SF bulletin

By Stephen Barlas, Mike Osheroff, Lance Thompson, Terri Thornton

GOVERNMENT

SEC Proposes Exec-Comp Reporting Enhancements

By Stephen Barlas, Editor

The Securities & Exchange Commission's (SEC) proposed changes to corporate reporting on executive compensation aren't particularly far-reaching at first glance, but there's potential for some major modifications once the proposals get fleshed out.

The SEC will propose a change to the Summary Compensation Table (SCT), first required of proxies in 2007. Companies and institutional investors have criticized the SCT for obfuscating rather than clarifying the pay of a company's top five executives. The change would force companies to disclose the aggregate grant date fair value of awards computed in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-Based Payment." The current requirement is for disclosure of the dollar amount recognized for financial statement reporting purposes.

Charles G. Tharp, executive vice president at the Center on Executive Compensation, which represents *Fortune* 500 companies, says the SEC proposal is a good start but doesn't do enough to clarify the ambiguities in the SCT. "We believe that the SEC is missing an opportunity to clarify what executives really make," Tharp said. The Center believes the SCT should be revised to separate actual pay earned during the reporting year, including salary, discretionary bonus, and annual and long-term incentives, from the estimated accounting expense of long-term incentive plans. The current reporting of pay mixes actual pay with the accounting estimate of restricted stock and stock options that may or may not be earned, depending on the company's performance in future years.

Tharp noted, "This mélange of actual current pay and potential future pay distorts the relationship between pay received and performance. It also confuses the relationship between potential future pay and the future performance required to achieve that payout. Unfortunately, the SEC's proposed change does not address this issue."

In what could be a potentially significant expansion of executive compensation reporting, the SEC will require companies to discuss and analyze its broader compensation policies and overall actual compensation practices for employees generally, including nonexecutive officers, if the risks arising from those compensation policies or practices may have a material effect on the company. The impact and reach of this proposal are unclear but bear watching as comments come in and the SEC is forced to be more specific, which would occur, ostensibly, in the context of a final rule.

Thomas Quaadman, executive director for financial reporting policy and investor opportunity with the U.S. Chamber of Commerce's Center for Capital Market Competitiveness, said, "We support more disclosure but would have significant concerns if the disclosure process is in fact used to create new mandates."

GOVERNMENT

New SEC Push for Expanded SRI Reporting

The changes to compensation reporting and consultant disclosure were in the works long before the SEC decided to form an Investor Advisory Committee, whose mem-

BOOKS

Personal Ethics

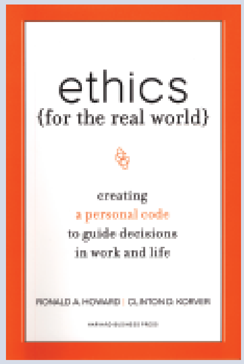
Each of us has a value system that we use to help decide the proper course of action in situations that affect other people. In *Ethics for the Real World*, Ronald A. Howard and Clinton D. Korver explore how that value system is developed and offer guidelines for its application in life. Instead of focusing on ethical transgressions that fill the headlines, the authors concentrate on everyday ethical practice: how we treat our friends, spouse, and neighbors. Their hypothesis is that ethical interaction really begins with a relationship between two individuals. With consistent, well-developed ethical practices on a small scale, the ethical lapses we read about in the newspapers will be less likely to happen.

The source of ethical practice is grounded in all major religions—the "thou shalts" and the "thou shalt nots"—and codified in most legal codes. Most of these rules have been developed over thousands of years to make living in society more manageable. "Thou shalt not kill" is meant to preserve human life in the community, while "Thou shalt not steal" is meant to preserve the practice of private property. "Thou shalt nots" are easy to follow: If an ethical rule requires not doing something, then don't do it.

Problems arise with proscriptions that start with "thou shalt," which tend to be ethical goals rather than rules. Take an ethical pronouncement as simple as "feed the hungry." I can feed my family and perhaps share with a homeless person, but am I to really try to feed the hungry in other locations and countries? The problem is that the impossibility of feeding all the hungry makes it too easy to ignore more actionable parts of the goal to share our bounty with others. "Thou shalts" then lose their effectiveness, if not meaning.

Immanuel Kant's categorical imperative says to perform every action as if it were to become a universal standard of relationship, very much like the Golden Rule: Do unto others as you would have them do unto you. Ethical practice in Kant's view is fairly simple. If we don't want others maiming, stealing from, or lying to us, then we don't maim, steal, or lie.

Another theory of ethical practice was developed by Jeremy Bentham and John Stuart Mill in the late 1700s. They believed that an action is ethical if it provides the greatest good for the greatest number. In other words, it may indeed be ethical to maim, steal, or lie in a given situation if it results in a greater good for a greater number of people. In the "feed the hungry" example, Bentham and Mill would say it's ethical to take food that a citizen has horded and redistribute it against his will to feed his hungry neighbors.



Ethical practice breaks down at the intersection of "thou shalt" and Bentham and Mill's consequential framework. The former is entirely open-ended, allowing us to never be able to fulfill its proscription, and the latter depends on our complete knowledge of others and the situation we are in. It lures us into activity that ends up being in tune with our own egos and self-interest.

In *Ethics for the Real World*, Howard and Korver point to the development of personal ethics based on practices of Kant tempered by the complexities of modern life. One can't be all things to all people, and one can't possibly know what is best for his or her neighbor, let alone others across the country and oceans. The most we can hope for is an understanding of the person next to us. That's why Howard and Korver's model of ethical action is Kant's imperative. Because of limited resources and an imperfect knowledge of our world, the only realistic site of ethical relationship is between two individuals. Ethical practice must arise from interaction between "me and you" where the rest of humanity is a subset of "you."

To the authors, ethical practice is all about being true to the person next to us.—Mike Osheroff, osheroff@wa-net.com

SF bulletin

bers were apparently named the first week of June, a week before the SEC announced the formation of the Committee and asked for public comments on what it should be doing. That timing was a little strange. Usually, an agency creating an advisory committee asks for nominations, then thinks about the people suggested, and then names the members of the committee. That didn't happen here. Kayla Gillan, deputy chief of staff at the SEC, didn't respond to an e-mail asking why the members were announced without public input. Richard Hisey, president of AARP Financial and AARP Funds, and Hye-Won Choi, senior vice president and head of corporate governance at TIAA-CREF, will be the Committee's co-chairs. It's unclear whether the Committee will set its agenda or whether it will respond to the SEC's request for advice on commissioner- or staff-generated regulations.

It's a no-brainer, though, to believe that the Committee will be recommending corporate reporting changes. Three members of the Committee come from the "socially responsible investing (SRI)" community, including Choi. Luis Aguilar, who was the prime instigator for the Committee's formation, said, "We expect to discuss the issue of enhanced disclosure with the Committee; this is an area in which the social investment community has been intensely interested for several years."

Thomas Quaadman responded, "If you start going down that road, linking company actions or compensation schemes to socially responsible criteria, you start to go down a slippery slope. And who is to say what is 'socially responsible'?"

SEC More Aggressive

By Terri Thornton

In a rare public appearance this past May in Atlanta, Ga., SEC Commissioner Luis Aguilar made it clear that the regulatory board is getting much more aggressive.

"The handcuffs are clearly being taken off," he said, indicating that national and global barriers to aggressive

PHOTOGRAPH: PORTER KEADLE MOORE

L.-r.: Don Berecz, director of Georgia Southern University's Center for Forensic Studies in Accounting and Business; SEC Commissioner Luis Aguilar; and Porter Keadle Moore Partner Phil Moore at the conference.

investigation and prosecution are falling. He added that a bad economy increases pressure to meet difficult revenue targets; therefore, without the Sarbanes-Oxley Act (SOX), the current economic situation could be much worse. Noting that his remarks represented his own opinion, rather than the Commission's as a whole, he added that it's time to stop the extensions that have allowed 7,000 smaller public companies (roughly 65% of all public companies) to avoid complying with SOX Section 404(b).

He also said that when companies are brought before the SEC, the ones who fare best in the penalty phase are those who are cooperative, transparent, and show a willingness to acknowledge and correct their own mistakes.

"An ounce of prevention...is worth a pound of cure, or at least will carry great weight in our deliberation of what penalties are proposed," he concluded.

Aguilar also noted that, with the departure of SEC Chair Christopher Cox, the effort toward adoption of International Financial Reporting Standards (IFRS) is moving at a somewhat slower pace. While the Commission under new SEC Chair Mary Shapiro remains open-minded, adoption of IFRS is now a less-urgent priority, he said.

Aguilar spoke at the Third Annual Fraud and Forensic Accounting Education Conference hosted by Georgia Southern University's Center for Forensic Studies in Accounting and Business and by Porter Keadle Moore, LLP, accounting firm.

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BOOKS

Disruptive Innovation

Despite the opportunities, the odds remain stacked against the growth-seeking innovator. In *The Innovator's Guide to Growth*, Scott Anthony, Joseph Sinfield, Mark Johnson, and Elizabeth Altman describe how most innovation efforts deliver disappointing results. They perceive that a fog enshrouds the world of innovation, obscuring high-potential opportunities and making success a fleeting phenomenon. Their belief, backed by significant research and experience, is that disruptive innovation is the key to plugging growth gaps and routinely surprising the market.

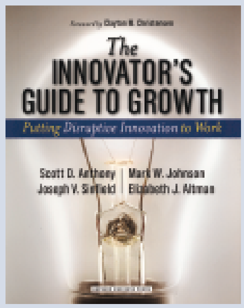
The fundamental premise of *The Innovator's Guide to Growth* is that the right process roadmap and organization structures can enable managers and entrepreneurs to build growth businesses more reliably and create innovation capabilities.

If you want to influence or shape a market in which you compete, sustaining strategies are the key to achieving your goal. But if you want to redefine a market, create a new one, or defend against attack, disruptive strategies are essential to success. Many of the principles required to successfully manage disruptive innovation may appear counterintuitive—or even threatening—to managers in established companies.

The critical principles for disruptive success are:

1. Overshooting creates conditions for disruption. Companies almost always end up "overshooting" progressive tiers of a market with products that provide too much performance for the average customer. Disruptors connect to customer groups dissatisfied with existing offerings by lowering performance along one dimension and increasing it along overlooked dimensions, such as simplicity and convenience.

2. Disruption comes from breaking the rules. Successful disruptive innovators master the art of trade-offs. Disruptors redefine the notion of performance by focusing on the overlooked innovation levers of simplicity, convenience, accessibility, and affordability.



3. Business model innovation often powers disruption. The true disruptive power of an innovation isn't in the features and functionalities of the offering but in the business model that creates the product or service.

Following the right processes, structures, and principles can improve your chances of creating innovation growth and guide innovators seeking new ways to compete in established markets or improve internal processes.

The Innovator's Guide to Growth focuses on both the concepts and practices of innovation, and it provides practical, market-tested tools and approaches. Included are checklists, question guides, templates, and activities that identify successful practical tips and techniques. Several of the tools and worksheets are available at www.innosight.com/resources. These tools can help innovators identify opportunities that others are likely to miss, craft solutions that create new growth while disorienting market leaders, manage the risk of early-stage projects, and implement structures and systems to create winning businesses.

The authors believe that the concept of innovation is in transition between a theory of random trial and error and perfectly predictable paint-by-numbers rules. They call this transitional period the "era of pattern recognition." Their book describes patterns related to spotting opportunities, developing ideas, building businesses, and creating capabilities in this period.

The primary audience for this book is senior executives and middle managers seeking to create new growth business. Many of the concepts and tools should be useful for entrepreneurs, venture capitalists, investors, government officials, strategists, consultants, and other individuals with an interest in innovation. While the focus is on new growth, the tools and approaches also provide different ways of strengthening and extending existing businesses.—Lance A. Thompson, Thompson Management Consulting Services, LLC, lancephx@aol.com