# Board Focus 2012: Issues and Developments

Governance developments in 2011 brought some good news. Shareholder governance proposals were at their lowest level since 2002. Support declined for controversial proposals, such as shareholders' right to call special meetings or act by written consent, and ISS conceded that its recommendations about written consent proposals should reflect the company's governance as a whole. Even say-on-pay voting had some worthwhile effects. It gave shareholders the means to express more targeted dissatisfaction, driving a decline in opposition to director incumbents, and it prompted more and better dialogue between many companies and their major shareholders and better disclosure about the business rationale for pay decisions.

But regulators and shareholders remain energized. The SEC brought a record number of enforcement proceedings in 2011, a trend likely to continue, and it and the PCAOB have several important regulatory initiatives underway. For their part, shareholders remain acutely focused on stock performance as the yardstick to evaluate a company's execution, despite market swings experienced in 2011 that reflected more than anything else fragile economic and political conditions worldwide. The Eurozone crisis and election year politics will keep business prospects extremely challenging and uncertain. In this context, it is critical for boards to frame their deliberative processes in a way that assures the protection of the business judgment rule, while positioning themselves and management to meet expectations of regulators and investors alike. We highlight below some of the issues we believe boards should keep in mind in 2012.

**M&A in 2012 – Significant Opportunities … and Risks**

While the first half of 2011 continued 2010's M&A growth trends, growth stalled in the second half leading to only a very modest uptick for the full year. Spin-offs were the one type of transaction that attracted substantial interest last year, as companies decided (sometimes on their own, but sometimes with prompting from activists or other investors) that their businesses would generate better returns and have better prospects if split into two or more companies.

There is reason to expect growth in deal activity in 2012, despite current market and economic challenges. Prospective acquirers have substantial cash resources and reasonable or even strong stock prices, banks are willing to lend for at least some acquisitions, private equity firms have significant unused investor commitments, and hedge funds are actively seeking positive results. In this environment, directors should be mindful of whether the company's current condition presents opportunities for it and its stakeholders.

- ***Seller's market***. Interest rates remain low, potential strategic partners looking for synergistic mergers may have significant cash reserves, and financial sponsors are eager for deals. All this suggests that advantageous pricing may be achievable for companies considering a sale of control or selected divestitures. Firms considering strategic sell-side transactions must review the current financial state of the firm, markets, likely bidders and antitrust or other regulatory uncertainties. Careful planning for any transaction process in light of legal requirements is also important. Among other things, boards pursuing these transactions should be sensitive to, and take steps to prevent or limit, potential conflicts of interest on the part of their financial advisors. Recent developments also confirm that antitrust considerations are not solely a buy-side concern.

- ***Acquisition risks.*** For companies considering acquisitions, directors must do their homework to understand the business being acquired; integration challenges and plans, including anticipated positive and negative synergies; antitrust or other regulatory risks, both in the United States and overseas; and financing, litigation and other consummation and post-closing risks. For example, acquiring a company that turns out not to be compliant with the Foreign Corrupt Practices Act or similar foreign statutes or regulations (whether or not it was subject to those provisions prior to being acquired), can result in expenses to investigate and fix the problem, loss in income from possible changes in the target's business model and the payment of fines. In the aggregate, these costs can dwarf the purchase price of the acquisition.

- ***LBO activity***. With financial sponsors on the prowl for opportunities, management teams across a variety of industries may be approached about potential leveraged buyouts. Also on the prowl, however, are plaintiffs' law firms, which are well aware that a flawed LBO process will create significant legal pitfalls for the target's board and give rise to potential claims. If a board believes its CEO is likely to be approached by a financial sponsor, the CEO should be instructed to advise the lead independent director immediately of any approach. Appropriate protocols should then be put in place to assure that any process is actively supervised by the independent directors.

- ***Defense review.*** The past two years have witnessed a modest but meaningful amount of hostile deal activity and shareholder insurgency, as well as negotiated deals disrupted by interlopers. Given this activity, directors of potential targets should consider a review of their defenses to understand vulnerabilities and be prepared to move quickly to fulfill their fiduciary obligations. One difficult decision faced by some boards this year relates to the renewal or non-renewal of a shareholder rights plan scheduled to expire. In reviewing these plans, boards should take into account potential threats to shareholder interests that may justify such defenses, as well as the policy of ISS to recommend "no" or "withhold" on director nominees who have voted to extend a right plan and the policies of other relevant institutions. Some companies have rights plans "on the shelf" that a board can consider adopting quickly if appropriate when faced with actual hostile activity. But the "on the shelf" approach is not entirely satisfactory for many smaller companies or even for some larger companies, given the expanded use of derivatives by some investors to establish a large economic position that can effectively be converted (after regulatory clearance) into a large ownership position. Nevertheless, given the ISS policy and similar positions of some institutions, it is not surprising that almost 80% of companies with rights plans scheduled to expire in 2011 allowed them to expire, and a majority of the extensions were for periods of two to five years rather than the once-standard ten years.

- ***The vision.*** In any contest for control, a company's strategic plan will take center stage and may very well prove to be the determinative factor. In order to mount an adequate defense against any unsolicited offer or proxy contest – and for more basic reasons of oversight – the board should ensure that the company's strategic plan is current, has adequate support in company and market data and reflects the best judgment of management.

**Balance Sheet Management and Vulnerability to Insurgency**

The ratio of liquid assets to total assets of non-financial institutions in the United States is the highest in over 50 years. Feeding this fattening of the balance sheets are a historically low level of business investment relative to pre-tax corporate profits and, in some cases, issuances of debt at low cost without any near-term plans for use of proceeds. While the financial crisis of 2008-09 and subsequent economic uncertainties may have led to this situation, directors should now be asking how much longer their companies can justify retaining significant excess capital on the balance sheet. Indeed, directors should be asking how much longer investors will tolerate this trend. A common misconception is that hedge fund insurgents target only underperforming or distressed companies. In fact, one recent study concluded that the boards and managements that are most frequently attacked in activist filings on Schedule 13D are those overseeing companies characterized by steady cash flows and healthy balance sheets.[1] Directors should be carefully considering:

- Whether to invest more in the business;
- Whether to engage in more strategic acquisitions or similar transactions;
- Whether to return more value to shareholders through share buybacks and dividends; and
- Whether to incur more leverage to have additional flexibility to do any or all of the above.

Studies have shown hedge fund activists to be highly effective at inducing increases in leverage, share buybacks and dividends.[2] The same studies have shown that, despite the frequent adoption by hedge fund insurgents of the moniker "operational activist," very few of them have

[1] April Klein & Emanuel Zur, Entrepreneurial Activism: Hedge Funds and Other Private Investors, 64 J. Fin. 187 (2009) ("Klein & Zur").

[2] *See, e.g.*, Klein & Zur.

proven to be particularly adept at causing improvements to the operating performance of companies. But when a board is perceived to be "standing still" on top of a healthy and growing balance sheet, activists will not hesitate to enter the scene to advocate changes to the board, management and strategic plan. Boards should explore, and push outside advisors and management to help them understand, whether more aggressive uses of excess capital may be appropriate and communicate their conclusions and reasoning to investors. This effort may do more than traditional anti-takeover mechanics to protect a company from interference by an activist who purports to know more than the incumbent directors and management about how to run the business and who, in the face of a seemingly passive board, may generate enough momentum to steer the company in radical directions that are not prudent. Despite the challenges of macroeconomic and industry uncertainties, by focusing appropriately on these issues in advance, boards may be able to reduce the likelihood of activist campaigns or have more credibility with investors if a campaign is launched.

**Preparing for the Annual Meeting**

- ***One-size-fits-all approaches to governance practices.*** The past several years have seen the homogenization of governance practices due both to the press of shareholder concerns and the threat of "no" or "withhold" recommendations by the principal proxy advisory firms in director elections. Even as boards have refreshed their practices, the pressure to conform continues, whether or not justified.

  As boards prepare for the annual meeting, they should recall that the exercise of their fiduciary duties in the interests of the company and its shareholders may not always be coincident with the voting policies of the proxy advisory firms. Those policies may reflect a minority viewpoint among the company's shareholders, and in any event, they reflect a generic one. Boards should not hesitate to deviate from them when the company's circumstances warrant, while recognizing that doing so will place pressure on effective shareholder relations. In 2011, there was a marked increase in companies that challenged recommendations of proxy advisory firms in additional soliciting materials sent to shareholders or used for investor meetings. These materials were also posted on company websites and filed with the SEC as soliciting material. We expect this practice to grow, given the pressure on communications, particularly since the proxy statement has become a cumbersome legal document. We also expect companies will continue to anticipate objections by proxy advisory firms and investors in their proxy statements.

- ***Private ordering proposals for proxy access.*** According to ISS, 16 SEC-reporting companies have received shareholder proposals advocating proxy access bylaws. The proponents are a mix of institutional and retail investors (including public funds), and some of the proposals purport to be binding. In general, the proposals break down into three main groups based on ownership and holding requirements:

- 1% for two years or 100 investors holding $2,000 of stock for one year; one director or 12% cap on board seats (generally following the model form of access bylaw published by the U.S. Proxy Exchange and received by seven companies)
- 1% for one year, 25% cap on board seats (proposed on a binding basis by Norges Bank Investment Management and received by six companies)
- 3% for three years; 25% cap on board seats (received by two companies).[3]

True to predictions, the proponents emphasize that their proposals have been targeted at companies that have either had well-publicized issues or where performance is perceived as poorly correlated with executive pay. So far, four companies have challenged the inclusion of the proposals in the proxy statement on a variety of procedural and substantive grounds,[4] although no company has announced that it will make its own proposal in response. Hewlett-Packard's March meeting will be the first to address the subject.

As in the case of other practices (*e.g.*, majority voting), we expect a limited number of approaches to the principal elements of an access bylaw will gain traction over time, but there are more "moving parts" to an access bylaw than the thresholds noted above. These include how "beneficial ownership" is calculated (*e.g.*, how derivative positions are treated) and the various disclosures or undertakings that could be requested of the nominating shareholder or group (*e.g.*, an ownership "standstill"). Although most companies will not face these proposals in 2012, boards should be familiar with the main elements of an access bylaw. Management should also keep the board abreast of the vote outcomes for the 2012 access proposals and how affected companies respond, particularly since other alternatives (*e.g.*, bylaws policies requiring reimbursement of solicitation expenses of successful insurgents) remain marginal practices at best.

- ***Re-slating and succession practices.*** Shareholder involvement in the director nominating process is likely to increase, particularly when a company has performance issues. A board can mitigate the risk of activism by focusing on the quality of its own composition. SEC rules have focused attention on this issue, since they effectively require companies to demonstrate how well director skills and experience align with company needs. Steps to improve nominating and succession processes include:

  - ***Re-slating process.*** Implement a meaningful re-slating process for incumbents based on evaluations of their individual contributions. Many boards have shied away from individual evaluations,[5] probably because they would be viewed as potentially divisive,

[3] One individual proponent submitted a binding proposal at one other reporting company calling for 2% / one year thresholds.

[4] Chiquita Brands International, Inc., Sprint Nextel Corporation and Textron, Inc. (all involving non-binding proposals of the first type identified above) and Wells Fargo & Company (binding proposal of the second type identified above).

[5] According to the Conference Board, only 34% of companies in the non-financial services industry assess director performance on an individual basis, and, perhaps surprisingly, this practice is most infrequent among larger companies. The Conference Board, *The 2011 U.S. Director Compensation and Board Practices Report* (the "2011 Conference Board Report"), at 15.

but in today's environment of smaller boards, even one director who lacks engagement can be a handicap. A board should evaluate whether its composition is optimal not just in terms of the existing business, but also in terms of the direction the business must go to thrive in an uncertain environment. The board should also consider the dynamics of the group. Each year, there are several prominent examples of board dysfunction. It is better to face the issue head-on than to deal with the challenges of fixing the problem after a visible collective failure.

- ***Policies on director nomination and succession.*** Review the board's policies on director nomination and board succession matters. These should not be viewed as "check-the-box" compliance matters. Thoughtful attention to these documents can help the board build consensus about what is needed, facilitate sensible re-slating and prioritize recruiting.

- ***Director turnover.*** Many boards keep a list of potential candidates, detailing their qualifications and other attributes for ready reference. This practice, which is not just a short-term tool, can reduce recruitment time and board disruption when vacancies occur. Boards should also consider whether they have enough of what they need – whether, for example, a key skill set or experience profile is embodied in a single director who may be hard to replace.

**Executive Compensation Matters**

- ***Correlation between executive pay and operational and financial performance***. Directors should examine whether operational performance metrics in short- and long-term incentive plans reflect the right type and mix of criteria. Will incentive programs reward executives based on successful operation of the business and payouts correlate with shareholder returns over time? Will the metrics facilitate a simple and effective presentation of the pay-performance linkage?

  When evaluating the correlation between pay and performance, boards should consider relative performance, not only as compared to their own identification of peers, but against those likely to be selected by ISS under its new compensation assessment approach.[6] Recent press focus on option gains arising from grants made during the financial downturn highlights the cyclical nature of the markets and the perceived unfairness of large option gains for executives when companies' stock rebounds in absolute terms, even if not in relative terms.[7] A critical reassessment of the company's peer group and the rationale

[6] ISS, *Evaluating Pay for Performance Alignment, ISS' Quantitative and Qualitative Approach* (Dec. 20, 2011).

[7] *See, e.g.,* David Kacieniewski, "Tax Benefits from Options as Windfalls for Businesses," *The New York Times*, Dec. 30, 2011, at A1. The separate arguments in the article about corporate tax benefits arising from stock options have no merit. The existing framework is consistent with the generally applicable tax rules that (1) correlate the timing, amount and character of compensation inclusion by employees with the deduction for employers and (2) recognize that an arm's-length sale of property for less than fair value constitutes an expense or loss in the amount of the discount. The corporate deduction is also consistent with the common

supporting adjustments to company results for purposes of incentive payouts are also increasingly important in making the case to shareholders that pay programs and awards are appropriate. A significant number of companies report that management is involved in the selection of the peer group.[8] While this may be entirely appropriate, the committee should bring the same care and constructive skepticism to management's participation in this exercise as it does in other areas where management can be expected to play a role notwithstanding actual or potential conflicts (*e.g.*, recommendations about targets or awards).

Further consideration should also be given to parts of the pay package that could be characterized as not performance-based. While many companies have scaled back or eliminated the use of employment agreements, reduced severance packages and supplemental pension benefits, and eliminated single-trigger change in control benefits, we expect these pay elements will remain under pressure. Specifically, the award of time-vesting options and stock awards for senior executives is likely to receive scrutiny this year, as it did in some highly-publicized situations in 2011. Even double trigger change in control benefits may be criticized in deals where the price is perceived as unattractive to target investors.

The interplay between compensation and business risks should also be reflected in pay design. The interplay between these risks is affected by the balance between short- and long-term components of the executive pay package, the slope of performance/payoff curve for incentive plans, share-ownership guidelines and the existence and terms of clawback obligations that go beyond legally-mandated provisions. Committees should consider more carefully whether management personnel responsible for businesses or functions with different types of risk should have compensation packages that vary with those differences.

- ***Clawback policies.*** New listing rules, expected in 2012, will force directors to reconsider clawback policies. While about half of public companies have some form of clawback policy,[9] the Dodd-Frank Act mandates them in the context of accounting restatements, and the legislation leaves little room for the exercise of director discretion when a clawback is triggered in that scenario. But judgment by directors about the timing and manner of compensation recovery will in many cases be crucial. For example, will a board find it

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sense observation that employees are compensated by their employers – in the plain meaning of those words – when they exercise in-the-money options and the amount of compensation they earn from their employers is the amount of the discount on exercise. The fact that arguments to the contrary were so prominently featured is, in our view, emblematic of the current atmosphere in respect of compensation issues.

[8] 2011 Conference Board Report at 13.

[9] 2011 Conference Board Report at 12. Shareholders also continue to press for broad clawback policies that go beyond a restatement predicate to require clawbacks when executives have engaged in any misconduct or unethical behavior. The New York City pension funds are advocating such policies in proposals submitted for the 2012 proxy season at several companies. *See* Press Release of the New York City Comptroller, "Liu, Pension Funds: Tougher Clawbacks on Executive Pay Needed" (Dec. 21, 2011).

useful to serve a senior executive with a clawback demand just when he is preparing to testify in a class action arising from a restatement? The conflict created – between a restrictive legal mandate and the necessity of judgment – puts a premium on director independence. Given that directors will be faced with difficult judgments in clawback situations, including in ways that could be characterized as benefiting management, directors should be particularly attentive to the risk of criticism that the development of the policies was unduly influenced by management.

It is also noteworthy that some D&O insurance providers are reported to be offering riders to cover compensation clawbacks. Before a company decides to purchase this type of coverage, the board or compensation committee should consider potential reactions by regulators and shareholders if and when the coverage is disclosed, as well as any public policy or other exclusions contained in the rider.

- ***Say-on-pay litigation.*** The results to date of litigation arising from the 2011 say-on-pay vote emphasize the value of a conservative approach to director independence. Divergent outcomes were reached in the first two say-on-pay derivative actions involving claims of directors' fiduciary breaches arising from failed say-on-pay votes. The *Beazer Homes* litigation was dismissed for failure to state a claim under Delaware law since plaintiffs could neither overcome the presumption of the business judgment rule nor demonstrate that pre-suit demand was futile.[10] The *Cincinnati Bell* case (now settled), brought under Ohio law, survived a motion to dismiss, and the court found that pre-suit demand was excused since the directors who devised and approved the compensation package, and whose recommendation to approve the package failed the say-on-pay vote, were unable to make "unbiased, independent business judgments about whether to sue" on behalf of the company.[11] We believe the logic of the *Beazer Homes* court should ultimately prove persuasive for most courts. But *Cincinnati Bell* is an important reminder that the application of the business judgment rule to support a quick dismissal of litigation depends in large part on a pristine factual background concerning director independence and scrupulous documentation of pay decisions to demonstrate that directors were informed and acted in good faith. This is particularly important where pay decisions may not correlate persuasively with company performance, measured not only based on committee-approved metrics but also on total shareholder return.

- ***Evolution of say-on-pay.*** The number of failed votes in 2011 was small, but the number and consequences of problematic vote outcomes (*i.e.*, less than 70% approval, according to

[10] *See Teamsters Local 237 Additional Security Benefit Fund, derivatively and on behalf of Beazer Homes USA, Inc. v. McCarthy, et al.*, No. 2011-cv-197841, slip op. at 11 (Ga. Super. Ct. Sept. 15, 2011).

[11] *NECA-IBEW Pension Fund, derivatively on behalf of Cincinnati Bell, Inc., v. Cox, et al.*, No. 1:11-cv-451, slip op. at 9 (S.D. Ohio Sept. 20, 2011) (order denying defendants' motion to dismiss).

ISS)[12] was not trivial. We do not expect to see a material change in those outcomes in 2012, especially since the main proxy advisory firms essentially grade pay programs on a curve. The proxy advisory firms were not notably successful in persuading shareholders to vote against pay programs in 2011. Of 340 companies receiving a "no" recommendation from ISS, only about 40 lost the vote. But the recommendations appeared to affect outcomes by about 25%. Compensation committees and boards regularly consider how proxy advisory firms will view proposed changes in pay design, but that discussion should be expanded to include reactions by key shareholders and how management will handle outreach, as well as directors' fiduciary duties in compensation decisions (which, as noted above, are not always congruent with proxy advisory firm recommendations).

**Audit, Compliance and Control Matters**

- ***Relationship with auditor.*** The PCAOB has expressed renewed concern about the quality of audits and auditor skepticism. PCAOB officials say that audit inspections have shown a surprising number of cases in which auditors have accepted management representations without verification. The PCAOB's request for comment about whether it should require audit firm rotation to address the problem[13] has elicited mostly negative reactions, and the SEC staff continues to permit companies to exclude from their proxy materials shareholder proposals calling for mandatory rotation. Some audit committees now periodically consider auditor rotation, and many others have undertaken contingency planning, including maintaining the independence of at least one other potential audit firm, in case a change becomes necessary or desirable. In our view, these are both appropriate recurring responsibilities of the committee, but there are other steps the audit committee can take to improve the auditor relationship and add value to its oversight of management, such as those described below.

  - ***Auditor-audit committee communications.*** The PCAOB recently reproposed a standard to improve the dialogue between the auditor and the audit committee,[14] by emphasizing more focused and meaningful communications. An important change in the reproposal is the inclusion of an objective that the auditor must obtain information from the audit committee relevant to the audit. The audit committee should not wait for the final standard to review its interactions with the auditor, which sometimes may be a matter of routine, stylized reports. The committee should consider asking the auditor to provide the information called for under the revised standard (or the most significant such information, given the company's circumstances), if the auditor does not volunteer it. Likewise, the committee should be prepared to respond to the auditor inquiries the

[12] *See* ISS, U.S. Corporate Governance Policy, 2012 Updates (Nov. 17, 2011), effective for meetings on or after February 1, 2012).

[13] PCAOB Release No. 2011-006 (Aug. 16, 2011).

[14] PCAOB Release No. 2011-008 (Dec. 20, 2011). Comments are due by February 29, 2012.

new standard would prompt. These include questions about the committee's knowledge of "violations or possible violations of laws or regulations," which are not limited to accounting or auditing matters.

The audit committee should also consider whether other board and committee activities complement effectively mandated auditor communications. These include the committee's executive session practices with the auditor and management personnel (*e.g.*, internal audit and compliance), management presentations about significant accounting policies and other key elements of the company's financial presentation, as well as the board's overall approach to director orientation. These activities, taken together, should be designed to ensure the committee receives both candid appraisals of material financial reporting matters and sufficient contextual information to facilitate its oversight.

- ***Evaluation of auditor performance.*** The PCAOB's auditor rotation proposal suggests regulatory skepticism about whether audit committees are sufficiently active in making auditor retention decisions. Accordingly, the audit committee should review its process for evaluating the auditor. Often the centerpiece of this exercise is the auditor's standard quality control report and independence communication included in the pre-read materials, and little meaningful discussion occurs on the subject. The committee should make separate inquiries of both management (including through surveys of senior financial management) and the auditor about the quality of the working relationship and the auditor's expertise and qualifications. It should seek a better sense from both about the significant areas where the auditor relies on representations or assertions of management or work of internal audit personnel, and the appropriateness of the reliance, given the relative risk of misstatement in those areas.

  The committee should also request information from the auditor about its most recent PCAOB inspection. Deficiencies noted by the PCAOB are included in a non-public portion of the inspection report (other than deficiencies that reach a certain level of significance) pending a remediation period. But auditors are free to summarize – or even disclose – the non-public matters and should be encouraged to do so. Although the reports derive from the PCAOB's review of certain aspects of a limited selection of audits by an accounting firm and its quality control system, they can provide relevant insights even if the company's own audit was not reviewed. (Of course the auditor engagement should require the auditor to notify the committee if the company's audit is selected.) This can also avoid surprises if the PCOAB eventually publishes a report because deficiencies are not remediated to its satisfaction within the permitted period. An example that received press attention in 2011 was the PCAOB's report on its 2007 inspection of Deloitte & Touche.[15] Similarly, the committee should make inquires of

[15] PCAOB Rel. No. 104-2008-070A (May 19, 2008).

the auditor any time press reports indicate that the auditor has been involved in a material independence violation or other proceeding.

- ***Preparation and red flags.*** In its review of the audit plan, the audit committee should be attentive to the changing risk profile of the company. As part of a large initiative on risk, which also included the adoption in 2010 of eight new auditing standards, the PCAOB recently published Staff Audit Practice Alert No. 9, *Assessing and Responding to Risk in the Current Economic Environment* (Dec. 6, 2011). Although applicable to auditors, it should be read by the audit committee. Highlighting the current challenging economic conditions, the Alert calls attention to several red flags that should be taken into account in planning the audit. They are equally relevant to the audit committee's oversight, both in connection with the close of the 2011 audit and the planning of the 2012 audit. Among them are:

    - Performance measures that may have become too aggressive, which may increase the pressure on management to manipulate results. Although the focus of the Alert is on audit risk, and therefore fraud risk, management could also engage in other activities to meet performance measures that may not be consistent with the board's expectations and prior discussions about business plans and strategy. (As noted above, risk associated with aggressive performance measures is also relevant to compensation committees, which typically set targets at this time of year.)

    - Financing or liquidity requirements that may raise challenges in funding or the risk of collateral calls and covenant violations.

    - Additional fraud risk factors (events or conditions that indicate (i) an incentive or pressure to perpetrate fraud; (ii) an opportunity to carry out the fraud; or (iii) an attitude or rationalization that justifies the fraudulent action) that can exist when financial stability or profitability is threatened. Among the examples given in the Alert are the following: a company that fails to consider all market information when determining a fair value measurement of a substantial direct or indirect sovereign debt exposure; excessive pressure on management to meet expectations of third parties that may have resulted from expectations created by management in press releases or other communications that may no longer be realistic; and excessive pressure on operating personnel to meeting management targets, including sales or profitability incentive goals.

    - Bias in accounting estimates, which could be signaled by inconsistency in the assumptions used to support different estimates; assumptions that are inconsistent with industry economic forecasts or the company's budgets or future business plans; consistent use of overly optimistic assumptions; and a significant cumulative effect of period-to-period changes in multiple accounting estimates, among others.

Staff Audit Practice Alert No. 8, *Audit Risks in Certain Emerging Markets* (Oct. 3, 2011), can also provide the audit committee with important guidance about risks associated with operations in emerging markets and context for its communications with the auditor about the company's financial statements and reporting practices.

- ***Status of IFRS adoption.*** Recent pronouncements of the SEC's Chief Accountant suggest that decisions about whether and how International Financial Reporting Standards will become applicable to U.S. companies are at least several months away, and implementation will almost certainly take several years. It is nevertheless important for audit committees and boards to ensure that financial management and auditors are following the process and keeping directors informed. Attention to two areas in particular is timely. First, the items of the company's accounting and financial reporting that will change most significantly under IFRS should be identified so that planning to address those changes can begin at an appropriate time. Second, systems development and implementation should even now take into account the potential impact of IFRS, including the scope and complexity of a company's business. While these considerations may not result in current changes, they are useful precautions, given the potential for future costs and surprises.

- ***SEC bounty program.*** Much has been written about the SEC's bounty program for whistleblowers and the potentially adverse incentives it creates. Less attention has been devoted to what boards and audit committees should do.

  - ***Hot spots.*** Boards should ensure that management considers areas of compliance risk that may come to the attention of whistleblowers. Key areas of concern could include violations of the Foreign Corrupt Practices Act, material errors in financial statements or other disclosure, misconduct in respect of customers or suppliers and anti-money laundering rules. Improper payments to government officials is a matter of particular government enforcement concern, and the Foreign Corrupt Practices Act, as well as the United Kingdom's Bribery Act, place a heavy emphasis on whether a company has adequate procedures to prevent violations.

  - ***Compliance programs.*** A principal concern is that potential whistleblowers will go directly to the SEC, without first alerting the company to compliance issues. The SEC's rules do, however, have provisions to encourage whistleblowers to report internally, and the audit committee should focus on maximizing the likelihood that this will be the case. The committee should ensure that procedures safeguarding whistleblower anonymity and protections against retaliation are robust. Steps should include management review of whistleblower protections, use of "voice of employee" surveys to get feedback about employee knowledge of and comfort with whistleblower programs and a review by the committee of management actions taken to strengthen compliance programs. Ensuring that supervisors at all levels receive training about avoiding retaliation is also critical, as is linking supervisor pay and performance evaluations to compliance.  The importance of these steps should not be underestimated:  there is substantial evidence that employees do not use formal complaint procedures, but simply approach their supervisors in cases where they believe complaints will be taken seriously and there will be no retaliation.

- ***Investigations and self-reporting.***  Because whistleblowers who first approach a company must go to the SEC within 120 days to get maximum credit under the bounty program, the company and the audit committee need to be in a position to make prompt and informed decisions about whether to approach the SEC before the whistleblower does.  The audit committee should ensure that management has a process for evaluating complaints promptly and reporting them to the committee.  The committee also needs a process for determining whether a complaint can be handled internally or whether it should involve outside advisors.  Board oversight should also include ensuring that management has "pre-cleared" (including for conflicts) advisors, including counsel, forensic accountants and crisis management consultants, who can be called in on short notice.

- ***Changed dynamics.***  Boards and committees that oversee investigations or enforcement matters should be aware of the changed dynamics the bounty program could bring to both.  Whistleblowers will urge the SEC to find wrongdoing and impose higher penalties.  This will be particularly true when the whistleblower is represented by counsel, which we expect will often be the case.  The whistleblower and counsel may not be at the table, but they can seek to influence the SEC, including through the political process and the media, especially in high profile cases.  The SEC will also be more likely to conduct investigations and will increase the thoroughness, time and expense of investigations related to whistleblower tips.

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Please contact any of the partners or counsel listed under Corporate Governance, Executive Compensation and ERISA or Mergers, Acquisitions and Joint Ventures in the "Practices" section of our website (www.cgsh.com) or any of your other regular contacts at the firm for further information about the matters discussed above.

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