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BDO BOARD REFLECTIONS

EUROPEAN DEBT CRISIS, INCREASED M&A AND EXECUTIVE COMPENSATION AMONG TOP ISSUES AT 2012 SHAREHOLDER MEETINGS

AS THE 2012 ANNUAL MEETING SEASON APPROACHES, SHAREHOLDERS WILL BE FOCUSED ON BOTH OPPORTUNITIES AND THREATS.

The steadily climbing stock market during the initial weeks of 2012 has fueled hopes that the long awaited economic recovery is finally gaining traction, but the European economic crisis still casts a long shadow of potential concerns. This uncertain climate should make for especially challenging annual meetings. BDO USA, LLP has compiled the following list of topics that corporate management and boards of directors should be prepared to address in connection with 2012 annual meetings:

- **European Debt Crisis.** The European economic crisis threatens the Euro and possibly the future of the European Commission. Sovereign debt holders or any companies with exposure (facilities or sales operations) in Greece, Italy or other Mediterranean countries need to be prepared for worst case scenarios. Shareholders will ask about contingency plans the company has in place should there be a major collapse. The SEC's Division of Corporation Finance weighed in and issued guidance in January instructing companies how to describe their risks

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BDO USA CORPORATE GOVERNANCE PRACTICE

BDO USA's Corporate Governance Practice was developed to provide guidance to corporate boards. The firm works with a wide variety of clients, ranging from entrepreneurial businesses to multinational Fortune 500 corporations, on a myriad of accounting, tax, risk management and forensic investigation issues.

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related to the European debt crisis more specifically. The guidance affects primarily financial institutions, but also any company with exposure to risk related to foreign currency and the EuroZone crisis. The SEC expects to see risks related to European debt described by country, segregated between sovereign and non-sovereign exposures, and by financial statement category, arriving at a gross funded exposure. Additional disclosures should include gross unfunded commitments made and information regarding hedges so that investors can see the total funded exposure. Reviewing the Corp Fin directive may assist management of all companies in preparing responses to shareholder questions on the topic.

- **Pulling Back on Outsourcing.** As the lower class moves into the middle class in Asia-Pacific countries, wages are increasing and businesses that outsourced to these countries are losing their competitive advantage. Should management look to re-domesticate previously outsourced services from these countries? A recent survey conducted by BDO found that outsourcing in the U.S. technology industry has declined for the third straight year.

- **M&A Plans/Takeover Defenses.** Most expect mergers and acquisitions activity to heat up in 2012. Given the lack of deals in recent years, management should be sure to shake the rust off their deal teams and be ready to take advantage of value buys as the economy emerges from the recession. By the same token, these same factors are likely to fuel hostile deal activity as companies seek to deploy cash reserves. Boards should have contingency takeover defenses in place to enable them to respond quickly to fend off attacks or maximize shareholder value should a transaction be accepted. BDO Capital Advisors, LLC offers timely analysis of recent and expected M&A activity; refer to *BDO Capital Industrial Markets Sector: Q1 2012 Transaction Review and Outlook* along with the *M&A Newsletter: Middle Market Update*.

- **Political Contributions.** Shareholder proxy proposals seeking disclosure of political contributions are at an all-time high and the 2012 presidential election will bring even more attention to the political spending of corporations. Boards should be prepared for this increased scrutiny and be ready to explain their oversight of political donations, lobbying activities and contributions to industry associations that lobby on their behalf. SEC Commissioner Luis Aguilar called for greater disclosure of corporate political spending in a recent speech.

- **Executive Compensation.** The advent of "say-on-pay" votes on executive compensation programs in 2011 did not produce the reaction that many predicted, as very few companies failed to receive shareholder endorsement of their programs. However, this issue will remain high on the shareholder agenda in 2012. Boards of companies that failed to receive a "yes" vote last year or had programs pass by a slim majority should be sure to address the compensation issues that were the focus of shareholder concerns last year. Boards and, more specifically, compensation committee members who appear to be unresponsive to these concerns, may find themselves the target of shareholder "vote no" campaigns when they are up for re-election. BDO's *2011 BDO 600 Survey – CEO and CFO Compensation Practices* details findings of CEO and CFO compensation practices of publicly traded companies in the energy, financial services (banking and non-banking), healthcare, manufacturing, real estate, retail and technology industries focused on mid-market companies. Institutional Shareholder Services (ISS), a highly influential proxy advisory firm, recently announced a new approach to evaluating executive compensation that connects executive pay for performance from both a quantitative as well as a qualitative perspective. We urge companies to understand and consider the ISS approach in assessing how their current compensation practices and policies stack up. Refer to BDO's recent Ac'sense program *Institutional Services (ISS): New Approach to Evaluating Executive Compensation*. Other relevant publications and resources include:

  - *SEC Adopts Rules Requiring Shareholder Advisory Votes on Executive Compensation (Say-on-Pay) and Golden Parachute Arrangements*
  - *NonProfit Standard: New Environment for Board Governance of Executive Compensation*

- **Next Wave of Dodd-Frank.** Not all of the Dodd-Frank Act regulations on executive compensation have been finalized, but their intent has broad support and it should be expected that shareholders will ask the company's position on key elements including:

  - *Clawbacks.* Has the company implemented "clawback" provisions that would allow it to recover compensation that was erroneously awarded in the three years prior to an accounting misstatement? Although the SEC has not issued any final rules[1] on recovery of executive compensation, a new rule adopted by the Federal Deposit Insurance Corporation (FDIC) allows regulators to take back up to two years of pay from former and current top executives and directors whose financial institutions were liquidated by the government, as summarized in this BDO Compensation & Benefits Practice publication.

  - *Hedging.* Has the company adopted a policy prohibiting an employee or outside director from hedging or pledging equity held directly or indirectly including compensatory equity grants?

  - *Independence.* Has the company assured itself that the members of the board's compensation committee are independent? For a listing of SEC independence requirements and considerations, refer to BDO publication *Considerations for Nominating Committees*.

  - *Vetting Advisors.* Does the compensation committee of the board engage the services of outside advisors including compensation consultants and legal counsel and, if so, by what process does it determine their independence?

1 The SEC expects to issue proposed rules by June 2012 and final rules by December 2012 on this topic. Refer to http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml#01-06-12 for more information.

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- In the *2011 BDO Board Survey*, which examines the opinions of more than 100 corporate directors of public company boards regarding financial reporting and corporate governance issues, board members shared their opinions on the implementation of two major components of the 2010 Dodd-Frank Act and its impact on their responsibilities. Additionally, BDO's *Effective Audit Committees in the Ever Changing Marketplace* publication, a practical guide to forming and running an effective audit committee, outlines several key provisions in the Dodd-Frank Act that we expect will impact corporate directors significantly, including some of the aforementioned topics.

- **IFRS.** The pressure from the international community continues to mount for the SEC to take decisive action as to whether and when the U.S. will incorporate international financial reporting standards (IFRS) into the U.S. financial reporting system. Chief Accountant James Kroeker, as quoted in a recent February 2012 speech to the IFRS Advisory Council meeting in London, indicated that an SEC decision on the use of IFRS by U.S. public companies is still a "few" months away. Kroeker used the term "endorsement" to describe an approach that involves the Financial Accounting Standards Board (FASB)'s review of IFRS standards and consideration on how to implement and incorporate them in the U.S.

- **Possible Auditor Rotation.** Given U.S. and European regulators' recent proposals to require mandatory audit firm rotation, management and audit committees should be prepared to discuss any questions regarding lengthy auditor tenures. Shareholders may want to know the process the company uses to select an audit firm, how long the current firm has been in place, when was the last time the audit engagement was put out for bid and how the audit committee ensures that the audit firm performs quality work.

- **Disaster Planning.** Beyond the terrible loss of human life, last year's earthquake and tsunami in Japan were powerful demonstrations of supply chain risks in a global economy. Any single failure in a business's supply chain can cause problems throughout the company. Boards should be prepared to articulate what they have done to prepare for low probability, but high impact events such as natural disasters. BDO's Risk Advisory practice offers relevant publications and assists clients by analyzing their existing infrastructure to identify areas in which incorporating risk management functions can benefit their business. In addition, refer to *Disaster Planning for Retailers: Five Considerations to Think About Now* and *Retail Resilience: Getting Back to Business After a Natural Disaster*

- **Cyber Attacks.** The proliferation of cyber attacks on businesses suggest that many companies are less adept at managing cyber threats as they are at handling risk in other areas. Weaknesses in networks and data security can expose businesses to significant losses in brand and market value. Shareholders may want to know how the company is taking a proactive and preemptive approach to cyber security. BDO's Risk Advisory practice offers relevant publications and provides risk-based information technology (IT) functions that assist clients in strategically aligning, measuring and governing their IT systems so that they operate with greater efficacy.

- **CEO Succession.** As businesses begin to rebound from the recession, executive movement should pick up – including CEO turnover. CEO succession is one of the board's most important responsibilities. Shareholders will want to know that the board has a succession plan in place and CEO candidates identified if needed. Refer to BDO publications *Effective Audit Committees in the Ever Changing Marketplace* and *Considerations for Nominating Committees*.

- **Accessing Capital.** Moody's has reduced credit ratings for banks and securities firms, which may further reduce the availability of financing in a still difficult economy. Given the tightening of lending terms in the U.S., are companies considering offerings on foreign exchanges to access capital? BDO Capital Advisors, LLC offers several resources to help your company when examining capital resources, including *M&A Newsletter: Middle Market Update* and *2012 BDO IPO Outlook*.

- **China.** There were numerous, well-publicized accounting scandals at Chinese businesses in 2011. Shareholders at companies operating in China or partnering with Chinese suppliers will want to know what type of due diligence or risk management the company has conducted on China based partners/suppliers to mitigate any exposure to poor financial reporting. BDO's Consulting practice has offered several publications and webcasts aimed at helping corporate directors understand the risks associated with doing business in China, including the following:

  - *Viewpoints: Thought Leadership from BDO Consulting (2011, Issue 2)*
  - *Ac'sense Program – FCPA Series: Doing Business Abroad – Spotlight on China*