

2011 Current developments for directors

Charting the right course



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To our clients and friends

It has certainly been an eventful few years. And while the recovery is more uneven than most of us would like, many forward-looking companies are refocusing on growth.

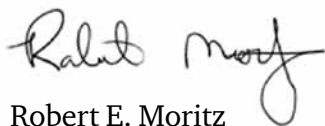
Directors have told us for years that they want to spend more time on strategy and growing the business. Acting on that feedback, we have compiled a special section in this year's publication to highlight some factors that are influencing companies' growth plans. In particular, we focus on how new global trends are affecting companies' operations and international expansion opportunities. Beyond the potential on the international stage, companies are also examining how they can foster innovation and find the next generation of products and services to differentiate them from their competitors. Evaluating whether your company has the right technology and workforce is part of that equation.

Of course, as companies focus on growth, they do so in a regulatory environment that is shifting the balance of power. Legislators and regulators are responding to shareholder demands for greater transparency and accountability, giving them a say on many issues that used to be reserved for directors. The full scope of regulatory reform may profoundly affect some companies — and in some unanticipated ways.

In addition to the changes being brought about by regulatory reform, companies are challenged with understanding the impact of and preparing to implement some major financial reporting proposals. The FASB and IASB continue to work on their priority projects that will affect the financial results companies report, and more importantly, their operations, in the years ahead.

Increased political and economic concerns over the federal deficit create significant challenges for the United States to overhaul its current tax system and provide greater incentives for investment and innovation. It remains to be seen if “globally competitive” tax reform can be achieved.

Directors will want to help management chart the right course. As you work to help your companies grow and prosper — and cope with the evolving regulatory and tax environment — PwC is committed to helping you understand the challenges and prepare for them. Please let us know how we can be of further assistance to you and your company.



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Table of contents

Three themes for directors in 2011	01
Special focus section	
Building competitive advantage in a global economy	03
Rebalancing of the global economy	03
Innovation as a strategic imperative	06
Leveraging IT	07
Recalibrating the workforce	08
Growing through acquisitions	09
Focus on key developments	
A watershed year: shifting governance influence	10
Executive compensation	11
Proxy access	13
Financial reporting developments: major changes ahead	15
Financial instruments	16
Leases	16
Revenue recognition	16
Checking in with IFRS	17
Regulatory and enforcement developments	18
SEC: enhanced oversight and enforcement powers	18
Focus continues on FCPA	19
Changes at the PCAOB	20
Key tax changes	21
Tax policy in a deficit-driven world	21
Disclosing uncertain tax positions	23
Appendix	
Dodd-Frank: impact on derivatives	24

Three themes for directors in 2011

Help management play offense

After a period of retrenching operations and reacting to economic stresses, companies need to — and indeed, will find it refreshing to — focus on growth again. Directors should insist that time is made for meaningful strategy discussions. Those discussions work best when directors bring their combined perspectives and experience to collaborate with management in exploring opportunities, push management to stretch in expanding products and geographic reaches, and help management navigate the pitfalls ever present in forging new paths.

Communicate and connect

Whether it's with your major shareholders or a broader group of your stakeholders, people want to understand what is going on in your company. In particular, with the say on pay votes starting in 2011 and proxy access possible in subsequent years, it's vital to engage with major shareholders and understand their concerns. That may mean certain directors — possibly the lead director or the compensation committee

chair — will play a role in those meetings. Recognize also that communications are changing, given the influence of social media. Because companies no longer control the message, directors will want to understand how management is responding to this phenomenon.

Understand the shifting business environment

Numerous changes are coming in the next few years — from regulation driven by the financial crisis, to major changes in financial reporting, which may have operational and strategic implications. Recognize that various regulators and enforcement agencies are increasingly active, whether it's the Department of Justice and the SEC focusing on the Foreign Corrupt Practices Act, or the IRS monitoring tax compliance. These changes are placing a real burden on management, increasing the difficulty of operating the business. Directors can play a vital role in helping management understand the implications of this changing world, and they can help ensure the company is adapting to the new paradigms.

Building competitive advantage in a global economy

While the shape of the global economic recovery remains uncertain, companies in the United States and around the world are wasting no time charting new courses for sustainable growth and building a competitive advantage.

We live in challenging times. Numerous unfolding — and sometimes contradictory — events are fueling uncertainty about the direction of the world economy, making it difficult for companies to know how to react. The global recovery is slower than expected. And, at the time of this writing, unemployment remains stubbornly high, housing markets are stagnant, and fiscal deficits are at unsustainable levels in the United States and Europe.

Yet those factors no longer tell the entire story. Many Asian companies are benefiting from a robust economic recovery. Even in the United States and Europe, corporate profits are up and deal-making is accelerating. While the shape of the global economic recovery remains uncertain, companies in the United States and around the world are wasting no time charting new courses for sustainable growth and building a competitive advantage. Some are using the recession as an opportunity to accelerate their strategic agendas. Directors will want to understand how their

companies are adapting to new circumstances, taking advantage of opportunities in global markets, leveraging technology, and recalibrating talent, as well as what part acquisitions may play in their growth plans.

Rebalancing of the global economy

The global economy is rebalancing, as nations change relative position. For example, in 2010 China surpassed Japan as the world's second-largest economy. And while the US economy remains the largest, the demographics of countries such as China, India, Brazil, and Indonesia could change the mix yet again.

Many believe that over the long term the US economy will no longer be the main driver of economic growth, and that trade and investment patterns will consequently change. Those shifts will likely have a major influence on investing internationally, and on currency, regulatory, and reputational risk.

Investing internationally

As a result of the global recession, governments around the world have intervened heavily in their markets and are changing policies and regulations governing the business environment. Today more than ever, government fiscal policies are shaping economic outcomes. Therefore, it is prudent to not only evaluate a country's potential for growth but also its foreign investment environment before making investment decisions.

In Europe, governments have shifted fiscal policy toward austerity; accordingly, economic growth is projected to slow in 2011. In contrast, consumer demand is likely to remain steady or rise in China, Brazil, and Australia, where stimulus helped the private-sector economy gain traction. The strengthening of many emerging market currencies, in relation to the US dollar, has hurt the competitiveness of their exports and could limit the opportunities for sourcing in those markets.

Some governments, including Indonesia and Poland, are implementing policies to attract foreign investment through tax breaks for capital investments, subsidies for new businesses, or low-cost financing. Such governments view foreign investment as an important source of capital for their economies. On the other hand,

some governments give the advantage to local businesses over outsiders. For instance, China has provided preferential loans to domestic players, while Russia has enacted policies that restrict foreign companies from investing in "strategic" sectors.

Additionally, brands and businesses that are perceived as "foreign" may also be subject to rising nationalist and anti-globalization sentiment. That may hinder a company's ability to succeed in cross-border mergers and acquisitions, especially if the public perceives the company is gaining undue market share or control.

New dimensions of currency risk

Marked differences in the speed that countries are recovering from the global economic slowdown are impacting exchange rates and rapidly shifting the costs of doing business abroad. The relatively faster growth, coupled with historically low interest rates and rising savings rates, has further intensified currency appreciation among emerging economies. In response, policy makers in these countries have turned toward currency management to protect manufacturers.

Policy makers in export-oriented emerging economies are particularly under pressure to act, as the appreciation of their currencies reduces the competitiveness of their exports. If those nations don't

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follow China's lead and manage currency appreciation, they will fall further behind China as to the relative cost of their exports. But following China's currency policy can be expensive. And so countries have been looking for alternative ways to slow the strengthening of their currencies. For instance, Brazil and Thailand have created and expanded taxes on capital inflows into credit markets.

Management should monitor exchange rate movements and policy changes that affect the company's operations and discuss with the board how it will respond to related challenges. Management also should consider the strategic business implications of potentially significant and long-term currency shifts — perhaps most importantly from a rising yuan and yen and a falling dollar.

More regulatory risk

The credit crisis and resulting global recession prompted governments to rethink their role in the marketplace, with many policy makers taking the view that greater intervention is warranted. In most industrialized countries, the focus is on constraining risky and unregulated activities and restoring consumer and investor confidence. The Dodd-Frank Act is a prime example. Longer term, governments may be able to reduce their direct involvement as economies rebound.

In a number of emerging markets, however, increased state intervention appears to reject basic free-market principles. US companies operating in these markets may find their competitiveness threatened by state-owned enterprises and domestic companies that benefit from government policies. If such anti-free market policies continue to be adopted, foreign companies may also face increasingly intrusive partnership, licensing, and technology transfer requirements, as well as environmental, health, and safety standards that are not as rigorously enforced for local companies. Companies may also face different risks and opportunities as governments seek to increase their countries' competitiveness and reorient their economies toward more sustainable drivers of growth — as with proposed labor market changes in Chile and tax reform in India.

More complex reputational risk

Doing business in emerging markets, which often have lower environmental, health, and safety standards, also exposes companies to reputational risk. Advances in communications, including social networking, enable criticism about the company's behavior in its foreign operations to spread more widely and quickly than in the past.

Innovation as a strategic imperative

The emergence of these global trends, including global rebalancing, will likely create new competitors from different corners of the world. For companies to sustain growth and build competitive advantage, innovation must become a strategic imperative. Companies remain committed to the operational efficiencies they've achieved during the economic

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crisis. But that cost discipline may stifle innovation, which is vital to grow in a competitive world market. If your company isn't bringing new ideas to market, your competitors will.

Innovation is meaningful only if the new products or different processes create value. Innovation is not only about how much your company spends on R&D or the number of patents it registers, but also about developing a culture that encourages employees to think about what's next and what could work.

Companies innovate in two ways. The first involves incremental changes that help reduce waste or increase efficiency in existing operations. These changes are generally modest in nature. Having employees on the lookout for these opportunities is important, but such changes will only rarely move the needle in a big way.

The game-changing ideas usually come instead from the "innovation lab." As R&D focuses on the next generation of products or services, many of its ideas won't succeed. Indeed, failure rates typically range between 70% and 90%. Managers who grew up in companies where failure is not tolerated often have a difficult time making the leap to risk such a high failure rate. So what factors support innovation?

- An environment that expects and tolerates a certain level of failure as the team tries out new ideas. It doesn't hide failure but instead shares lessons learned. It avoids demoting or otherwise punishing individuals whose ideas don't work. And it's suspicious of repeated success, as that could mean the team isn't stretching.
- Support to advance ideas past initial stages. That doesn't mean the company needs to provide a great deal of funding. But it does mean the funding needs to be available at the right times, so the team can either reach important milestones, or discover quickly if an idea doesn't work and move on to other ideas.
- The right measures. Some companies track what is moving through their development pipeline — how many products are at the various stages from incubation through acceleration and scaling. Some set goals for the percentage of revenue from products they didn't have a few years earlier, as a measurement overall of how well they are innovating. They also tie these measures to the performance goals set for employees.

The ultimate goal is competitive advantage: bringing a unique good or service to market that your competitors can't easily replicate.

Leveraging IT

Information technology, once relegated exclusively to operations, is emerging as a strategic business function. It has become a potential source of competitive advantage and, therefore, directors will want to understand the opportunities for and possible risks of technology to their company. Among the most important technology developments is cloud computing.

Companies still spend the lion's share of their IT operating budgets — by some estimates, upward of two-thirds — on ongoing maintenance, leaving relatively little for innovation. Demands on existing infrastructure have increased sharply in recent years. Companies are generating enormous amounts of information and sharing it in ways and at speeds that were unthinkable a few years ago. Cloud computing holds the promise of being a true solution to meeting these many demands.

Cloud computing allows computing services to be supplied over the internet without the need for companies to provide their own internal hardware or platform support. The cloud provides the servers, switches, and storage needed to build an application environment. Cloud computing provides clear cost advantages to companies that can lease computing and data storage capacity from web-based providers. How? By reducing companies' capital investments in equipment and software, and lowering operational maintenance costs. In addition, cloud computing is scalable, with an on-demand model that lets companies pay as they go.

Momentum for cloud computing and its supporting technologies has been considerable. But companies are only starting to feel the real impact. Cloud computing can play a strategic role for all companies, not just those in the technology or services industries. By doing away with typical IT constraints — limited resources, consuming maintenance, and incompatible systems — cloud computing frees a company to pursue growth and innovation. Companies should be viewing cloud computing developments as a source of competitive advantage with great potential, instead of as an incremental improvement in information technology. Directors will want to understand how management is leveraging the opportunities cloud computing brings.

While IT innovations bear promise, directors should also be aware of some of the associated risks.

- Cloud computing entails data security risk, particularly in moving company data to a third party for storage, processing, or support. These data integration and ownership concerns need to be addressed to protect intellectual property as well as to safeguard employee, customer, and counterparty information.
- It's easier now for employees to adopt unapproved external solutions when the IT department isn't meeting their

needs quickly enough. But such “shadow IT” solutions won’t necessarily be reliable, interface with the company’s existing systems, or meet the company’s data security and privacy standards. Management needs to establish adequate controls to monitor the prevalence of such applications, determine whether they pose significant risk, and ensure the company is properly protected.

- Because we take technology for granted, employees could inadvertently disclose sensitive data on social networks or leave the company’s networks vulnerable to attack through their online actions. To reduce such risks, management can increase training available to employees and focus resources on protecting data that is most at risk, instead of trying to lock down everything.

Successful companies manage human capital and talent as strategic assets.

Recalibrating the workforce

Structural shifts from the rebalancing of the global economy are being felt as much inside companies as outside. As one CEO observed: “Even though we’ve had a 9–10% reduction in terms of staffing, we’ve also had increases. We see a lot more people, for example, on the digital side being added to our talent base.”

This is a trend that many American workers are well aware of. They are being challenged to learn new skills and deliver higher productivity in a tough labor market. In fact, new skills needed to succeed in today’s business environment include greater risk awareness, change management, and the ability to work across diverse cultures and respond to new consumer demands. Many companies that downsized aggressively — and US companies were at the forefront of global retrenchment — could soon face a shortage of skills suited to the new global economy.

Successful companies manage human capital and talent as strategic assets. They continually strive to align their workforces with company objectives through providing distinctive work environments, benefits and incentives. In fact, our 2010 annual Global CEO Survey found that about a third of US CEOs are changing their people strategy — with respect to training and development as well as staff morale and employee engagement programs. And a fifth say they are taking a fresh look at pension and healthcare arrangements.

Increased workloads, job reductions, and overall economic and employment uncertainty have strained employee morale, and as welcome as the recovery is, it adds even

greater challenges in workforce management. Human resources' role may need to focus more on finding and motivating the right talent. To do so, human resources needs to understand the business strategy and identify the talent required to support that strategy.

Growing through acquisitions

Not all growth is organic. As companies emerge from the recession, many have accumulated significant cash reserves and are considering acquisitions. It's important for management to be able to predict the earnings impact from possible acquisitions, but it is challenging to do this reliably.

In assessing a potential acquisition, companies typically estimate the fair value of intangible assets so they can project the expected amortization expense, which can be a significant factor in future earnings. Historically, these estimates were driven by "benchmarks," which were based on the percentage of purchase price allocated to amortizable assets in past transactions. Benchmarking can be useful, but it has limitations. A 2009 change to acquisition accounting for certain items (such as earn-outs and in-process research and development) means

that benchmarks based on transactions that closed prior to 2009 won't factor into the earnings impact of such items. Management needs to adjust the estimation and expectation for such factors to avoid post-acquisition earnings surprises.

How can management avoid these surprises? By taking more time in pre-merger negotiations, using more sophisticated valuation techniques, and drawing on valuation and acquisition accounting expertise, as needed. If management can more accurately estimate the earnings impact of potential acquisitions, the board is able to make better-informed decisions.

Directors' actions

- Understand how global developments are affecting both existing operations and investment opportunities.
- Discuss with management how it plans to further pursue and promote innovation as a key element to support growth.
- Discuss with management the value that cloud computing can bring to the company and how it can exploit the strategic opportunities while managing the risks.
- Understand how management is reshaping the skills and size of the company's workforce in light of its strategy and today's economic conditions.
- Discuss with management the level of analysis performed to support acquisition-related earnings guidance used in decision making.

A watershed year: shifting governance influence

Directors will want to collaborate with management on the best strategy for further developing relationships with important shareholders and engaging them on sensitive issues.

Get ready. Your shareholders will be casting an advisory vote on executive compensation and golden parachutes. They may also be able to nominate directors in your proxy. Your compensation committee will have additional factors to consider in overseeing executive compensation, and your company will be providing even more executive compensation disclosures. It has been an active year, to say the least, for legislators and regulators.

These changes reinforce the importance of engaging with your shareholders. It is clear that directors will want to collaborate with management on the best strategy for further developing relationships with important shareholders and engaging them on sensitive issues.

The Dodd-Frank Wall Street Reform and Consumer Protection Act is aimed primarily at financial

market regulation. That said, some of the Act's financial services provisions will affect companies that are not in the financial services sector. For example, companies that use derivatives or have financing arms may be affected (See Dodd-Frank: impact on derivatives in the appendix). The Act also has executive compensation and corporate governance requirements that apply to all public companies.

The SEC and other regulatory bodies are tasked with implementing 500+ rules, conducting 60 studies, and issuing the 90 reports required by the Act. There will be many opportunities to weigh in on regulatory policy along the way, and directors should discuss with management which elements of the Act affect the company and which provisions management expects to comment on as rules are developed.

Executive compensation

Since the financial crisis began, executive compensation has been a lightning rod for legislators and regulators. Accordingly, it is not surprising that the Act contains many new executive compensation requirements.

Say on pay

One way Dodd-Frank tries to address concerns about executive compensation levels is by giving shareholders an advisory vote on executive compensation (a say on pay). Shareholders also will have a separate frequency vote at least every six years on whether they want that say on pay vote to occur annually, biennially, or triennially. The votes will start with companies' first annual meetings after January 21, 2011. The SEC proposed a rule in October 2010 to clarify how these two new votes should occur and will likely issue final rules in early 2011.

The frequency of voting proposal would have companies include four choices on the proxy ballot — one year, two years, three years, or abstain. Companies may recommend which frequency they would like shareholders to select, and why.

Both the say on pay and the frequency votes are advisory — that is, the board isn't bound by how shareholders vote. However, the SEC's proposal also would require companies to discuss in their Compensation Discussion and Analysis how past voting results — for both say on pay and frequency — have influenced compensation policies and the company's actions.

The Act also requires companies to disclose (generally in the proxy associated with a transaction) specific information about golden parachute compensation arrangements for executive officers. Shareholders would get a nonbinding vote on these arrangements. While proposed rules were issued in October 2010, this element of say on pay voting won't be effective until the SEC adopts final rules, expected in the first quarter of 2011.

While the advisory votes are nonbinding, directors will be under pressure to react to the voting results. If they don't, they could become targets of a withhold vote campaign in a subsequent board election. Companies that either voluntarily adopted say on pay or were mandated to do so (because they had received funds through the Troubled Asset Relief Program) typically received overwhelming

shareholder support in those votes. Indeed, only three companies received "negative" say on pay votes in the 2010 proxy season, each for different reasons.

Many directors are concerned that say on pay gives ever-greater influence to proxy advisory firms. Why? Institutional investors may not have the resources to adequately review and analyze the complex compensation disclosures for the hundreds — or thousands — of companies in which they invest. As a result, they will probably have to rely more heavily on recommendations from proxy advisory firms when casting their votes in future proxy seasons. A number of companies are considering more active direct engagement with significant shareholders to counter the greater influence of the proxy advisory firms.

Given the sensitivity and high-profile nature of executive compensation issues, directors will want to ensure the proxy clearly describes the executive compensation philosophy and policies, and consider additional ways to engage with shareholders on executive compensation issues. They also should understand shareholders' perspectives when considering fundamental changes to executive compensation programs.

Compensation clawbacks

The Dodd-Frank Act requires public companies to adopt a clawback policy. If a company restates its financial statements (whether or not misconduct occurred) it must reclaim any excess incentive compensation that was paid to executive officers based on the erroneous financial information. That clawback covers the three-year period prior to the year of restatement. The proposed rules on clawbacks are expected in mid-2011.

Many questions regarding this provision remain unanswered. For example, will companies be able to reclaim incentive payments if executives are no longer at the company or don't have the money available? And how deep through the executive ranks will clawbacks reach? More fundamentally, will compensation programs change so incentive pay is based less on financial results? Will there be more resistance by management teams to restate incorrect financial statements?

Compensation committees and compensation advisors

Shareholders and regulators have questioned the effectiveness of compensation committees and the independence of their advisors.

Under Dodd-Frank, compensation committee

members will face additional independence requirements. They will not be allowed to receive compensation from the company apart from what they earn in their role as a director. They also will not be considered independent if they are an "affiliate" of the company. (Generally, an affiliate is an employee of the company or someone who owns, controls, or has the power to vote 5% or more of the company's outstanding securities.) These changes are similar to the additional independence requirements for audit committee members and may have little impact as most directors already meet these stricter independence requirements.

The Act also will require compensation committees to consider the independence of their compensation advisors. The focus on compensation advisor independence is not new. Starting with their 2010 proxies, companies had to report any fees the compensation consultant earned from providing services to management if the consultant also provided services to the compensation committee. Dodd-Frank directs the SEC to define the independence factors that compensation committees will have to consider — and those factors will capture relationships and activities that go beyond the services and fees involved. The rule is expected in spring 2011.

Companies may want to revisit the disclosure of directors' experience, qualifications, and skills to determine whether the value individual directors bring to the board is adequately communicated.

Expanded disclosures

Dodd-Frank also requires a number of expanded compensation disclosures. The SEC is expected to finalize rules on these disclosures in the second or third quarter of 2011. Companies will have to disclose:

- The relationship between executive compensation and the company's financial performance, including stock performance and dividend policy. This change may cause companies to supplement their narrative Compensation Discussion and Analysis with more graphical information, clearly demonstrating the relationship.
- The median compensation of all employees (excluding the CEO), the CEO's total compensation, and the ratio of the two. Gathering information for this calculation will be extremely onerous. Among the complexities are whether to include various statutory benefits, how to value those and other benefits, and how to deal with part-time employees.
- Their policy on whether employees or directors are permitted to hedge the risk in equity securities that were received as part of compensation.

Proxy access

Proxy access remains a contentious issue. After years of debate, the Dodd-Frank Act authorized the SEC to adopt proxy access rules, which it did in August 2010. The rule was to take effect for the 2011 proxy season, but the SEC delayed the effective date pending the outcome of a legal challenge. If legal issues are resolved by mid-2011, calendar year-end companies may face proxy access as early as the 2012 proxy season. Non-calendar year-end companies could have to adopt the rules before the end of 2011. (Smaller reporting companies — those with a public float under \$75 million — have a three-year deferral.)

The SEC's proxy access rule permits a shareholder, or group of shareholders, who have held at least 3% of shares continuously for at least three years, to nominate directors in the company's proxy statement. They can nominate up to one-quarter of the board.

The rule significantly decreases the cost for shareholders to nominate director candidates. In particular, smaller companies, companies with large institutional bases, or those that have historically been unresponsive to shareholder demands may be more

vulnerable. Yet, the share ownership requirements may reduce the likelihood that hedge funds or single-issue activist groups will be able to nominate directors.

While the path forward for proxy access has been delayed and may change depending on the outcome of the legal proceedings, it highlights the need for companies to communicate effectively with their shareholders about board composition and other critical issues. Directors can use the deferral of the effective date to develop a strategy with management on how the company would prepare for a situation where shareholders use proxy access.

Companies may want to revisit the disclosure of directors' experience, qualifications, and skills to determine whether the value individual directors bring to the board is adequately communicated. In PwC's study of 100 S&P 500 proxies from the 2010 proxy season, there was wide variation in the disclosures. Some companies provided an overview of the strategy behind their boards' composition and described how each board member fits that strategy. Other companies gave concise descriptions on why a

board member is relevant to the board. Regardless of the status of proxy access, directors should not lose sight of the fact that shareholders and hedge funds can continue to use conventional methods to launch a proxy fight.

With proxy access potentially leading to contested director elections, it could further expand the influence of proxy advisory firms. This is one of many areas the SEC is examining in its review of the US proxy voting system.

Directors' actions

- Collaborate with management on a strategy for further developing relationships with shareholders and engaging them on sensitive issues such as executive compensation and director nominations.
- Consider whether certain directors should be directly involved in discussing governance matters or compensation issues with interested shareholders.
- Understand whether any aspect of the company's current compensation practices are of particular concern to shareholders.
- Understand the profile of the company's existing shareholder base and how many meet the stock ownership requirements for proxy access.
- Discuss with management whether disclosures should be enhanced given their increased importance in the say on pay/proxy access era.

Financial reporting developments: major changes ahead

Given the uncertain timing of any mandated US adoption of IFRS, and recognizing that companies have scarce resources, we don't believe US companies should make major investments in IFRS at present.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) continue to work on several joint projects designed to improve and converge US generally accepted accounting principles (US GAAP) and International Financial Reporting Standards (IFRS). In response to concerns over the unprecedented pace of standard setting, in late 2010, they revised their work plans to prioritize issuing a more limited number of new standards, including those covering financial instruments, leasing, and revenue recognition. At the time of this writing, these standards were expected to be issued by mid-2011. The timelines on many of the other projects underway have been extended or postponed.

Changes at the FASB could further affect standard setting. FASB Chairman Robert Herz retired in October 2010 after

more than eight years of leading the FASB's standard-setting efforts. Leslie Seidman, a two-term FASB member, is serving as the acting chair. At the same time that Herz announced his retirement, it was announced that the five-member FASB would return to a seven-member board by early 2011. Because the projects under way were deliberated by the five-member board, it's possible that the tentative decisions reached could change once all three new board members are in place and the new board considers feedback on the proposed standards from companies and others.

Directors will want to understand management's approach to analyzing the potential accounting, business, and operational impacts of the significant projects under way. An overview of several key projects follows.

Financial instruments

Although the accounting for financial instruments is a joint project, the FASB and IASB have taken different approaches. The FASB has proposed that all financial instruments be measured at fair value on the face of the balance sheet, with limited exceptions. The IASB has proposed retaining a mixed-measurement model: amortized costs for some instruments (generally those instruments that the company expects to hold so it can collect contractual cash-flows) and fair value for others. The Boards have also proposed new accounting provisions for recording impairments of financial assets and hedging.

While the effects of the FASB's proposal on financial services companies are particularly wide-ranging, it will also affect companies in other sectors and will likely result in greater earnings volatility.

Companies are concerned about the differences in the two proposals and generally prefer the IASB's approach, believing that it better reflects a company's investment strategy. The views of financial statement users vary; some prefer fair value while others prefer a mixed measurement model.

Leases

The FASB and IASB have proposed significant changes to the way companies account for the assets that they lease. The proposal removes today's distinction between capital and operating leases. Companies will show assets and liabilities for all lease rights and obligations on the balance sheet. For many companies, adopting the lease standard will require significant resources to analyze the many leases companies have. Further, the expansion of the balance sheet may affect debt covenants and debt and capital ratios.

In addition to changing the balance sheet, the proposed standards would require companies to recognize more expense in earlier years, as interest on the lease obligation would be higher initially, similar to a mortgage. However, companies would also report certain improved performance measures, such as earnings before income taxes, depreciation, and amortization (EBITDA), because rent expense would be replaced by amortization and interest expense, both of which are backed out of that performance measure.

Companies that lease significant assets that are presently off-balance sheet may want to reconsider lease-versus-buy

decisions. For example, because leases will be recorded on the balance sheet, management might decide to discontinue a lease if the borrowing costs are greater than the company's typical cost of financing. That said, there may be valid business reasons for leasing significant assets, such as providing the company with greater flexibility to locate operations and replace outdated technology.

Given the expected impact of this standard, management will want to communicate the effects to shareholders, analysts, credit agencies, and other stakeholders. Timely assessment of the proposal's impact will enable management to start these discussions and avoid surprises.

Revenue recognition

A proposed new revenue recognition standard could fundamentally alter the way companies recognize revenue. Under the proposal, a company would recognize revenue when it satisfies its obligations to its customers, which happens when control of goods or services transfer to the customer. Although this may sound simple and similar to today's guidance, it is different. The standard will affect each industry differently, but almost all will see a change in the timing or measurement

of certain revenues and possibly greater volatility in reported earnings.

Because analysts and investors use revenue as a key metric to compare companies, management should prepare to explain how the change in financial reporting will affect revenue trends and comparability against competitors.

Management may also want to consider how it structures contracts to deliver goods and/or services in light of the proposed changes to the revenue recognition standard. This could influence the company's product and service sales strategy.

Checking in with IFRS

Ongoing convergence and development of major standards will bring near-constant change to US financial reporting over the next several years. We believe this continued convergence between US GAAP and IFRS will ultimately be followed by the United States changing to IFRS. The question is: When?

In 2011, the SEC will update its views about whether, when, and how US companies might transition to IFRS. Given the uncertain timing of any mandated US adoption of IFRS, recognizing that companies have scarce resources, and

understanding that the SEC is likely to allow for an extended conversion period, we don't believe US companies should make major investments in IFRS at present. But they should be involved in measured ways that make sense. How? By managing the impact of continuing IFRS adoption by their non-US subsidiaries. By understanding the impact of IFRS on their non-US counterparties and competitors, given how widespread IFRS adoption is around the world. And by monitoring key developments both in the SEC's plans and in the FASB's and IASB's progress toward issuing new standards. Those developments could signal when management needs to ramp up its IFRS-readiness activities.

Directors' actions

- Discuss with management the resources needed to fully analyze the accounting, business, and operational impacts of the major accounting standards under development.
- Discuss expected changes to the company's balance sheet, financial results, debt covenants and other key metrics, and how the company will communicate the impacts of these changes to shareholders, analysts, and credit agencies.
- Stay current on the SEC's views on the adoption of IFRS.
- Understand how management is planning for these significant changes and how the changes might affect:
 - the way the company approaches lease versus buy decisions
 - financial instruments and hedging strategies
 - the way the company sells its products

Regulatory and enforcement developments

New powers, resources, and incentives for whistleblowers will strengthen the SEC's enforcement and oversight capabilities.

SEC: enhanced oversight and enforcement powers

Although the SEC faced some reputational setbacks over the past few years, its mandate is now strengthened as a result of the Dodd-Frank Act. In particular, the Act provides the SEC's Division of Enforcement with a host of new legal tools and additional jurisdiction and duties, and requires the SEC to write almost a hundred new rules and conduct a number of studies and reports.

Some notable changes that Dodd-Frank is making:

- The SEC is implementing a greatly expanded whistleblower program. It will reward tipsters with payments ranging from 10% to 30% of any penalties or disgorgements of \$1 million or more. The program also will allow tips to be made anonymously through law firms. The SEC has set aside more than \$400

million for whistleblower rewards. Some companies and directors have expressed concerns that the program will make company hotline programs less effective. Why? Because whistleblowers may be motivated by possible monetary rewards to report issues directly to the SEC. The SEC's proposed rules attempt to address this concern by including a 90-day grace period for employees to report internally while preserving their "place in line" at the SEC. The proposal also allows the SEC to consider higher percentage rewards for individuals who report allegations internally first. And it proposes to charge whistleblowers who make frivolous complaints with perjury. Given the significance of this topic, directors will want to discuss with management how the proposed rule (and ultimately, the final rule) will affect the company's compliance programs.

- The SEC will be able to bring a greater range of charges. For example, it will have the power to charge individuals who may not have been directly involved in fraud but may have aided it through inadvertent but “reckless” behavior. As a result, companies may wish to review policies and procedures designed to detect and react to red flags that may indicate others’ wrongdoing.
- The SEC will have increased authority to gather evidence in enforcement cases and expanded power to exchange information with other federal agencies.
- The SEC will be empowered to inspect the records of advisors to hedge and equity funds, credit rating agencies, and swap dealers. New regulations affecting those parties may have implications for companies that interact with them.

Taken together, these new powers, resources, and incentives for whistleblowers will strengthen the SEC’s enforcement and oversight capabilities.

Focus continues on FCPA

In addition to focusing on the rules and regulations mandated by the Dodd-Frank Act, the SEC is teaming with the Department of Justice to more vigorously pursue violators of the Foreign Corrupt Practices Act (FCPA). Indeed, both criminal and civil prosecutions of FCPA violations are at an all-time high. Plus, with new whistleblower incentives, the number of SEC investigations into FCPA violations could increase substantially.

In addition, in 2010, the United Kingdom enacted its new anti-bribery law, which takes effect in April 2011. This is the UK’s first update to its anti-bribery statute since it was originally passed more than 100 years ago. It could signal that the UK will be more active in investigating and prosecuting such wrongdoing. Companies with operations in the UK can be charged with failing to prevent bribery and can face unlimited fines.

Given this backdrop, directors will want to understand how management is:

- Enhancing the company’s FCPA compliance program, and tailoring it to meet the company’s needs
- Setting a tone at the top that emphasizes the importance of compliance with the law
- Ensuring there are robust controls to prevent and detect criminal conduct, including an effective compliance and ethics program that takes into account FCPA (Such a program can reduce penalties after a violation has been proved.)
- Educating employees and nonemployees (agents) who may act on behalf of the company about the FCPA, including guidance on what to do if they witness or suspect a violation
- Monitoring the impact of the UK anti-bribery act and determining what changes may be needed to anti-bribery programs if the company does business in the United Kingdom
- Continuing to monitor and understand business relationships with third-party distributors, agents, and consultants to ensure their compliance and ethics programs are consistent with the company’s FCPA compliance objective

Changes at the PCAOB

The Public Company Accounting Oversight Board (PCAOB), which regulates firms that audit public companies, has three vacant board positions at the time of this writing. In part, that was due to uncertainty surrounding a Supreme Court case challenging its constitutionality. With that case decided and the PCAOB's future assured, it can more readily recruit new members. Given the majority of the board will be new, that turnover could impact the approach that the PCAOB takes to overseeing audit standards and to inspecting audit firms.

Two audit standards that are currently under consideration:

Communications with audit committees

In March 2010, the PCAOB proposed a new auditing standard that carries forward substantially all of the existing required auditor communications and adds a number of new requirements. It aims to enhance communications between auditors and audit committees. The PCAOB expects to release additional information on this standard in early 2011.

The proposed standard's objectives include ensuring that the auditor:

- Provides timely observations that are significant and relevant to the financial reporting process
- Evaluates the adequacy of the two-way communication between the auditor and the audit committee as it relates to the audit. If these communications aren't adequate, the auditor will have to take appropriate action, which might include communicating with the full board of directors, modifying the auditor's opinion, or withdrawing from the engagement.

Some are concerned that if the volume of mandatory communications to audit committees increases, it could detract from the focus on substantive issues.

Revisiting the auditor's report

Improving communications between auditors and investors remains a central goal of the PCAOB. As part of this process, the PCAOB is considering changes to the auditor's report, specifically the form, content, and user needs. Some have said auditors should provide more information about the quality of management's reporting, especially related to critical accounting estimates, and that auditors should publicly disclose more of the information they share with audit committees. Others question the wisdom of expanding the auditor's report in that way. They point to the audit committee's deeper understanding of the issues and its ability to discuss the communications with the auditors and management. The PCAOB expects to release additional information on this topic by mid-2011.

Directors' actions

- Recognize that the SEC will become increasingly active and visible in its enforcement and examination activities.
- Discuss with management how the company may be affected by the new SEC whistleblower program and what actions, if any, management is planning.
- Understand how the company manages its FCPA compliance obligations including the training it provides to employees and non-employees.

Key tax changes

Tax policy in a deficit-driven world

During the past few years, US government debt has grown significantly, to the point that debt as a percentage of gross domestic product is at one of its highest points. Over the longer term, projected growth in Social Security and government healthcare spending — and the increased cost of servicing the federal debt — lead most budget experts to conclude that the current fiscal path is unsustainable. Accordingly, even if Congress makes significant spending reductions, it is likely that tax revenue will have to increase.

In coming years, the federal deficit and accumulated federal debt will be major factors in shaping tax policy. In the short term, Congress will continue to need to address the implications of a “pay-as-you-go” budget law, which generally prohibits tax reduction unless it’s offset by permanent spending cuts

or increased taxes in another area. This tension has already been evident in 2010 as efforts to renew a number of expired business tax incentives, including the research credit, have been delayed by a lack of agreement on revenue-raising offsets.

In early 2010, President Obama established a commission charged with proposing recommendations to balance the budget (excluding interest payments on the debt) by 2015. At the time of this writing, the commission has not issued its formal recommendations. But in November, the commission co-chairs released information about the options they are considering to reduce federal deficits — by significantly reducing spending and broadening the income tax base. The savings and additional revenue would be used to reduce the deficit and to lower individual and corporate tax rates. Also under consideration is ceasing to tax foreign earnings of US multinational companies.

In coming years, the federal deficit and accumulated federal debt will be major factors in shaping tax policy.

Many US trading partners are addressing similar concerns about deficits and overall debt growth. In many cases, countries are taking significant steps to reduce government spending and raise taxes. That said, they are trying to avoid raising business taxes so they can maintain a competitive business environment and attract capital.

For example, the UK government is reducing its corporate income tax rate from 28% to 24% over four years, while increasing its VAT from 17.5% to 20% starting in 2011. This continues a general trend in recent years among many developed economies to reduce corporate tax rates and rely more on consumption taxes. Such policies have the potential to promote investment and maintain tax revenue in a manner that many economists believe to be less harmful to international competitiveness and economic growth.

In contrast, the United States relies predominantly on individual and business income taxes to finance the cost of government. Indeed, it has the second-highest statutory corporate tax rate among the Organization for Economic Cooperation and Development (OECD) member countries, a group that includes major US trading partners.

In addition, nearly all major US trading partners also promote the competitiveness of multinationals based in their countries by largely exempting foreign business earnings from tax when they are distributed to the parent company. The United States is the only G-8 country and one of the few OECD member countries that imposes tax on foreign business earnings returned for domestic investment. This is a critical difference, as nearly half the income of US multinationals is earned by their foreign subsidiaries.

It remains to be seen whether the new Congress will address the high US statutory corporate rate and pursue tax policies that make US companies more competitive around the globe. In light of current deficits, revenue concerns may inhibit such reforms. Many believe that without a significant new revenue source, the United States cannot achieve globally competitive corporate tax reform in a “revenue neutral” manner. In the absence of a new revenue source, revenue-neutral reform within the corporate sector would result in both “winners” and “losers,” depending on each company’s particular tax circumstances.

Disclosing uncertain tax positions

Going forward, companies with audited financial statements and more than \$100 million in assets will have to disclose uncertain tax positions to the IRS as part of their federal income tax returns. Specifically, companies will have to provide a concise description of each US tax position that is uncertain and rank them based on the amount of the federal income tax reserves recorded for financial accounting purposes. That list will include any tax positions for which the company didn't record a tax reserve because it expects to litigate the tax position. Companies don't have to disclose highly certain or immaterial tax positions.

The required disclosures generally will begin in a

calendar-year-end company's 2010 federal income tax return. Although no state currently has a similar requirement, we believe it is likely that certain state tax authorities will mandate similar disclosures. For example, California has announced it will require taxpayers to file the federal form with their California tax return.

As part of the guidance on these new disclosures, the IRS has confirmed that generally it will request tax accrual work papers only in extraordinary circumstances. In addition, it no longer will assert that a company that discloses a tax document as part of the audit of its financial statements waives any attorney-client privilege for that document. Although this change doesn't bind the Department of Justice in tax litigation, it is a welcome step by the IRS.

Directors' actions

- Discuss with management its evaluation of how the company might be impacted by the various aspects of a revenue-neutral tax reform.
- Discuss with management how a broad-based consumption tax might impact the company and how management anticipates addressing any impacts.
- Recognize that the new uncertain tax position disclosures in companies' tax returns will likely lead to significant changes in how the IRS selects and conducts examinations.

Dodd-Frank: impact on derivatives

A 2009 PwC report found that more than 90% of Fortune 500 companies and half of mid-sized companies use derivatives to hedge some of their day-to-day business risks, from interest rates to the price of oil. Such companies may be affected by the Dodd-Frank Act's new derivatives regulations, which will change the structure of the over-the-counter derivatives market. (Over-the-counter derivatives are contracts that parties directly negotiate with each other, without going through an exchange.)

Under the Act, the SEC and the Commodities Futures Trading Commission will require certain over-the-counter derivatives to go through central clearing houses and trade on exchanges. They also will review trading information to monitor risks in this complex market.

What does this mean for companies that use derivatives?

- If companies replace over-the-counter derivatives with exchange-traded derivatives, they may find that certain hedges are less effective. Why? Because the standardization of exchange-traded derivatives

may make it more difficult for companies to execute certain hedge strategies and could result in greater mismatch with the hedged exposure.

- If the exchange-traded derivatives are less effective, fewer hedges may qualify for hedge accounting treatment, which could result in greater earnings volatility.
- Those companies that want customized derivatives may find that their costs increase, as counterparties may be less willing to enter into contracts for customized derivative instruments.

The rule-making process over the next several years will reshape the US derivatives markets. In addition to the uncertainties related to the rule-making, the FASB is reconsidering the accounting guidance for all financial instruments, including derivatives. Companies with significant hedging activities should closely monitor regulatory and accounting developments in this area. (See "Financial instruments" in the section on financial reporting developments.)

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