

## Welcome to Ac'sense Compensation Risk - SEC's Enhanced Disclosure Requirements

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## Compensation Risk - SEC's Enhanced Disclosure Requirements

February 2010



## Reminders

In order to receive participation credit, you must:

- Be **appropriately registered for Webcast #14287** within the [BDO Online CPE Network](#)
- Be logged in for the **entire** webcast
- Be responsive to **all** polling/review questions

## Q&A Feature

- Technical questions may be submitted via the [Q&A Feature](#) on your screen. Time permitting, presenters will respond to these at the end of the session.
- Please submit as much information as possible (e.g., slide number reference, presenter, etc.).
- Submit Technological Support Issues to [LiveChat](#) under the "Support" tab.



## Today's Presenters

**MIKE CONOVER** - Senior Director, Specialized Tax Services - Compensation and Benefits Practice, BDO

**SYDNEY LEO** - Managing Director, Risk Advisory Services, New England Practice Leader, BDO



## Today's Agenda

Background

Highlights of Regulations

Compensation Risk

- Focus of the regulation
- A plan for compliance

## Background

### Executive Compensation

- *Perennial focus of public attention*
  - ❖ *In 'good times' - exclamation & sensation!*
  - ❖ *In 'bad times' - exasperation & frustration!*
  - ❖ *In recent years - more & more scrutiny!*
- *Recently... 'a perfect storm'*
  - ❖ *Unprecedented turmoil in financial markets*
  - ❖ *Near collapse of the economy & investment portfolios*
  - ❖ *TARP monies - tax payers' 'bailout' of troubled organizations*
  - ❖ *In the midst of the storm - more examples of excessive pay!*
- *Public Outrage - "ENOUGH!!!!"*

## Background

The public demands -  
*END COMPENSATION EXCESSES!!*

Legislators and regulators respond -

The themes:

- *Accountability / Objectivity*
  - ❖ *Board member independence & qualifications*
  - ❖ *Consultant independence*
- *Shareholder involvement*
  - ❖ *'Say on pay' - 'Golden Parachutes'*
- *Built-in Pay Plan Safeguards*
  - ❖ *Caps - Claw backs - Delay / Deferral*
  - ❖ *Mitigate / Manage RISK*

## Background

Proposed legislation - 9 proposals in Congress focused on solutions to the 'pay problem'

- *'Say on pay'... and other curbs on pay practices*

### Regulatory Response

- *U.S. Treasury*
  - ❖ *Pay restrictions on TARP recipients*
  - ❖ *Appointment of Special Pay Master, Ken Feinberg*
- *Federal Reserve*
  - ❖ *Issues requirements for banks to initiate review for compensation risk*
- *Securities & Exchange Commission*
  - ❖ *Adopts regulation for enhanced proxy disclosure*

## Background

Outrage over excessive executive pay has fundamentally changed the executive compensation landscape for the foreseeable future...

## Overview

### SEC - Proxy Disclosure and Solicitation Enhancements

(Finalized & Adopted - December 16, 2010)

"...to enhance the compensation and corporate governance disclosures..." registrants are required to make about:

- Overall compensation policies and their impact on risk-taking
- Stock and option awards for executives and directors
- Director and nominee qualifications, legal proceedings & diversity
- Company leadership structure
- Board's role in the risk management process
- Potential conflicts of interest of compensation consultants that advise companies

## Our Focus: Compensation Risk

**Focus** - "...reasonably likely to cause a material adverse impact..."

**Scope** - all employee plans, particularly incentives, are included... other areas too ➤ employment / severance agreements

## Our Focus: Compensation Risk

### Objective -

- Goes beyond the amount of awards payable under any particular plan or plans to participants
- To discover the risks, the focus must be on the measures, processes and practices that link plan participants' behavior and compensation to the business

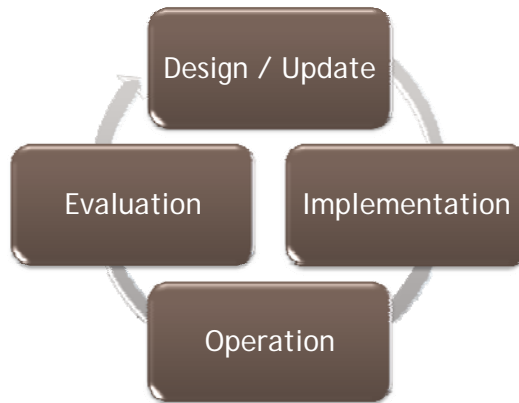
## Analysis Framework - Beginning

For some, the process begins and ends right here...

Design

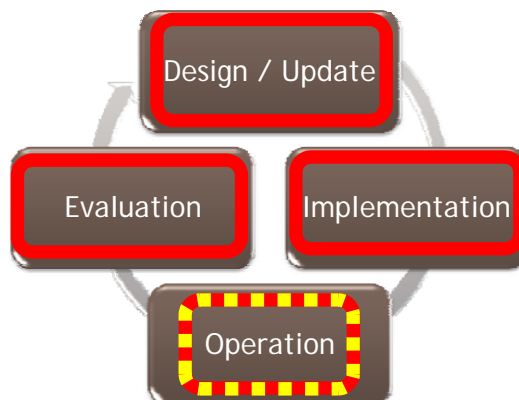
## Analysis Framework - Lifecycle

However, there's much more to be considered...



## Analysis Framework - Risks Throughout

Risk may be found in any area... let's consider one...



## Compensation Risk

### The “classic” stock option plan...

- Very simple concept...
- Straightforward, *typical* terms and provisions...
- Justifications -
  - ❖ “Everybody uses them...”
  - ❖ “Ours is just like all the others...”

*Any “risk” here???*

## Compensation Risk

### Example:

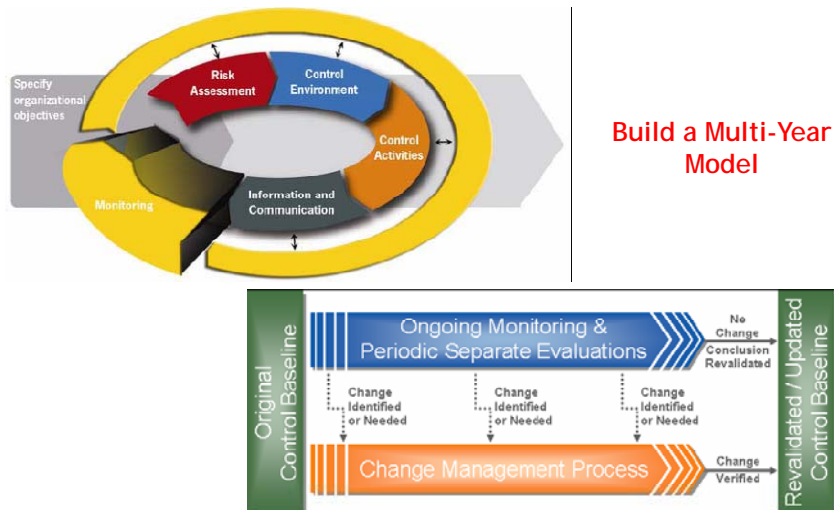
- Stock option plan
  - Consider *Option Backdating*
  - The risk:
    - Little or nothing to do with the design of the plan
    - Risk is in the processes and procedures used to operate the plan

## Compensation Risk Assessment (CRA)

### The need: A process for risk assessment

- One-size-fits-all will not work
  - ❖ Compensation practices vary considerably... industry-to-industry and company-to-company
  - ❖ 'Boilerplate disclosure' will not be acceptable
- A pragmatic approach
  - ❖ Quickly determine the extent of examination required
  - ❖ Focus attention on the plans / areas that require it
  - ❖ Report findings - recommend steps to mitigate risks
  - ❖ Leave a process behind to support ongoing compliance
- Not a one-time requirement

## Leverage 2008 COSO\* Monitoring Guidance



# THE COMPENSATION RISK ASSESSMENT

## Year 1



## PHASE 1



### Plan The Assessment

- Establish risk-rating parameters
  - For all areas of each plan
  - For pertinent aspects of each plan area
- Develop work plan for risk assessment
  - Satisfy compliance requirements
  - Meet compliance dates

## PHASE 1



### Plan The Assessment

- **Identify Involved Parties & Assign Roles**
  - **Board Members**
    - Compensation Committee - Audit Committee - Risk Committee
  - **Executives**
    - C-Suite Executives - Senior Risk Officer (SRO) - Designated Project Manager
  - **Outside Advisors**
    - Legal Counsel - Compensation Consultant

## PHASE 2



### Compensation Program Inventory

- **Collect governance & administrative policies covering:**
  - Design requirements
  - Necessary approvals from ALL parties involved
  - Periodic evaluation
  - Modification of terms / expiration
- **Inventory of all compensation plans**
  - Participants
  - Opportunities - Potential Payout
  - Performance measure(s)
  - Other documents: employment agreements; severance plans; etc.

## PHASE 2



### Risk Identification

- Methodical scan / initial rating of plans to assess risks:
  - Plan design
  - Associated processes and practices
  - Governing policies
  - Other pay-related agreements
- Prioritize plans based on overall risk ratings
  - Highlight areas that warrant closer review
  - Overview of inherent risks

**Top-Down  
Risk-Based  
Approach**

## PHASE 3



### Risk Rating & Prioritization

- Set scope of the assessment
  - Select specific plans, processes and practices proposed for review
  - Determine assessment steps required to address the areas included in the scope of the examination
- Secure approval for proposed assessment

## PHASE 4

Phase 4.  
Analysis and  
Testing

### Analyze and Test Plans / Policies

- **Conduct plan reviews and related testing**
  - **Plan Design**
    - Design flaws may pose risk
  - **Plan Documentation**
    - Evaluate adequacy of documentation
      - Governance & administration
      - Plan documents & award agreements
      - Employment / severance agreements

## PHASE 4

Phase 4.  
Analysis and  
Testing

### Analyze and Test Plans / Policies

- **Conduct plan reviews and related testing**
  - **Plan Administration:**
    - Sources of error - calculation errors
    - Weaknesses in controls
    - Accounting, tax and reporting
  - **Misalignment Analysis** - examine plan in terms of:
    - Company strategy / plan metrics 'congruence'
    - Proper risk/reward ratio
    - Possible financial or other 'behavioral' risks
  - **Competitive Assessment**
    - Prevalence
    - Prominence

## PHASE 4



### Analyze and Test Plans / Policies

- **Review general policies**
  - Adequacy of policies
  - Conformity to policies and procedures
- **Summarize identified risks & sources of risk**
  - Results of plan analyses
  - Results of policy analyses

## PHASE 5



### Findings and Reporting

- **Document results of the risk assessment**
  - Identify areas for attention/action
  - Analyze and deliberate how to mitigate / manage identified risks
- **Review with designated representatives**
  - Affirm / reach concurrence on results
  - Ensure relevance of final report
  - Review mitigation alternatives

## PHASE 5



### Findings and Reporting

- **Prepare report - findings, conclusions and general recommendations:**
  - Identified risks
  - Sources of risk
  - Recommendations on how to manage risk
- **Review and approve report for presentation to the organization**

## PHASE 5



### Findings and Reporting

- **Meet with board and compensation / audit committee:**
  - Findings
  - Recommendations to mitigate / remediate risk
  - Facilitate discussion to ensure:
    - Statutory requirements are satisfied
    - Fiduciary responsibilities are fulfilled (secure protection from liability)

## PHASE 5



### Findings and Reporting

- Adopt changes to improve effectiveness
- Proxy disclosure of risk review, findings and remedial steps taken:
  - Proxy filing information
  - Changes in risk profile - extent to which the company monitors its compensation policies
  - Compensation Committee Report of the safeguards that discourage risk-taking, manipulation of earnings, etc.

## PHASE 5



### Findings and Reporting

- Prepare an ongoing process to monitor and satisfy compliance requirements related to compensation-risk
- Other issues may need to be addressed:
  - Code Section 162(m) issues
  - Additional responsibilities of Compensation Committee
  - "Qualified Risk Expert"
  - "Risk Factors" disclosure in Form 10-K

## THE COMPENSATION RISK ASSESSMENT Subsequent Years

Changes and  
New Plans Only



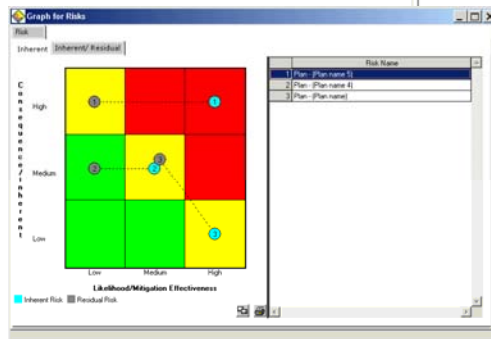
## The BDO CRA Toolkit



- Methodology and User guide
- Knowledge and Templates

## The BDO CRA Toolkit

- Automated Tool



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## Summing Up

Many companies are just now beginning to address the SEC's disclosure requirement for compensation risk

- There is uncertainty
  - ❖ The meaning of "... reasonably likely... adverse material risk..."
  - ❖ What needs to be done
- No 'best practices' to follow...
  - ❖ SEC's guidance is principles-based
  - ❖ Needs will vary company-to-company

Start sooner rather than later... plan the assessment based on needs vs. time left to filing deadline

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## Summing Up

There is a solution for companies searching for a practical approach to compliance with SEC requirements and allowing the board to make these representations confidently based on all aspects of compensation plans...

- Rapid assessment of company requirements
  - ❖ Establish company-specific criteria
  - ❖ Inventory compensation plans, policies and practices
  - ❖ Early identification of areas that warrant review requirements
  - ❖ Thoughtfully plan... particular attention to scope
- Conduct the assessment... do what needs to be done
- Produce meaningful output / outcome
  - ❖ Findings, conclusions and recommendations
  - ❖ Satisfy all reporting and regulatory compliance requirements
  - ❖ A process for ongoing compliance

## Presenter Contact Information

Today's Presenters:

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## Ac'sense Upcoming Programming

Currently scheduled\*:

- Q1 Financial Reporting Technical Update - April 16, 2010
- Mergers & Acquisitions: Addressing Current Trends and Risks - May 20, 2010
- Q2 Financial Reporting Technical Update - July 1, 2010
- Q3 Financial Reporting Technical Update - October 8, 2010
- Q4/YE Financial Reporting Technical Update - January 7, 2010

\* We intend to continue to add additional webcasts throughout the year

Ac'sense Programs and Website:

<http://www.bdo.com/acsense/>

- NOTE: Link to a self-study course of today's program will be available shortly at:

<http://www.bdo.com/acsense/events/compensationrisk.aspx>



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## CPE Certificates

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1. Individuals - by logging onto the <http://university.learnlivetech.com/BDOonline> after the session is completed and clicking **on My Learning - Completed Items**. Under the Certificate column, click the **Print** button beside the completed webcast.
2. Group participants - After receipt and processing of submitted group sign-in sheets to [cpdregistrar@bdo.com](mailto:cpdregistrar@bdo.com), group participants will be proctored into LearnLive and will be notified via e-mail when they can retrieve their certificates, following the steps above.
3. Sign-in sheets may be downloaded from the following: <https://university.learnlive.com/content/public/1029/accessinstructions/CPE%20Attendance%20Sheet.doc>



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## Evaluation

- We continually try and improve upon our programming and appreciate constructive feedback
- Following the program, we will be sending out a thank you e-mail that contains a link to a brief evaluation
- Thank you in advance for your consideration!

That concludes today's program.  
Thank you for attending!

February 2010