:

1. Profits made, which were not in the best interests of customers (for example, as we've seen in some financial services firms with both institutional and individual clients -- or in other products that harm the customer)
2. Profits made, which were not in the best interests of investor rights and the capital markets generally (for example, as we've seen in some investment banking businesses)
3. Profits made, which are not sustainable
4. Profits made, without recognizing the risks taken or the other follow-on impacts in generating those profits
5. Profits made, with no recognition of the capital required to generate them
6. Profit made or increased, by laying off employees or eliminating or reducing their hours, pay, healthcare or retirement benefits
7. Profit made or increased, that others, not they, were responsible for (for example: changes in accounting or in governmental tax policy)
8. Profits made, through actions which hurt the community, country or world (for example: environmental damage or other actions that harm)
9. Stock price increases, which are not sustainable
10. Stock price increases, which are driven by investor demand, unrelated to the executive's real creation of long term sustainable value

And *how should we change how we pay to better reflect our values and true pay for performance*? ***

The push for and adoption of changes to pay plans related to numbers three and nine above are already underway with murmurings on number four. (See the November 15, 2008 Declaration of the G-20 Summit on Financial Markets and the World Economy http://www.whitehouse.gov/news/releases/2008/11/20081115-1.html.)

In the years ahead, government and investors will be asking and answering more and more of these uncomfortable questions if boards do not. The challenge for boards will be whether they will ask these questions first and effectively answer them – or wait for the answers to come from outside.

While whether or not the labor market for corporate executives is a competitive one can be debated, the current down economy provides a unique opportunity to structure pay programs that recognize the true values of the company -- aligned with the statements the company wants to make about itself -- and what it is willing to pay for.

It is time now for introspection, insight, schooling, and understanding so that the solutions (whether by government, investors or the board) reflect the scalpel of a surgeon rather than the axes or hatchets of those who understandably want change. The challenge for boards will be to make *significant* changes to compensation philosophies and practices that will improve the 94% (self-disapproval) score.

The Challenge for Policymakers and Enforcement Agencies

"Federal officials are bringing far fewer prosecutions as a result of fraudulent stock schemes than they did eight years ago"… According to Arthur Levitt: "'As an overheated market needed a strong referee to rein in dangerously risky behavior, the [SEC] commission too often remained on the sidelines'" (New York Times, Lichtblau, 12/24/08)

The importance of an effective, working chair at the table for government has come into sharp focus with the meltdown and Madoff scandals. ****

The challenge for policymakers and enforcement agencies will be in developing a curiosity to find more effective ways of:

- Developing analytics for decision making purposes and priority setting processes that work
- Enforcing existing regulations – and determining the right mix (in the public interest) of public enforcement and private litigation/action

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- Determining the long term impacts of their actions on the economy as a whole
- Defining public goods and how best to protect and enhance them
- Creating a governmental culture which encourages the exploration of new ideas
- Increasing their own competency and holding themselves accountable

The challenge for policymakers in this down economy will be to not only create the governmental and legal frameworks for success and innovation in the economy but also to explore innovation in their own competencies, practices and analytics which will make their efforts effective.

"The challenge the S.E.C. faces is not adopting new, or better, regulations for the financial markets. The astounding fraud perpetrated by Mr. Madoff was not the product of a lack of regulations — Rule 10b-5 does quite nicely covering every type of fraud imaginable. Ms. Schapiro has to defend the S.E.C. from outside pressures to go easy on those who violate its rules…Enforcement does not come from the top down, but the culture of the agency does emanate from the commissioners and its division heads." (New York Times, Henning, 12/22/08)

The role of government will be an important area for debate.

Despite the loss of trust in the capital markets, there are still some who are calling for the dissolution of the PCAOB -- and while at the same time calling Sarbanes-Oxley "inadequate", suggest companies should be able to opt-out. (Forbes, Niskamen, 12/17/08)

For policymakers and enforcement agencies, a review of sections 302, 401, and 702 of Sarbanes-Oxley and how guidance and enforcement could be more efficacious should receive a high priority. http://www.accountability-central.com/single-view-default/article/accountability-and-sarbox-coffee/?tx_ttnews%5BbackPid%5D=1735&cHash=aaa20b1e54

Section 302 "Corporate Responsibility for Financial Reports" states that corporations should ensure: "the report does not contain any untrue statement of a material fact or omit to state a material fact…" (Section 302 (a) (2)) and "fairly presents in all material respects *the **financial condition*** and results of operations of the issuer". (Section 302 (a) (3)) (italics added) A "déjà vu all over again" statement in the November 15, 2008 Declaration of the G-20 Summit on Financial Markets and the World Economy re-iterates the Sarbanes-Oxley language. In the agreed upon "Common Principles for Reform of Financial Markets", the G-20 signers state: "We commit to implementing policies consistent with the following common principles for reform…Strengthening Transparency and Accountability: We will strengthen financial market transparency, including by enhancing required disclosure on complex financial products and ensuring *complete and accurate disclosure by firms of their **financial conditions***." (italics added) (It also states: Incentives should be aligned to avoid excessive risk-taking.)

"Disclosure of financial condition" and "meets accounting requirements for financial statement reporting" *are not equivalent* and the economic crisis has clearly demonstrated that. Policymakers and enforcement agencies need to address how to provide guidance and enforce this provision so that in restoring the capital markets the wide spectrum of issues associated with ***financial condition*** are disclosed in corporations' reports as Sarbanes-Oxley intended and the new G-20 agreement intends. (See also the call to address this issue in the July 24, 2006 issue of the Digest http://www.thevaluealliance.com/PDF/CGADigest072406.pdf)

Section 401 of Sarbanes-Oxley entitled "*Enhanced Financial Disclosures*" deals with the reporting of ***off- balance sheet** and special purpose entity liabilities*. (italics added) The November 15th Declaration of the G-20 Summit on Financial Markets and the World Economy re-iterates this language: Accounting standard setters should significantly advance their work to address weaknesses in accounting and disclosure standards for ***off-balance sheet*** vehicles. (italics added)

Again the question for policymakers and enforcement agencies is how to provide guidance and enforce what Sarbanes-Oxley intended and the new G-20 agreement intends so the issue is finally addressed.

Section 702 deals with "Commission Study and Report Regarding ***Credit Rating*** Agencies". A "déjà vu all over again" statement in the November 15, 2008 Declaration of the G-20 Summit on Financial Markets and the World Economy re-iterates the Sarbanes-Oxley concern: "Regulators should take steps to ensure that ***credit rating*** agencies meet the highest standards of the international organization of securities regulators and that they avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products. This will help ensure that credit rating agencies have the right incentives and appropriate oversight to enable them to perform their important role in providing unbiased information and assessments to markets."

Early in December, the SEC passed rules that address some of the concerns, particularly related to conflicts (Bloomberg, Westbrook, 12/3/08) and policymakers need to continue the work so that the issue is finally addressed.

In addition, they need to consider more generally the accuracy of credit rating agency appraisals and the impacts that credit rating agencies can have on economic investment and productivity.

Many corporations and tax-exempt organizations, unfortunately, have experienced issues with rating agencies due to rating agency analysts who do not understand the economics of the particular business they are rating. Because of their lack of understanding, these analysts encourage companies to maximize certain ratios the analysts think are important despite the fact that maximization of these ratios by companies is often *not good* for the long run economic health or productivity of the business.

Companies, which are seeking to placate the rating agencies to obtain lower costs of capital, take actions to maximize ratios the rating agencies think are

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important, but which do not serve the corporations or their investors or creditors in the long run. Companies end up maximizing a ratio, resulting in a non-economic decision, which could be avoided by addressing the "***accurate means of appraisal***" of credit ratings which Section 702(a)(20 (B) of Sarbanes Oxley was seeking to address.

Other issues of disclosure for policymakers and enforcement agencies include nominations disclosure (how members of the board are really chosen) – and executive compensation disclosure including disclosure about compensation design and its impact on ***financial condition*** and long term outcomes. (See http://www.sec.gov/rules/proposed/s70306/ebloxham041006.pdf)

The Challenge for Institutional Investors

The challenge for institutional investors investing in the public and private markets on behalf of corporations, funds, and individuals will be to *add real value* in the investment process – and to change and adapt to the shape and mix of organizations that will require funding 10 – 15 years from now.

The opportunity of the meltdown has been to again demonstrate (as the tech bust did) the lack of useful information (other than about stock "consumerism") embodied in short term market prices.

To add value, funds and institutional investors must either seek to improve the functioning of companies and financial practices -- or to actively allocate capital away from companies and financial instruments that do not have the corporate governance and structures to support long term value. Resisting the temptation to adopt a "no one could have known" mantra along with intensely curious learning will be required as those that entrust their welfare to them will increasingly hold them accountable.

The challenges for institutional investors are to become curious about finding more effective ways of:

- Understanding the kinds of corporate governance structures and financial instrument properties that create long term value
- Understanding whether those structures and properties exist in the assets they choose
- Structuring their own compensation based on sustainable long term results, not short term annual jumps
- Understanding the impacts of their actions (and inactions) on the capital markets and on the other stakeholders in the economy and holding themselves accountable

The Challenge for the Audit Profession

"The eight largest U.S. accounting firms continue to exhibit substantial deficiencies in their audits of publicly traded companies of all sizes—partly because of a lack of care and professional skepticism"… "the Public Company Accounting Oversight Board said the accounting firms' deficiencies included 'critical and high-risk parts of audits,' such as revenue, fair value, management's estimates, and the determination of materiality and audit scope." (Financial Week, Roland, 12/5/08)

Working on these issues should receive top priority by all those concerned with audit quality.

The Challenge for Compensation Professionals

The "say on pay" movement is expected to gain momentum during the 2009 proxy season and legislation requiring say-on-pay votes at public companies is likely to be introduced in Congress next year. (Washington Post, Landy, Heather, 12/21/08)

The challenges for compensation professionals will be to remain relevant as the changes in compensation accountability occur, including say on pay. Executive compensation professionals who want to contribute to the solutions will take the opportunity of the current crisis to re-examine their current thinking and explore shifts in thinking about who they are there to serve and what is required to serve the greater good.

For Everyone

For everyone the challenge will be to recognize that this is about all of us. The challenge will be to stay awake -- and to not keep silent out of fear, to stop protecting what was, and to actively search out insights, to remain curious -- and apply those actions first to what we ourselves can do.

For everyone the challenge will be to focus on the inputs of our decision making and our use of those inputs i.e. expanding whom we listen to and what we do with what we have heard.

The general public was better at predicting the recession than economists or CEOs. CEOs "were overly optimistic" and economists were afraid to make a mistake or "be the bearer of bad news". (Financial Week, Roland, 12/17/08)

There are many issues in the way humans make decisions and to improve outcomes those processes need to be addressed.

Thinking with fewer biases provides insight and allows new opportunities to become visible. Paying attention is key. Steve Walton states: "Even when you know about biases [in your thinking processes], you have to *act intentionally to overcome them.*" (Knowledge@Emory, 12/11/08) (italics added)

If we can all conquer that, we'll have a sure recipe for success.

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* Both "transfer pricing" i.e. the allocation of profits to geography in the financial statements and "tax disclosures" can be difficult but important issues for boards to monitor and oversee with respect to disclosure. Goldman Sachs has been in the spotlight as it reported that its "effective income tax rate dropped to 1 percent from 34.1 percent" stating that it was due to "more tax credits as a percentage of earnings and because of 'changes in geographic earnings mix'". (Bloomberg, Harper, 12/16/08) Goldman Sachs has responded to queries by stating "We incurred substantial losses in our principal investing businesses in higher tax jurisdictions (like the U.S.), and these

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losses were responsible for our abnormally low tax rate"…"We have no meaningful income in low tax jurisdictions." (Financial Week, Fink, 12/23/08)

** Other current issues: "Banks that are getting taxpayer bailouts awarded their top executives nearly $1.6 billion in salaries, bonuses, and other benefits last year, an Associated Press analysis reveals." (Associated Press, Bass and Beamish, 12/21/08) At the same time, "The rolls of companies nipping at labor costs with measures less drastic than wholesale layoffs include Dell (extended unpaid holiday), Cisco (four-day year-end shutdown), Motorola (salary cuts), Nevada casinos (four-day workweek), Honda (voluntary unpaid vacation time) and The Seattle Times (plans to save $1 million with a week of unpaid furlough for 500 workers). There are also many midsize and small companies trying such tactics…[but] these efforts are far less widespread than layoffs." (New York Times, Richtel, 12/21/08)

*** Economic Value Management: Applications and Techniques discusses ways to address many of these pay for performance questions and the stakeholder- related issues of corporate oversight. (Wiley, Bloxham, 2003)

**** Other recent examples of the need: Re: the bailout:"lawmakers included a mechanism for reviewing executive compensation"; however the insistence of a last minute change by the administration has "effectively repealed the only enforcement mechanism in the law dealing with lavish pay for top executives." (Washington Post, Paley, 12/15/08) Re: the $50 billion Madoff case: the SEC "received repeated warnings from outside whistle-blowers and at least twice looked into Mr. Madoff's brokerage itself." (Wall Street Journal, Scannell, 12/15/08) "Internal SEC documents show how the agency, prompted in 2006 to investigate by Mr. Markopolos's complaints, found serious violations at Mr. Madoff's firm, but took no public action." (Wall Street Journal, Zuckerman, 12/18/08)

A three part series in the Washington Post beginning December 29 called "The Beautiful Machine" (O'Harrow and Dennis) provides insights into the causes of the crisis.

ABC topics of interest: Accountability www.accountabilitycentral.com; Boardroom leadership www.thenewboardroomleaders.com; Corporate governance www.corpgov.net

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