THE CORPORATE GOVERNANCE ALLIANCE DIGEST

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Published as a public service by **Eleanor Bloxham**, CEO of The Value Alliance and Corporate Governance Alliance and **John M. Nash**, Founder and President Emeritus of the National Association of Corporate Directors, (which celebrates its 35th anniversary this year).

Eleanor Bloxham, Editor-in-Chief

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In The News

by Eleanor Bloxham

(Please click on the links to access relevant articles.)

Are women directors the new go-to resources for overseeing high stakes board and C-suite changes? Women are still very much the minority on boards. And even more the minority in board leadership roles like board chair, lead director or chair of the nominating and governance committee. Two examples do not a trend make, but at Yahoo, Patti Hart, the chair of the nominating and governance committee is overseeing the search for new directors. She also led the recent CEO search according to the Wall Street Journal. At RIM, new chair Barbara Stymiest, who the Wall Street Journal says is known as a "turnaround artist", is overseeing overhauls.

Chair/CEO split: Are you split? If the roles are combined, expect flak not only from investors according to the Globe and Mail, but also chairs of other companies, according to the Wall Street Journal.

Ethics: According to the Ethics Resource Center's 2011 National Business Ethics Survey, a whopping 42% of employees say their employers have a weak ethical culture. (As a board member, are you informed? What would employees at the companies you oversee say? Are they asked?) Corporate retaliation against whistleblowers has nearly doubled since 2007, the survey reports. That's no way to ensure whistleblowers won't go to the SEC first. (As a board member, do you get information in executive session from the ethics officer on retaliation – and how widespread it is? What is corporate policy and reality?)

Olympus Lessons: The alleged fraud and cover-up at Olympus was wide-reaching and holds the standard lessons about board oversight, corporate culture and control practices. It also has positive lessons for companies who wish to build trust following corporate crises; published by CNNMoney/Fortune.

Loneliness on the job? As a board member, it's important to have people with whom you can speak confidentially about touchy board topics. Who can your CEOs reach out to – do they? As part of corporate culture oversight, do you know how connected workers feel to others in the company? Less connectedness results in lower productivity, morale and engagement, according to the New York Times. This impacts corporate reputation – and valuation.

Corporate Performance and Valuation: Part I

by Eleanor Bloxham

Board directors, responding to a recent National Association of Corporate Director's survey, ranked their board's top priorities. S*trategic planning and oversight* ranked number one; corporate *performance and valuation*, number two. Given widespread board priority on corporate performance and valuation, I'll be covering what boards may wish to consider over the next several issues.

Many boards have adopted practices over the last decade to make their oversight of corporate performance and valuation more effective. To gain outside perspectives, board members read analyst reports. To address fulsome discussions, CFOs provide information well in advance and, rather than give presentations, attend meetings to answer board member questions. Boards specify information relevant to business performance, beyond standard financial information.

But given the current climate, there is more that boards may want to consider. Consider the valuation of Apple (which has recently been exchanging places with Exxon as the company with the largest market capitalization). While there may be no immediate large scale threat to Apple's valuation, Apple's new reality is likely fewer raving fans.

How did Apple's outsourcing gain big attention? Not from a shareholder, an employee, a supplier, media or governmental agency. Apple is under fire because techie and Apple fan Mike Daisey was curious about how the gadgets were made. Daisey shared his story on NPR and it is well worth listening to (or reading if you prefer). The New York Times (and other news outlets) have now expanded on the story in powerful ways.

As a board member, it is important to specify to management what supply chain information you want to receive (for acquisition targets also) and review disclosures to build trust with investors and the public. Great board discussions focus on how the supply chain would stand up to scrutiny. What would our raving fans (like Mike Daisey think) if they knew the ins and outs of our operations and what really goes on? (Do we know what really goes on?) If interviewed, what would the employees of our suppliers say? (Part of what made Mike Daisey's report so compelling was his interviews of Foxconn's employees leaving work.) Here is a New York Times' article with reactions from Chinese readers. Other US companies are named (perhaps yours). There is a larger issue at stake as well: Chinese views of the U.S. which could harm all U.S. commerce.

The Apple incident reinforces that the *drivers of valuation* of any firm include all the corporation's stakeholders and not just the obvious ones. In valuing a company and understanding its performance, these relationships can have major "game-changing" impacts. It is easy to model cash flows, but wild swings in valuations occur based on inflection points caused by changes in stakeholder relations.

Next Digest: More on corporate performance and valuation.

Immediate action step on the stakeholder relations front: It is proxy season. Read the company proxy: Is it understandable? What does it say about "us"?

Other resources/information: To understand the questions that are being raised about Apple, articles in: The New York Times, also here and here, the LA Times, the Daily Beast, the Guardian and MarketWatch and elsewhere are well worth reading.

Available in libraries (or for purchase), my 2002 book Economic Value Management: Applications and Techniques, introduced the concept of corporate valuation based on stakeholder analyses, which Monks and Lajoux recognized as its own approach in their book: Corporate Valuation. (Since 2002, others have popularized similar concepts e.g. Michael Porter's shared value, without the explicit tie-ins to corporate valuation techniques.)

Explaining the Upward Spiral in Executive Compensation

by Tama Copeman, Chair of the Board of Mid Atlantic Diamond Ventures, tama@alcyone7.com.

Rising CEO compensation frustrates many board members and for good reason: *setting CEO pay-above-the-50th percentile broadly leads to unbounded growth in pay.* (Similar results will occur if a large portion of companies set aggressive increase targets each year.) Although advisory say-on-pay votes now available to shareholders provide a check, the votes provide a weak check on rising pay.

System dynamics is a methodology for understanding the behavior of complex systems which can be applied to understanding the dynamics of executive compensation. Originally developed by Forrester at MIT Sloan in the 1950s to provide insight into corporate and managerial problems, system dynamics is currently being used by the public and private sectors for policy design, environmental change, economic behavior, project management and supply chain analysis.

The basis of the method is the recognition of feedback, interlocking, and time-delayed relationships among components of a system. A system's feedback structure drives the dynamics of the system. So-called causal loop diagrams provide a visual representation of the feedback loops in a system and enable the creation of mental models for qualitative analysis.

In a system dynamic of growth, loops with all positive links are self-reinforcing and produce unbounded growth. Balancing loops provide self-correction in the system. They are created when there are an odd number of negative links and are self correcting. John D. Sterman ("Business Dynamics – Systems Thinking and Modeling for a Complex World", McGraw Hill, 2000) provides many examples of applications of causal loop diagrams.

As a CEO's compensation is set above the 50th percentile within the peer group, the average of the peer group rises correspondingly. The causal loop model in Figure 1 illustrates self-reinforcing compensation behavior. If the majority of boards employ above 50th percentile pay positioning, the peer-group compensation increases with the rate of growth dependent on the fraction of companies using this strategy. If the majority of boards employ below 50th percentile pay positioning, the peer-group compensation decreases. The latter case is, naturally, less likely. Conversely, as CEO pay increases, say-on-pay concern also increases with a corresponding push to reduce pay. The causal loop model illustrates self-correcting say-on-pay behavior. Within a corporation, the internal "say on pay" is far stronger than the advisory shareholder vote, as senior management, human resources and budgetary factors weigh in.

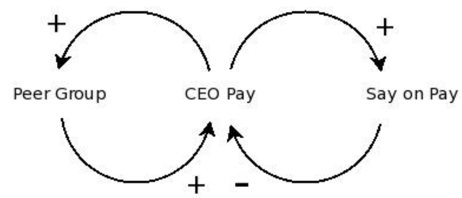

Figure 1. Causal Loop Model applied to CEO compensation

The above cycles occur on a one-year basis; however other balancing factors can enter throughout the cycle. The Wall Street Journal (June 30, 2011) reported: "Companies may not have to abide by shareholder advisory say-on-pay votes mandated under the Dodd-Frank Act, but lawyers specialized in securities class action suits have already brought a half dozen suits against directors and executives for ignoring their results. A number of firms have tried to settle the claims quickly."

Peer benchmarking has been a powerful tool in compensation. System dynamics provides a simple perspective to understand the dynamics at work. Unless there are changes to the current systems-dynamics for CEO pay, CEO compensation will continue to spiral upward.

A Lines of Defense Approach to Corporate Oversight

by Sean Lyons, Principal, RISC International (Ireland), sean.lyons@riscinternational.ie.

The financial crisis of 2008 exposed weaknesses in corporate oversight at all levels. As a result, stakeholders are now demanding higher standards of corporate citizenship and improved oversight. To safeguard stakeholder interests and optimize stakeholder value, corporate oversight needs a clear structure of accountability which can be readily understood and monitored.

To gain a measure of comfort that critical activities are being appropriately addressed, stakeholders commonly rely on various lines of defense, internal and external to the organization.

Internal lines of defense provide stakeholders with a degree of confidence that the organization is operating effectively and appropriately.

A well established concept that has traditionally been deployed across different industries is the so-called "Three Lines of Defense" model. This model has also often been the preferred model of regulators when they review an organization's oversight structures. A widely accepted industry standard within the European financial services sector it has been advocated by the likes of the European Central Bank, Bank for International Settlements and Financial Services Authority as a sound practice for banks in achieving a strong governance culture. This model recognizes operational line management, tactical oversight functions, and independent internal assurance as three lines of defense in an organization's governance/control framework. While this model recognizes the oversight roles of executive management and the board of directors, it does not specifically recognize their roles as specific, additional lines of defense.

A more robust model and one that I advocate explicitly includes five internal lines of defense.

Internal Lines of Defense

1. Operational Line Management (e.g. business units)
2. Tactical Oversight Functions (e.g. compliance, risk management etc)
3. Independent Internal Assurance (e.g. audit function)
4. Executive Management (e.g. senior management)
5. Board of Directors

Clearly from a broader stakeholder perspective all these lines of defense are important. It seems that regulators are catching on. On October 17, 2011, the SEC's Carlo di Florio, director of the office of compliance inspections and examinations referred to five internal lines of defense in his address to the National Society of Compliance Professionals (NSCP).

Organizations need to ensure that this internal lines of defense framework is effectively operating within the organization so that there is an appropriate oversight hierarchy in place in strategic, tactical, and operational decision making.

In addition to the internal lines of defense, a number of external lines of defense can also safeguard and protect stakeholder interests.

External Lines of Defense

6. External Auditors
7. Shareholders
8. Rating Agencies
9. Regulators

In the event that the organization itself fails in its obligations, stakeholders can help ensure that their interests are being safeguarded by understanding and collaborating with these lines of defense.

External lines of defense can extend beyond individual firms to also provide corporate oversight at regional and national levels. In fact outside the corporate realm itself this oversight model can be extended beyond the regulators to elected public representatives (the Government) who are ultimately responsible to their electorate.

A "lines of defense" framework provides a comprehensive system of "checks and balances". Functioning properly, it ensures the organization is fulfilling its fiduciary duties, legal obligations, and moral responsibilities, while creating durable value and sustainable economic performance. That said, a chain is only as strong as its weakest link. To operate effectively, each line of defense must fulfill its oversight duties both individually and collectively.

For more information please see: http://ssrn.com/abstract=1938360

In case you were wondering… What is The Value Alliance and Corporate Governance Alliance? An independent firm providing board education, information, and advisory services since 1999.