Board Effectiveness Insights
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FOCUS

Board Effectiveness Partners (BEP) collaborates with directors and CEOs to objectively analyze and improve the effectiveness of their boards.

INSIGHTS

We publish *Board Effectiveness Insights* periodically to encourage dialogue on strengthening board effectiveness. We welcome your suggestions, thoughts, and agreement or disagreement. Please visit www.bepartners.net for more details and other chapters of *Board Effectiveness Insights.*

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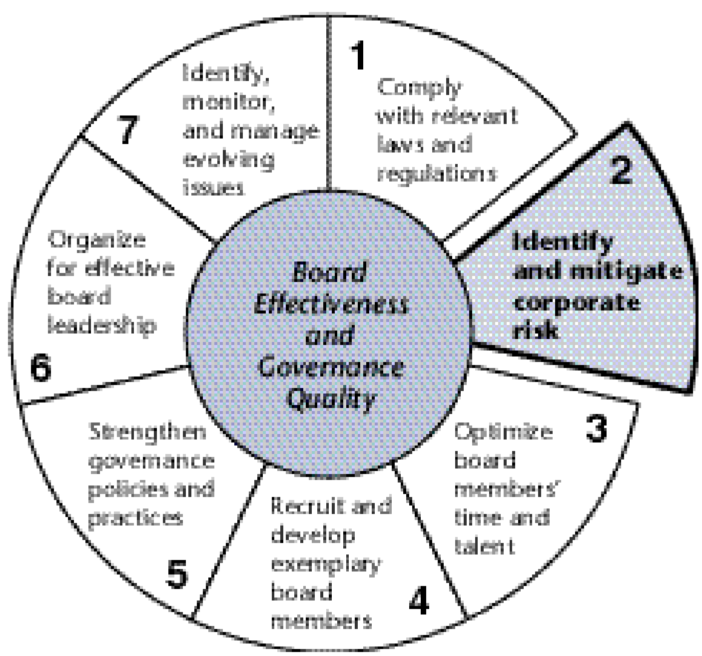
Identifying and Mitigating Corporate Risk

During the past several months, a number of prominent names have joined the unfortunate parade of corporate casualties in the headlines and now share reporting space with the likes of Enron and the former WorldCom. Corporate directors we know agree on an essential point: they do not want to see their companies or themselves skewered in the business news and the criminal justice system.

Whether the measure is ethics or economics, avoiding the wrong headline or trouble with the law seems to boil down to corporate performance. And the buck stops in the boardroom. Boards need to refocus on strategic planning, CEO and C-level executive succession planning, board and management effectiveness assessment, economic and competitive analysis, legal compliance, developing human capital, and financial legitimacy.

Another critical focus for directors, **risk mitigation**, is certainly no less important for sustainable success. Board Effectiveness Partners (BEP) believes directors can and should take pragmatic, preemptive steps to avoid the costly mistakes made by the boards now caught in the glare of business headlines. Achieving growth and shareholder value in these demanding times requires managing risks effectively.



At the board level, the effects of recent failures to mitigate risk can be measured by the lost jobs, squandered investments, and failed ventures that often translate into the costs of higher Directors and Officers (D&O) insurance premiums and the damaged reputations of directors. Tillinghast-Towers Perrin recently reported that corporations paid out 36 percent more to litigious shareholders than in the previous year. During that period, D&O insurance premiums jumped almost 30 percent.

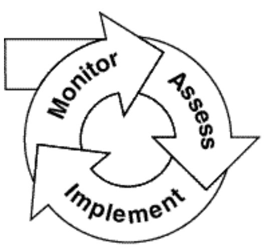
Today, too many D&O policies contain important exclusions to coverage, such as excluding losses related to fraud and the restatement of financials. This new paradigm in D&O insurance coverage can create a significant risk to directors' net worth. Noting increased risk to directors,AIG, the world's largest underwriter of D&O insurance, advises companies and directors to carefully evaluate their D&O coverage in terms of the potential dilution of limits, exclusions and, very importantly, carrier credit quality.

BEP developed this chapter of *Insights* to encourage boards to be much more proactive in identifying and mitigating risks. BEP believes that it is vital that boards periodically complete a comprehensive and independent assessment of risks, mitigation plans, and implementation progress.

Risks need to be identified and mitigated long before they can cause damage. Having said that, **BEP also urges boards to encourage CEOs and their teams to identify and take prudent risks. Companies that take no risks will eventually stagnate and then collapse.**

From BEP's perspective, risk identification and mitigation has three phases:

- **Assessment.** Mitigating risk begins with a comprehensive, focused assessment that highlights "landmines" and strategies for risk mitigation.
- **Implementation.** Value to the enterprise increases with careful, thorough, and measured implementation of risk mitigation plans.
- **Monitoring.** Risk mitigation is an ongoing process, including consistent monitoring of risk mitigation goals, implementation progress, and evolving risks to the enterprise. Monitoring mitigation progress enhances long-term viability and stability.



Risk Assessment

A Perspective / Wendy Lane

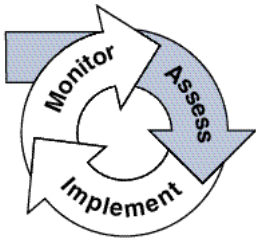
WENDY LANE, drawing on a wealth of experience in risk management from her tenure as Chair of the Audit Committee of Laboratory Corporation of America and membership on the former Audit Committee of Tyco International, outlines the following approach to risk management and mitigation.

Most directors today recognize risk assessment as a critical element in fulfilling their fiduciary responsibilities. At the same time, many directors are uncomfortable with what risk assessment means or how to go about it rigorously. Risk assessment involves two areas—the identification of risks themselves and the review of processes related to risk identification, disclosure, and mitigation.

Risk Identification

Risk Identification involves the careful study of potential risks in the following broad categories:

- The nature of the business itself, such as a high degree of regulation, dependence on commodity prices, or environmental risks.



- Operating risks, such as customer or plant concentrations, international sales, and continual R&D advances.
- Financial risks, such as breadth and depth of capital sourcing, capital structure, or heavy working or investment capital requirements, and foreign currency fluctuations.
- Organization and human resource risks, such as decentralization, union contracts, and turnover.
- Management risks, such as integrity, succession, and the depth of the management team.
- Board risks, such as independence and representation of diverse, strategically important perspectives.
- Contingency risks, such as litigation and environmental investigations.
- Risks associated with reliance on outside vendors or partners.

This is just a sampling of the broad range of potential risks that should be evaluated in a complete risk assessment. Prioritization will vary by industry and company, public and private status, and other considerations. Risks tend to increase with rapid growth and change, including such developments as acquisitions, new products, and management turnover. Risks may also increase with economic downturns or volatility. During these periods, and when a company is proposing or doing something new, directors must be especially vigilant in assessing and reviewing risks.

While risks may evidence themselves through financial benchmarks, changes in accounting policies, insider stock sales, or excessive management or employment turnover, a board needs to ensure that processes are established to identify and control risks proactively and on an ongoing basis.

Process Assessment

The second part of risk assessment involves **Process Assessment**, which includes the following important areas:

- ***Internal Audit.*** Review, for example, the internal audit unit's mission, scope, competence, and reporting relationship to the board as well as to management.
- ***External Audit.*** Review such factors as independence and communications and relationship with the board.
- ***Operating, Financial and Reporting Controls.*** Question the internal and external auditors, as well as management, as to quality controls and potential deficiencies.
- ***General Counsel.*** Review, for example, his or her mission and relationship to the board, and his or her view of disclosure.
- ***Disclosure.*** Review, for example, how disclosure of appropriate events is ensured. Is there an effective Disclosure Committee?
- ***The Board Itself.*** Review factors such as independence, mission, relationship to the CEO, composition, and vigilance as to risks as well as to opportunities related to matters presented to the board, and the ability of the directors (both insider and independent) to collaborate to reach sound decisions.

- ***Risk Assessment Review Program.*** Conduct a rigorous, comprehensive risk assessment which can serve as a baseline for subsequent reviews. Identify mitigating steps. Establish a program of follow-up reviews, on a predetermined schedule, of risks, mitigating steps, and progress.

Risk Mitigation

Once risks have been identified, the board must establish a **Risk Mitigation** program to address and assign responsibility for those risks that can be acted upon and to monitor those that cannot. This includes mitigation of any material weaknesses in processes that serve to uncover or control risks.

Many boards that are just now developing their risk assessment and mitigation programs, or are uncomfortable with their efforts to date, are engaging outside consultants to provide baseline risk assessment. A competent professional's view might be very useful in:

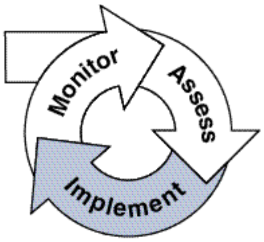
- Providing a rigorous review of the risk assessment area without diverting the board's attention from its other tasks of strategic and major operational decisions and without creating a risk-averse board, which might hobble the company's abilities to capitalize on opportunities.
- Identifying:
  — risks that are not apparent to insiders but can be identified by sophisticated outsiders with broader perspectives
  — risks that management does not present because it assumes these are "givens" or are irremediable
  — risks that are apparent

Risk assessment and mitigation is not a science or a matter of checklists. The process requires time, attention, and customization, particularly in establishing a baseline and in periods of change. Boards must carefully evaluate their management of this issue.

WENDY LANE is the Chairman of Lane Holdings, Inc.,a private investment and consulting firm. She has been a member of five public company boards and is currently the Chair of the Audit Committee and member of the Governance/Nominating Committee of Laboratory Corporation of America. She was a member of the Audit Committee of the former Board of Tyco International and of the Special Working Group to Establish Governance Policies and Practices for Tyco's new Board. Prior to founding Lane Holdings, Ms.Lane was a Principal and Managing Director of investment banking at Donaldson, Lufkin & Jenrette.

BEP agrees with Wendy Lane's perspective and suggestions. Moreover, BEP encourages boards to:

- Assess and mitigate the risks associated with mergers, acquisitions, and joint ventures, during growth strategy reviews . . . long before these initiatives are presented for final board approval.
- Understand the real exposures associated with catastrophic technology failures in terms of cash flow, customer and employee retention, business continuity, and profitability.
- Ensure management has test-proven recovery plans that thoroughly anticipate problems with, or the loss of, people, processes, or IT infrastructure.
- Ensure the compensation for officers and directors is sound and effective.



Implementation

Assuming an effective and thorough risk assessment, BEP urges our clients to build on our research and implementation experience. BEP believes that risk mitigation, and the management of prudent risks, can be effective when directors focus on the following:

- ***Board Agendas.*** Carefully constructed board and committee agendas are important tools to keep the board focused on risk assessment and mitigation strategy. At board meetings, directors should insist on periodic risk reviews that enable them to spot warning signals before a crisis ensues.
- ***Board and Executive Compensation***. More and more, media and investor attention are making executive compensation a potential risk area. Every member of the board need not be a compensation guru, but every member needs to understand the basics: Is pay tied to performance? Is the calculation of variable pay transparent? Are all the elements of compensation fully disclosed? Is compensation in line with industry practice? Although the press has focused on the risk that stock options may drive management to focus on short-term results, the board is expected to understand the whole package. Most boards should have a Compensation Committee. Professional guidance for this committee may be in order.
- ***Chaotic Change.*** Volatility within the company or industry can create an environment that generates uncontrolled, potentially dangerous change. It is essential to differentiate between planned and unplanned change. The board should carefully monitor change within an organization and recognize that unplanned change can serve as a warning for a variety of risks.
- ***Competitive Analysis.*** Closer scrutiny is warranted when traditional financial or productivity performance measures are significantly lower or higher than those of one's competitors.
- ***Corporate Culture.*** Board members should be vigilant and sensitive to subtle signals that can be early warnings of management arrogance, a trait that too often seems to correlate with compromised values.
- ***Formalized Controls.*** The board should be aware that management adheres to formalized controls and that these controls are effective. The board should assess, at minimum, the effectiveness of the corporate code of conduct, board independence, and whistleblower policies and procedures.
- ***Human Capital.*** Directors need to understand the breadth and depth of their senior leader talent pool, in terms of both character and competence. Clear succession plans for board members and the senior leadership team are priceless,particularly in a crisis.
- ***Integrity Missteps.*** Boards must be alert to small, apparently insignificant, missteps by the CEO or members of the senior leadership team. For example, expense reports or employee promotions that seem inappropriate could be early warning signals. They are, too frequently, overlooked.
- ***Performance Metrics.*** It is important that boards have the systems and information necessary to evaluate the performance of board members, the CEO, and

the senior leadership team members. Monthly and quarterly quantitative goals should be clearly defined and the status of executive performance regularly monitored.

- ***Transparent Financial Reporting.*** With or without Sarbanes-Oxley, the board needs timely, actionable, and digestible financial information that is tailored to the needs of board members.

Looking Ahead . . . What May Be Coming

One controversial practice BEP is carefully monitoring involves boards that are now requiring CEOs and CFOs to periodically file personal balance sheets with their boards or a trusted outside professional. Proponents argue that personal balance sheets might help to identify dangerous levels of debt or partnerships involving customers, suppliers, or competitors.

Supporters are convinced that personal reporting might help expose inappropriate IPO stock purchases or other financial instruments or unusual transactions or purchases including real estate, yachts, airplanes, and artwork.

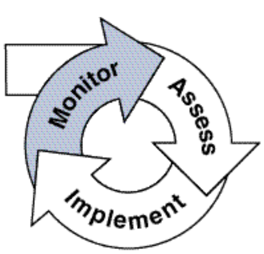
Balance sheet advocates believe high levels of debt, partnerships, and other unusual transactions might give the board reason to pause and ask questions of the executives involved. Some directors contend that an argument from an executive against submitting a personal balance sheet constitutes a "red flag."

BEP is currently evaluating the view that, in the vast majority of cases, personal balance sheets would likely affirm a board's confidence in its management.

Opponents of executive balance sheet submissions insist dishonest CEOs and CFOs will submit misleading balance sheets.

BEP will continue our ongoing analysis of board effectiveness best practices. We are certain that devastating news of CEO or CFO dishonesty can harm and, as we now know, destroy publicly traded companies and irreparably harm the reputations of honest and competent board members.

BEP believes board integrity and effectiveness are keys to corporate success. It is thought-provoking to consider that the tragedies involving Tyco, WorldCom, and Enron might have been identified and mitigated long before reputations and shareholder value were destroyed.



Monitor

BEP urges that boards continue to conduct objective and independent reviews focused on risk identification and mitigation. Many boards need to significantly strengthen their capacity to anticipate and assess the warning signs that might herald major problems. Addressing and managing corporate risk is an evolving challenge.

BEP believes that the tone and quality of fact-finding, analysis, and collaboration in the boardroom have a dramatic impact on the tone and quality of governance throughout an enterprise.

BEP encourages boards to consider the following during periodic risk reviews:

Objective	***BEP's Analytical Focus***
Achieve a win-win partnership between the CEO and the board	▶ Is the CEO comfortable periodically presenting and updating the top 10 risks to the board for ongoing oversight and guidance? ▶ Is most of the board's time devoted to tactics or strategic "life-threatening" risks and opportunities? ▶ How much board time is invested in evaluating and encouraging prudent risk taking?
Maximize communications	▶ Is the debate within the board open and focused on strategically important risks and opportunities? ▶ Are directors comfortable adding their risk mitigation concerns to the agenda? ▶ Is constructive collaboration encouraged?
Ensure that the board has the information necessary for effective decision making	▶ Do directors have the right information, in a timely and digestible form, to understand all the relevant aspects of the most crucial risks? Is this information reliable?
Create opportunities, not obstacles, to understanding issues	▶ Do board meetings and communications between board meetings contribute to collaboration and a full exploration of the risks facing the enterprise?

Even in the best economic times, risks threaten serious harm or instability to enterprises and directors. Many directors agree that the wise course favors the preventive medicine offered by an independent risk assessment review.

BEP has the expertise and experience to provide independent and objective analysis as boards assess and mitigate evolving risks.

BOARD EFFECTIVENESS PARTNERS

CLIENTS
The following is a partial list of the organizations served by BEP's Managing Partners, as consultants or executive leaders, prior to or since forming BEP:

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Bank of America
Bell Laboratories
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CIENA
Citigroup
Continental Grain
Corning
Covisint
EF Johnson
Fulcrum Analytics
Genzyme
Getronics
Greenwood Publishing Group
Harmon Solutions Group
Herder & Herder
IBM
Independence Community Bank
Johnson & Johnson
J.P. Morgan Chase
Kauffman Foundation
KeySpan
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Our Firm

Board Effectiveness Partners (BEP) collaborates with directors and CEOs to objectively analyze and improve the effectiveness of their boards.

BEP's business mission is to serve as the catalyst to enhance board effectiveness and governance quality—enabling directors and CEOs to guide their companies to continuously improved performance and competitive superiority.

Our Value

Continually Enhancing Performance
BEP Review and Implementation
Partnering with BEP
Committing to Effectiveness
Compliance

Managing Partners

BEP's Managing Partners have an average of 30 years of experience as CEOs, board leaders, or consultants. With career credentials that span industries from manufacturing to financial services, and skills ranging from strategy design to implementing change, we provide the breadth and depth of professional background essential to strengthening board effectiveness and governance quality.

Kevin English has devoted his career to leading business units, companies, and boards and has improved corporate performance as a CEO and Board Chairman.

John McCreight has dedicated over 35 years to consulting and partnering with CEOs, senior management, boards, and investors in defining and implementing large-scale strategic change.

Mark Schneiderman is a senior-level human resources professional who has held corporate leadership roles, and partnered with senior leadership and boards as a consultant, to facilitate strategy implementation and change management.

Alliance Partners

BEP nurtures relationships with over 100 Alliance Partners worldwide. Our Alliance Partners exemplify preeminence in their fields and complement our core competencies. Alliance Partners strengthen our capacity to improve board effectiveness and governance quality.

Research & Operations Center

Our Research & Operations Center (ROC) professionals are linked worldwide to our clients, Alliance Partners, industry experts, and the academic community. They focus daily on monitoring board effectiveness facts, opinions, successes, disappointments, lessons learned, and best practices.