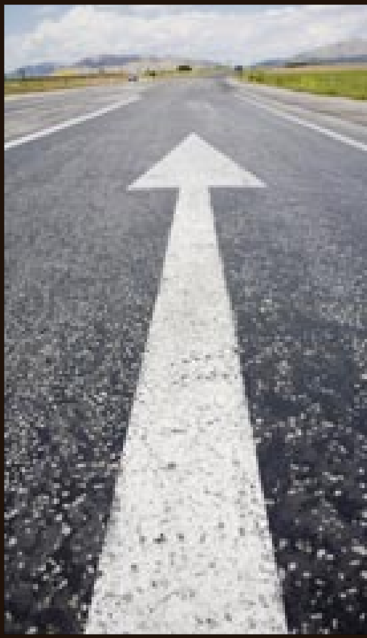
Chartered Accountants of Canada

Long-term Performance Briefing



WRITTEN BY
Alan Willis, CA

QUESTIONS FOR DIRECTORS TO ASK

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Preface

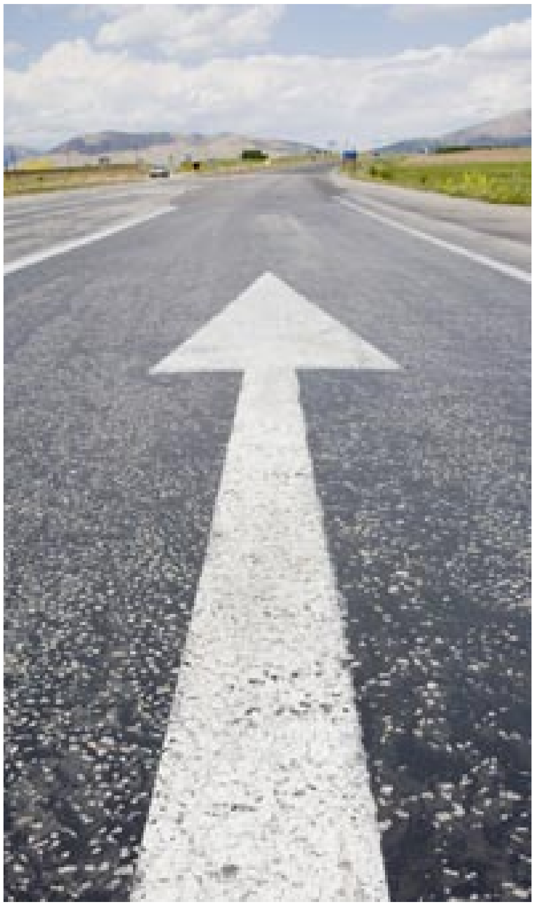
The Risk Management and Governance Board (RMGB) of the Canadian Institute of Chartered Accountants (CICA) commissioned this briefing to help Canadian directors focus on enhancing longer-term corporate interests despite the immediate pressures of the economic downturn.

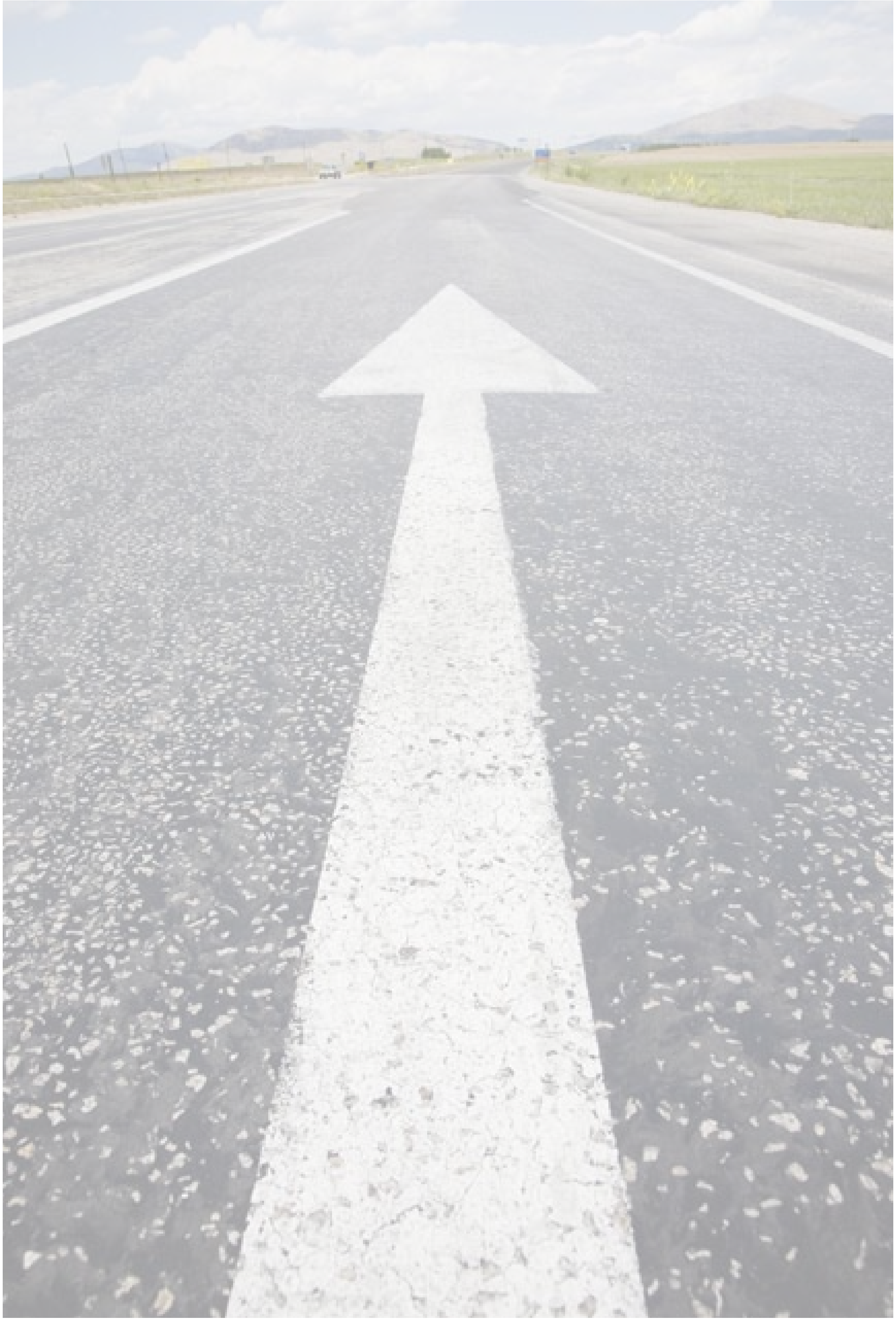
Survival is necessarily a priority for many companies during times of market turbulence and the board plays a crucial role in overseeing the steps taken by management to help the company ride out the financial crisis. However, the board may provide even greater value by bringing a deliberate focus on the longer-term issues essential to positioning the company for success in post-recessionary markets.

This briefing highlights areas in which directors must balance a long-term outlook with short-term expediency. It offers questions that are intended to be a catalyst for useful dialogue among directors, with management or with outside advisors.

The RMGB acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, the author, Alan Willis, CA, and the CICA staff who provided support to the project.

Brian Ferguson, CA
Chair, Risk Management and Governance Board





Introduction

In turbulent economic times, management may struggle to balance short-term survival priorities with the need to anticipate and be ready to take advantage of the post-recession business environment. The board must oversee management's plans and actions for surviving the market volatility in the short term, but may provide even greater value by focusing on the enhancement of the company's performance in the longer term.

Consistent with their responsibility to act in the long-term best interests of the corporation, directors play a key role in ensuring the ongoing success of the organization by addressing issues such as:

- what the future business environment may be, and how to prepare for it;
- identifying and preparing to take advantage of new opportunities;
- the possibility of unintended long-term consequences of decisions taken in the interests of short-term survival; and
- lessons to be learned from the market crisis about the company's strategy, business and assets, including its people.

In the past months, Canadian companies have faced exceptional business challenges, including:

- volatility in currency exchange rates;
- constraints on liquidity, credit and access to capital;
- decreased demand from Canada's largest trading partner;
- fluctuations in energy and resource prices;
- a changing regulatory environment;
- instability in banking systems around the world; and
- lack of consumer confidence.

It is likely that the post-recession business environment will involve transformative, structural change in many industries and markets, including:

- corporate governance reforms and changes to regulatory regimes,
- new forms of government intervention in and regulation of business,
- less plentiful debt and equity funds available in the capital markets, and
- increased complexity and inter-relation of business risks.

Anticipating and preparing for this "new normal" will be critical for long-term survival and success.

There are a number of key areas for boards to address in order to enhance the corporation's long-term performance. All of these are established elements of the board's oversight role, but merit particular attention in order to maintain focus on the corporation's long-term interests despite short-term pressures.

The first group of topics addressed in this briefing relate to positioning the company for success and creating value over the longer term:

- Business Strategy
- Risk and Risk Oversight
- Finance
- Organization & Workforce
- Stakeholder Relations & Trust
- Leadership

The remaining topics relate to governance and control policies and practices. They may underpin or undermine a company's ability to survive and thrive over the longer term:

- Executive Compensation
- Entity-level Internal Controls
- Board Dynamic, Structure and Processes

Business Strategy

Business strategy should be considered in light of possible future economic scenarios within the “new normal” context. Different scenarios, even extreme ones, should be contemplated and their probability evaluated. The assumptions underpinning the scenario used by management to formulate strategy should be carefully examined. This process can form the basis of an enterprise-wide business strategy that addresses both risks and opportunities.

The strategic plan should allow the company to be nimble, flexible and adaptable to change. Oversight of strategy should not be a passive annual ritual, but rather a dynamic process involving frequent updating and review.

For more information, see the CICA publication *20 Questions Directors Should Ask about Strategy*.

Valuable lessons can be learned from the company’s experience during the recent market turmoil regarding the validity of assumptions underpinning the business strategy and the company’s ability to adapt to changing conditions.

Questions for Directors to Ask

1. What management assumptions about the future state of the economy, capital markets and risk environment underpin the business strategy? What time horizon does the strategy address? Consider for example:
   - Has management evaluated the implications of various economic scenarios over differing timeframes?
   - Is the strategic plan based on a specific scenario? If so, how was it selected?
2. Under the economic scenario used by management to formulate strategy, what are the long-term implications for the company in terms of:
   - operations,
   - capital projects,
   - competitive environment,
   - mergers and acquisitions,
   - new opportunities,
   - risk management strategies,
   - access to capital, and
   - availability of other resources?
3. What is management’s best assessment of the business strategies likely to be adopted by competitors? Have these been taken into account in developing our own long-term strategic plan?

Risk and Risk Oversight

Effective oversight of risk has been a subject of board deliberation for many years; however, the impact of the global recession and related financial crisis has brought this subject to the forefront. Management of risk is inextricably linked to strategy and can be determinative of a company’s long-term viability. As a result, the identification and oversight of risk is a critical component of the board’s role and is key to enhancing the company’s long-term performance.

For more information, see the CICA publication *20 Questions Directors Should Ask about Risk*.

The financial crisis highlighted the complexity and interrelation of business risks in the global economy, and the need to revise traditional business thinking about risk and uncertainty. Risk management must now take into account other global issues with potentially widespread impacts such as climate change, disease and pandemics, and terrorism.

Risk oversight should include open discussion periods at board meetings in addition to board review of management reports and presentations. Directors are encouraged to consider whether there are lessons to be learned from the recent market turmoil about the company's approach to risk and risk management.

Questions for Directors to Ask

4. What process does management use to identify significant business risks? Are there other risks that are critical to the successful execution of the company's strategy that should also be considered?
5. What assessments has management made about the likelihood and impact of significant business risks? Are we comfortable with those assessments?
6. Are management's conclusions as to the risks the company is prepared to accept in line with the company's risk tolerance level, taking into account the risk management strategies to be employed as well as the returns anticipated?
7. Have we documented our risk management process and the work done to identify and manage risk, as part of the board's oversight responsibility?
8. Have significant opportunities been overlooked or neglected due to overemphasis on downside risks?

Finance

Financial issues such as access to equity and debt capital and managing liquidity will continue to be significant for Canadian companies in the longer term. Finance and investment are key to the development of business strategy, and financial management and liquidity are essential to successful execution. The role of the CFO has never been more critical[1], nor the board's financial acumen more valuable in enhancing long-term corporate performance.

Questions for Directors to Ask

9. What can be learned from the effect of the global financial crisis on the company's financial condition and how should this inform future strategy? Consider for example:
   - How sensitive are the company's finances to currency fluctuations or devaluations?
   - How might the company be affected by regulatory changes resulting from the financial crisis, such as changes to the leveraging capacity of financial institutions?
   - What are the implications for the company's financing strategies if equity markets continue to be volatile or borrowing becomes more difficult or expensive?
   - Will the company be able to meet its pension fund obligations, including any additional obligations arising from low returns and interest rates?
   - Have the company's credit ratings been affected, either by business operations and conditions or by pension obligations? If so, will it be able to meet the terms of existing debt and to refinance as necessary?
   - Could otherwise sensible and well-executed hedging and risk management strategies for the core business have unintended long-term consequences?
   - Does the company have investments that should be divested or liquidated in order to strengthen its financial condition?

1 See *The CFO's role in navigating the downturn*, McKinsey & Company, Perspectives on Corporate Finance and Strategy, Number 10, Winter 2009

Organization and Workforce

Workforce reductions and realignment of business units in order to cut costs may be short-term survival tools, but may not be in the long-term best interests of the company. Such decisions present an extraordinarily difficult balancing act. Adequate human resources and an appropriate organization structure are essential to successful execution of strategy: downsizing today is not necessarily synonymous with right-sizing for tomorrow.[2]

For more information, see the CICA publication *20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee*.

Where downsizing or reorganization has occurred, it is critical to ensure continued employee engagement and alignment of staff with the company's revised strategy. The company's long-term ability to attract and retain employees is key to its future success: this should not be neglected by management when, for example, making changes to compensation structure and policies.

Lessons learned as a result of the market crisis about the company's organization and its people should inform the board's oversight of company structure and human capital going forward.

Questions for Directors to Ask

10. If the company has reduced its workforce in order to survive the current crisis, will sufficient human resources be available for successful implementation of its post-recession long-term strategy?
11. Will the company's compensation strategy assist in attracting and retaining key employees?
12. Will the company's present organizational structure be appropriate for the nature and scale of business operations in the post-recession business environment?
13. What actions have been taken to build employee understanding of and alignment with organizational changes?
14. Are there any significant long-term constraints or risks associated with the workforce and how are these to be managed?

Stakeholder Relations and Trust

Stakeholder relations and trust are important intangible assets, and present an opportunity to enhance long-term business value.[3] Value-supporting and trust building relationships should be sought with investors, employees, customers, suppliers and other stakeholders, especially in communities where companies have or plan to have operations.

Timely, effective corporate reporting and external communications are important tools and the board's role in this area should not be limited to oversight of compliance with regulatory disclosure rules, but should be to encourage forthright communication and relationship building with key stakeholders.

Questions for Directors to Ask

15. Are we satisfied that management's strategic plan has appropriately taken into account the value of relationships with key stakeholders over the long-term?
16. Is management paying sufficient attention to building key stakeholder relationships? Are we paying sufficient attention to stakeholder relations and their value to the company?
17. Does our communication plan go beyond regulated minimum requirements in order to build strong stakeholder relations?

2 See *Balancing Cost and Talent Needs: Tough Solutions for Tough Times*, Towers Perrin, 2009

3 See *The Trust Imperative – Taking Governance to the Next Level*, The Conference Board of Canada, November, 2008

Leadership

Having the right CEO and management team for the company's circumstances is critical. The company's leadership needs will change over time, and different skills sets will be needed to deal with different situations.

In the present, boards have an important role to play in mentoring CEOs, few of whom have experience leading companies through a serious recession. Directors must satisfy themselves that the leadership team is dealing effectively with the challenges presented by the financial crisis.

For more information, see the CICA publication *20 Questions Directors Should Ask about CEO Succession*.

However, boards must also plan for CEO succession in order to safeguard the company's long-term interests. Today's CEO, selected several years ago under different business circumstances, may not be a good fit with the company's future direction, particularly if the company's strategy is undergoing substantial change.

Questions for Directors to Ask

18. Are we satisfied with the performance of the CEO and the leadership team in managing the company through the economic crisis?
19. Is succession planning for the longer term being adequately addressed? Have we assessed the company's leadership needs in light of our expectations regarding the future business environment and related changes to the company's strategy?

Executive Compensation

Executive compensation is currently under intense scrutiny by stakeholders and regulators as the economic crisis has exposed cases of excessive risk taking motivated by incentive pay.

Aligning executive pay with performance is generally regarded as key to an effective compensation program, but the choice of which performance measures to use is critical. In some cases, the board's compensation committee uses one set of performance indicators to evaluate CEO performance, the audit committee uses another set when evaluating corporate performance, and senior management uses yet another in setting business targets, leading to a disconnect between incentives and desired results. Tying incentive compensation to short-term performance indicators can encourage excessive risk taking and be detrimental to the company's long-term health.

For more information, see the CICA publication *20 Questions Directors Should Ask about Executive Compensation*.

Directors, particularly those sitting on compensation committees, should review executive compensation practices in light of the lessons learned from the financial crisis. Incentive programs should be calibrated to motivate executives to enhance company performance and should align their pay with sustainable long-term results.[4]

Questions for Directors to Ask

20. Does the executive compensation plan, including the metrics on which incentive compensation is based, effectively align executive pay with the longer-term orientation embedded in the company's strategic planning?

4 For more information, see the CICA Director Alert *Human Resources and Compensation Issues during the Financial Crisis*, by Lisa Slipp, July 2009.

Entity-level Controls

Oversight of internal controls is a key board responsibility. Entity-level controls can reduce the likelihood of management or employees focusing excessively on short-term performance to the detriment of the company's long-term interests, or engaging in unethical actions or those that could jeopardize the company's reputation.

Board oversight of entity-level controls such as codes of business conduct and support for management signals about long-term value generation are ways in which the "tone at the top" will reinforce a longer-term perspective in all aspects of doing business.

Questions for Directors to Ask

21. Are we satisfied that a focus on long-term performance is pervasive throughout the organization, supported by the tone at the top?
22. Are appropriate entity-level controls in place to protect the company's reputation and long-term interests?

Board Dynamic, Structure and Processes

The mindset of directors and the dynamic of the board, as well as its structure and processes, can all help foster a long-term perspective.

The backgrounds and experience of directors can affect the board's disposition to think long-term or short term, as well as the likelihood of achieving an appropriate balance between the two. Some individuals are pre-disposed to fast, short-term action, while others take a more considered approach to decisions. The board chair and governance committee should factor these dynamics into their recommendations when seeking and nominating new board members.

The organization of the board and the manner in which responsibility is assigned can also affect its ability to adopt a long-term orientation. Committee structures and mandates as well as the manner in which issues such as risk and strategy are included on the board's agenda will influence the manner in which directors discharge their oversight responsibilities.

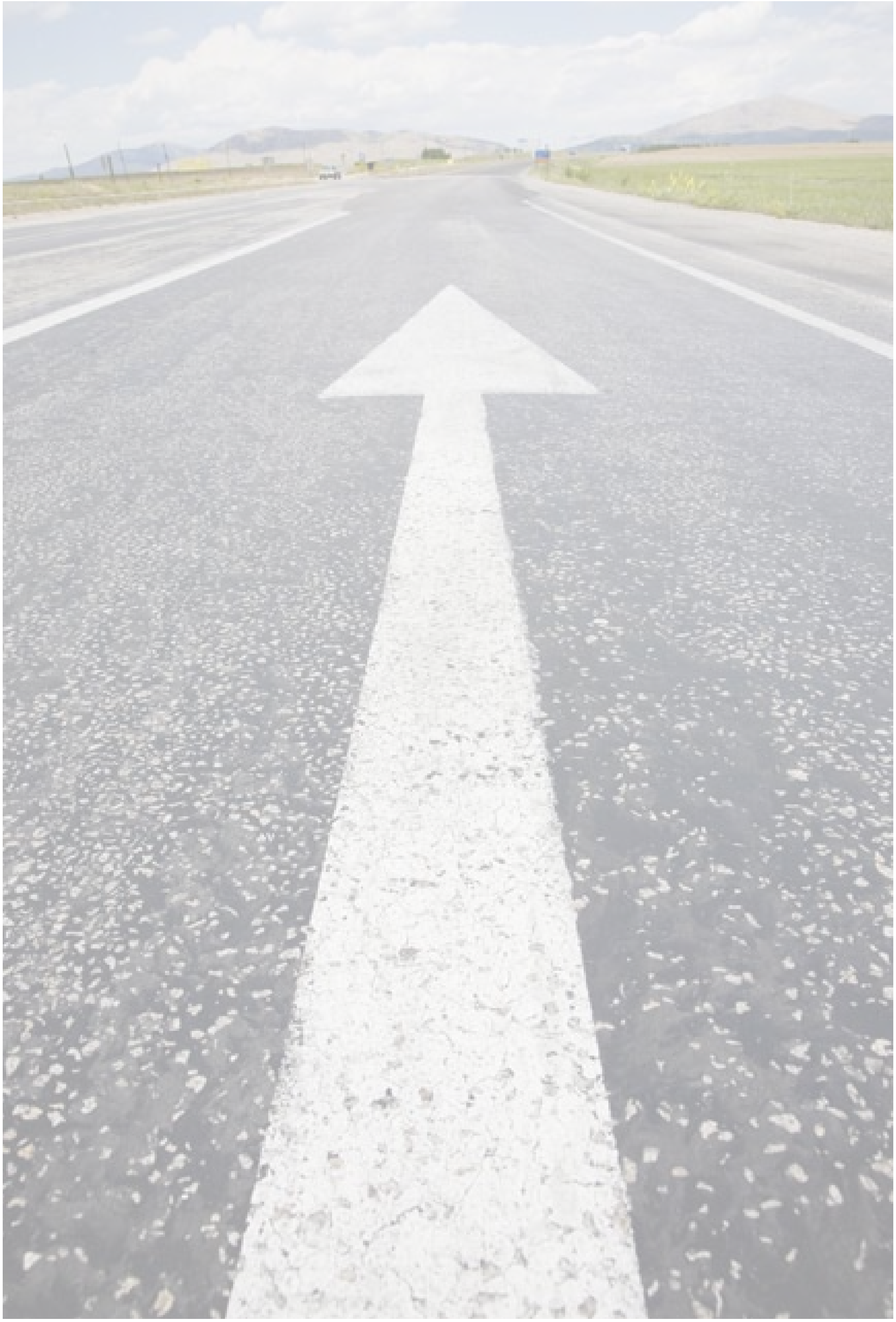
Boards may slip into fixed patterns of behaviour and interaction during meetings which are not conducive to challenging long-held views or asking tough questions. Directors should consider whether changes to the dynamic, structure or processes of the board would assist board members in focusing on the company's long-term performance.

Questions for Directors to Ask

23. Does the composition of the board include a blend of experience and backgrounds and a dynamic that is conducive to appropriate balancing between long-term and short-term perspectives?
24. Is there a need to adjust the board's committee structure or amend the mandate and terms of reference of existing committees?
25. Is there a need to increase the number or length of board meetings or change their format in order to enhance our ability to exercise oversight in an integrated manner and with a longer-term mindset?

Conclusion

Safeguarding the long-term interests of the corporation is a fundamental duty of the board of directors. Paying attention to the topics discussed in this briefing and asking the right questions about them will help directors fulfill this duty while enhancing the company's performance and positioning it for success well beyond times of economic downturn, financial crisis and market turbulence.



Where to find more information

CICA Publications on governance

The Directors Series

The 20 Questions Series

20 Questions Directors and Audit Committees Should Ask about IFRS Conversions

20 Questions Directors Should Ask about Building a Board

20 Questions Directors Should Ask about CEO Succession

20 Questions Directors Should Ask about Codes of Conduct

20 Questions Directors Should Ask about Crisis Management

20 Questions Directors Should Ask about Crown Corporation Governance

20 Questions Directors Should Ask about Director Compensation

20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance

20 Questions Directors Should Ask about Executive Compensation

20 Questions Directors Should Ask about Governance Assessments

20 Questions Directors Should Ask about Internal Audit (2nd ed)

20 Questions Directors Should Ask about IT

20 Questions Directors Should Ask about Management's Discussion and Analysis (2nd ed)

20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing

20 Questions Directors Should Ask about Risk (2nd ed)

20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee

20 Questions Directors Should Ask about their Role in Pension Governance

20 Questions Directors Should Ask about Special Committees

20 Questions Directors Should Ask about Strategy (2nd ed)

Director Briefings

Climate Change Briefing – Questions for Directors to Ask

Long-term Performance Briefing – Questions for Directors to Ask

Director Alerts

Fraud Risk in Difficult Economic Times – questions for directors to ask (July 2009)

Human Resource and Compensation Issues during the Financial Crisis – questions for directors to ask (July 2009)

The Global Financial Meltdown – questions for directors to ask (October 2008)

Executive Compensation Disclosure – questions directors should ask (February 2008)

The ABCP Liquidity Crunch – questions directors should ask (October 2007)

The Not-for-Profit Directors Series

20 Questions Directors of Not-for-profit Organizations Should Ask about Fiduciary Duty

20 Questions Directors of Not-for-profit Organizations Should Ask about Governance

20 Questions Directors of Not-for-profit Organizations Should Ask about Risk

20 Questions Directors of Not-for-profit Organizations Should Ask about Strategy and Planning

Liability Indemnification and Insurance for Directors of Not-for-Profit Organizations

The CFO Series

Deciding to Go Public: What CFOs Need to Know

Financial Aspects of Governance: What Boards Should Expect from CFOs

How CFOs are Adapting to Today's Realities

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Risk Management: What Boards Should Expect from CFOs

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Internal Control: The Next Wave of Certification. Helping Smaller Public Companies with Certification and Disclosure about Design of Internal Control over Financial Reporting

Internal Control 2006: The Next Wave of Certification – Guidance for Directors

Internal Control 2006: The Next Wave of Certification – Guidance for Management

Understanding Disclosure Controls and Procedures: Helping CEOs and CFOs Respond to the Need for Better Disclosure

Available at www.rmgb.ca

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About the Author

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Alan Willis, Chartered Accountant, is an independent consultant in the fields of corporate governance, performance measurement and business reporting, with a particular focus on the linkages of these topics with sustainability and the business value of stakeholder relations. He directed the development of CICA's 2004 guidance on MD&A preparation and disclosure and wrote the related briefing *20 Questions Directors Should Ask about Management's Discussion and Analysis*. He co-authored CICA's Executive Briefing *Climate Change and Related Disclosures*, and its guidance publication, *Building a Better MD&A: Climate Change Disclosures*. He has worked extensively with Canadian and international initiatives to develop performance indicators and reporting guidelines relevant to corporate management of and disclosure about climate change impacts, environmental performance and corporate social responsibility. He is a member of the International Corporate Governance Network and its Committee on Non-financial Business Reporting.

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