



**Peer-to-Peer Candid Conversations on  
Special Topics for Directors: Best Practices  
November 10, 2009**

**Summaries from each table discussion**

## Audit

Max Carrier, KPMG

### Risk

- Boards should consider where the risk oversight responsibility should reside
  - Most Boards place the responsibility with the Audit Committee
  - This probably occurs because fraudulent financial statements are deemed to be the number 1 cause of a company succumbing to its number 1 risk - the loss of its reputation
- Regardless of what committee has oversight responsibility, a best practice is for bi-annual committee reports being made to the full board
- Questions that Board members should be asking:
  - Is there a good understanding of a company's risk by its management?
  - What is done within a company to mitigate risk?
  - Is there a cultural embracing of risk identification and mitigation by operating decision makers?
  - Is management quantifying risk as well as opportunities?
  - How should a Board quantify its risk tolerance?
  - What is the impact on a company's risk given the increase in Washington D.C.'s focus on business activities and actions

### Internal Audit

- Audit Committee's should be sure that internal audit is properly staffed and funded.
  - Concerns were expressed that if internal audit is not squeaking, it does not get more resources, even if it is needed.
  - Common resource shortfalls for internal audit are in the specialist areas (systems, environmental, derivatives, etc.).
- As a best practice, SOX control testing should be moving from internal audit's responsibility to become testing that is embedded with process owners.
- Growing a company's employees by rotating future leaders through internal audit is another best practice.
- Questions that Audit Committee members should be asking:
  - 1 Is the internal audit department properly staffed and funded
  - 2 Are remediations to address internal audit findings being implemented timely?
  - 3 Are internal audit departments able to complete their annual audit plans and if not why?
  - 4 Do the responsibilities for ERM identification and auditing mitigation and control cause conflicting responsibilities for internal audit departments
  - 5 Can technology use increase the effectiveness of internal audit?

### SOX Control Testing

- Audit Committees should be seeing very few deficiencies and the cost of compliance decreasing. However, concerns do exist whether decreases in a company's headcount could cause an increase in deficiencies.
- It was noted that SOX control testing for small filers has again been deferred.
- Best practices for companies include 1) embedding control testing with process owners and 2) technology-based vs. manual controls becoming a larger percentage of a company's control reliance.

- Questions that Audit Committee members should be asking:
  - What is the impact of reductions in headcount on internal controls and testing thereof?
  - What is the timing of control testing - is it spread out throughout the year or weighted to the fourth quarter and post year-end?
  - What is the cost of compliance testing now vs. the cost in prior years?
  - What percentage of controls is technology based vs. manual? What could be the benefit of increasing the use of technology controls?
  - Where does responsibility for control testing rest? Is more responsibility resting with process owners?
  - Are deficiencies decreasing?

## Compensation

Lisa Croley, Hewitt  
Bill Gentry, Hewitt

- Potential disclosure changes are coming. Committees need to understand what the disclosure requirements are when issued and make sure there is an adequate process to address.
- "Stock price is tied to company performance with a rubber band." Consider both a company's stock price and financial performance when determining compensation design.
- There is no magic bullet for mix of pay (cash v. equity, short- v. long-term). Industry, size, capital requirements and place in "life cycle" as well as what makes senior management "tick" are important when designing compensation programs to drive behavior and performance. This may mean more cash and less equity or vice versa. Short-term incentive periods may be shorter or longer than a year and long-term incentive periods may be shorter or longer than the common 3 year performance period.
- Should there be a broad application of recoupment policies beyond what is currently required?
- Keep It Simple...both compensation design and performance goals.

## Finance

Adam Dunayer, Houlihan Lokey  
Rick Rogers, Texas Capital Bank

### Current Environment

- High Quality Credits
  - No issue refinancing
  - Terms dictated by refinancing requirement from a maturity or need to increase or otherwise change existing credit facility.
    - New deals will be have higher cost and tighter terms
    - Deals without near term maturity and still compliant with the existing covenants that are generous by current standards and no internal need to change the credit facility are insulate from the changes to the credit market until maturity.

- Broken Models
  - Companies in the this category have real credit issues
  - Borrowers and lenders agree on the major issues and that significant changes to the capital structure are needed.
  - Either looming maturity or current covenant issues are bringing the credit back to negotiations in an unforgiving market.
  - By and large these credit issues are being dealt with by a combination of options available to owners and lenders.
- All others
  - The largest group of borrowers fall into this category
    - Companies that will survive
    - Impacted greatly by the new credit environment
    - Despite cash flow sufficient to allow survival on a debtless model, existing leverage in these companies is likely now well above market
  - Directors need to acknowledge conflicts as decision arise that impact not just the shareholders, but also the lenders.
  - There is a changing dynamic of Borrower/Lender relationship
    - Directors need to be aware of potential impact of the change on the company
    - Directors need to address the companies model to the extent that it depends upon ready access to credit.

#### **Directors' Role in the current Credit Environment**

- Larger Role... Informed Direct Action
  - More details of borrowing options
  - Directors have responsibility to understand
    - Concerning credit agreements
    - Ask more questions when making changes to credits facilities and entering new ones.
  - Director Exposure Higher in this environment
    - As the economic equity of the company declines
    - Directors need to constantly assess their fiduciary role
    - May need to retain separate counsel ask value of firm falls to address fiduciary responsibilities

#### **Boards Role in Assuring survival in tough times**

- Consider actions not typical in a normal environment
  - Consider drawing credit lines to assure liquidity is available
  - Refinance early to impact the debt amortization
    - Early action may allow survival by taking options not available later.
    - Directors have a responsibility to know:
      - Where the company stands with lenders and impact on company if credit is less available

## Governance

Ken Carroll, Carrington Coleman

- **Staggered versus non-staggered boards.**
  - The consensus was decidedly opposed to the “fruit-basket-turnover” approach embodied in the required election of all directors each and every year. In the words of one of our members, “continuity trumps all.”
  - The preservation of institutional memory and capability, along with the time necessary to see projects through - made possible by a staggered board - was felt to be of signal importance in ensuring long-term shareholder value and corporate performance.
  - Certainly staggered boards embody something of a disincentive for a new outside investor, who cannot take control of a board in one election cycle. But those who have served on boards for a number of years saw much greater potential problems from the prospect of excessive turnover each year.
  - One need look no further than our own Congress for an example, where the entire House is up for election each year, while the Senate comprises a “staggered” body, with a third up for election each cycle. The prospect of attending to annual elections for each board member simply creates too much of a distraction. And the prospect for disruption of a board that has learned to work together productively is simply too great. On a related issue, those in our group did not favor mandatory term limits for directors. Again, the sacrifice of experience and productivity to an arbitrary limitation seemed imprudent.
- **CEO/Chairman split.**
  - Favored the recommendation that the office of Chairman be occupied by a truly independent director, rather than by the CEO.
  - Recognized the value of having the Chairman be a truly independent counterweight to the CEO, and did not feel this created confusion as to “who’s the boss”.
  - Would not compel an immediate split where one person currently occupies both positions, but would favor the adoption of that separation when the current CEO/Chairman steps aside. Meanwhile, in those circumstances where both offices are currently held by the same individual, our group also strongly favored the use of a truly independent “Lead Director,” who would confer with the Chairman/CEO about agenda and policy, and of course chair and lead executive sessions of the outside directors - i.e., someone, again, who could stand toe-to-toe with the CEO to present an independent viewpoint.
  - Warned against accomplishing the CEO/Chairman split in name only. For example, the chairman’s position should not be the post to which a COO or even CEO moves upon retirement from office; the chairmanship should be held by a truly independent director.
- **Shareholder access to proxy.**
  - The idea that a 1% shareholder - or certainly a group comprising only 1% - would be entitled to a place on the company’s proxy seemed to our directors an invitation to chaos, particularly if combined with other proposals like the non-staggered board and the Chairman/CEO split.

- Most responsible boards are carefully assembled with an eye toward the responsibilities each board member will fulfill - e.g., audit or compensation experience. Throwing open the gates in this manner seems to invite disruption for well-functioning boards simply to serve an ill-defined concept of corporate democracy.
- And, of course, there are numerous practical problems. Literally speaking, a corporation would face the prospect that scores of individuals could be nominated for each director's position. How would informational materials be assembled and disseminated, much less intelligently digested by voters? How would corporations deal with, for example, cumulative voting? In sum, this seems an idea that requires a significant amount of additional thought and refinement.

## Nominating

Peter Lodwick, Thompson & Knight

The ten significant observations made by our group with respect to an effective and fully functional nominating committee are as follows:

- In recruiting new directors, the committee should study and define the company ethos and needs first, and recruits within those parameters.
- Engaging an outside search firm, and searching the NACD database, are worthwhile pursuits in identifying potential new directors.
- There is not a belief that expanded disclosure requirements will lessen the pool of qualified candidates.
- Assigning an experienced director as a "mentor" to a new director is beneficial. A formal orientation process, with company officials, with the CEO, with the Board and with the "mentor" is essential.
- Except where impractical, splitting the role of CEO and Chairman of the Board is advisable.
- The use of a rotating chairmanship is not beneficial per se, but should be examined on an individual basis.
- There was no consensus on the advisability of term limits, with the predominant thought being that effective nominating committees render term limits moot.
- Annual evaluations, when handled properly and confidentially, are a useful tool in conforming conduct.
- Any candidate should be evaluated for her potential contributions to strategic planning, an increasingly important Board function.
- Diversity is a key ingredient to an effective Board.

## Risk Management

Scott Uhl, EWI

- Board-level discussions of Enterprise Risk Management (ERM) should include company-wide policies regarding risk assessment and risk management, with the goal of assuring directors that matters of consequence identified during the examination process are satisfactorily addressed by management.
- The challenge for the boards oversight function is to implement an ERM is that is holistic, organization-wide, and a standardized risk management process for the organization, so that it incorporates an integrated view of the risk unique to any particular organization and data flows up to the board and board input flows back down to management and the organization for action or implementation. When an integrated approach to risk management is used as the company's framework, there will be consistent reporting of relevant business and risk information to appropriate individuals at various business units across the enterprise to make decisions on a common, risk-informed basis.
- While boards and independent directors are often reliant on management for company-specific data relative strategic, operational, enterprise, reputational & finance risk, boards should also endeavor to obtain independent trend and market data from value-added professional service firms that can provide current macro-market data, trends and context relative company-specific risk. This process can help assure that all risk, previously identified and not, are incorporated into the ERM dialogue at the board level.

## Strategy

Rick Lacher, Houlihan Lokey

Jay Duke, BDO Seidman

The table was most concerned with how a Corporate Director successfully interacts with the other members of the Board and management to fulfill the requirements of the role. The major areas we discussed and the take-aways from our discussion are as follows:

- A Corporate Director must Challenge Senior Management on the Development and Execution of the Corporate Strategy. While it is normal and acceptable for a Director to participate in the development of the corporate strategy; it is senior management's job to execute and the Board's job to evaluate strategy on an ongoing basis and its execution.
- A Corporate Director must evaluate whether the Company has the Right Personnel and Resources to Properly Execute on the Strategy. As part of the Director's role, the Director must determine if the personnel and resources are proper to successfully achieve the strategy. For example, if a company wishes to enter the Asian market, do they have experienced personnel in place to run those operations and proper joint venture partners? The same is true for development of a new product line or entering any new markets. In our global economy, this role is more important than ever.

- Since the Start of the Current Recession through Today - Many Companies Survived by Managing Costs and Resources; however, now a Company must have a Growth Strategy to Move Forward. The Director must understand that managing the middle and retraction can only carry a company so far and is not the key to survival. Therefore the Directors must challenge management to develop strategy to continue the company as a going concern.
- An Annual Off Site Strategy Meeting over a Period of a Few Days can be Extremely Beneficial to a Corporate Director and Management. To often the Corporate Director is so caught up in the day-to-day work as a director that a thorough understanding of the operations and strategy suffer. In addition, there is not enough time in quarterly meetings to develop relationships with key operational people of the company. To overcome the aforementioned issues and provide adequate time to understand the operations and strategy as well as key personnel, an annual off site director and management retreat may be beneficial.
- All Companies are Unique and have their Own Approach to Leadership and Governance. Our group agreed that there is no one perfect way to properly govern and be a Director of a company. Depending on a company's health and what stage they are at in their development and growth as well as the mix of directors and senior management; many different approaches may be successful. Therefore be flexible and consider all facts and circumstances. Do not lock into a specific or particular method of being a solid Director.
- Diversity of Experience and Background can be a Benefit to a Corporate Board. A board should strive to have solid directors that represent all facets of the industry and business as well as experience in finance and capital markets. Such diversity leads to better perspectives, better understanding of the business, best practices and the best possible strategies for the companies they represent.