State of Governance
SURVEY REPORT

An Analysis of Corporate
Governance Practices Among
Middle-Market US Companies

MOSS ADAMS LLP

Certified Public Accountants | Business Consultants

Contents

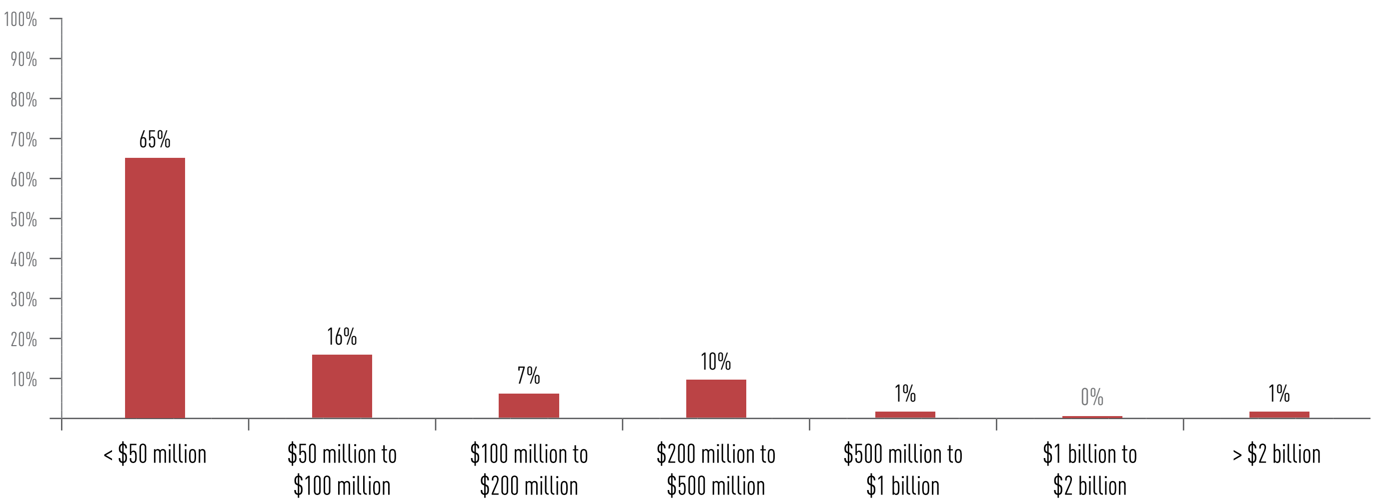
About this Study

The Moss Adams State of Governance Survey was designed to analyze corporate governance practices among middle-market US companies.

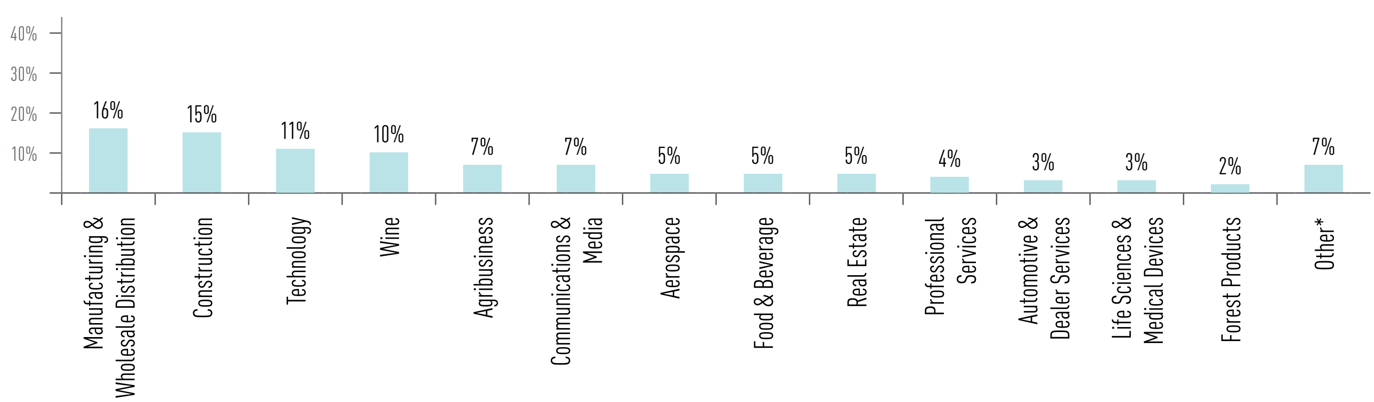
The methodology for this assessment included a survey with questions on a range of topics tied to corporate governance. These questions specifically referenced legislation and guidance to gauge the nature and extent of such practices. Respondents were asked to comment on specific aspects relating to their company; their responses were then analyzed by Moss Adams professionals.

For effective analysis of the survey results, respondents were classified as either public or private entities. It was striking that 94 percent of the respondents were from private companies. Respondents were also classified by their industry and latest available annual revenue, both given below.

Respondents by Revenue



Respondents by Industry



*Respondents in this category included apparel, clean technology, restaurants, federal contractors, hospitality, retail, and transportation and logistics companies.

Foreword

The principles of corporate governance are built on a moral, ethical, and legal framework. Consequently, they extend beyond the law, spilling over into how we make every business decision. The last decade and a half saw change in governance laws across the globe—sometimes accelerated by high-profile failures of some of our largest organizations.

Notwithstanding the magnitude and consequences of those changes, we're left to ask whether companies are truly adapting to these fundamental shifts or are simply repeating the same set of practices year after year. Ultimately, what stings most about the profound, negative events we've witnessed is the gaps aren't only regulatory in nature; rather, they're in the moral fabric of corporate governance.

This aside, debates, discussions, and surveys relating to corporate governance typically target large or highly visible companies. But issues related to corporate governance are equally if not more portentous for relatively small companies. The focus of these studies has been—and remains—on the rights and responsibilities that accompany a board position, which is clearly vital yet often perceived as ceremonial.

This unique report represents our first review of corporate governance practices among middle-market US companies, all but one with revenue under $2 billion. It aims to uncover real, ground-level issues and challenges in corporate governance and provide best practices the middle market can readily implement. We hope you'll find it a useful tool in improving your organization's governance and its overall operations.

Sincerely,

Eric Miles
Partner, Business Risk Management | Moss Adams LLP

Executive Summary

Background and Methodology

The corporate governance system in the United States is focused on unlocking value for shareholders. Entities including the Securities and Exchange Commission (SEC), NASDAQ, and New York Stock Exchange (NYSE) as well as statutes such as the Sarbanes-Oxley Act, Dodd-Frank Act, and various state and federal rulings emphasize full compliance. There are severe consequences in terms of fines and penalties for deviations from the rules.

The parameters we used to assess the state of corporate governance are based on a set of fundamental attributes, each of which must be deployed systematically, consistently, and diligently throughout a company's processes and levels. These attributes relate to:

- Boardroom practices
- Audit committee functions
- Internal audit and risk management functions
- Executive compensation philosophies
- Whistle-blowing mechanisms
- Management of shareholder relationships

The messages we uncovered in our survey were mixed regarding corporate governance among middle-market companies. We'll look at the results surrounding each of these attributes in turn.

Boardroom Practices

Sound boardroom practices are intrinsic to good governance. Survey results in this area showed two positives: first, that boards are present in 70 percent of private companies, and second, that 67 percent of public companies select their board directors by a nomination committee.

However, 12.5 percent of public companies fell short of the requirement that a majority of their board be independent directors. More than half of the private companies in our survey—86.5 percent, in fact—failed to meet the same test. This poses a significant risk of cronyism; objectivity in oversight is compromised when board directors are interested parties in business decisions.

For 87 percent of public company respondents, the size of the board ranged from four to seven directors. It was encouraging to see 84 percent of private business respondents operating with a board in excess of three directors.

Also good news is the presence of documented standards describing the function of the board in 100 percent of public company respondents and 70 percent of private company respondents. As for the recommended segregation of the chairman and CEO roles, this was true of 87 percent of public and 59 percent of private companies.

Function of the Audit Committee

The reluctance of 84 percent of private companies to establish audit committees is an unhealthy state of affairs. Small size doesn't insulate a business from fraud, and the issue is exacerbated by the fact that, of private companies that did have an audit committee, 35 percent hadn't identified any committee member with recent and relevant financial experience. More than ever, the emphasis has to be on skill and experience in selecting audit committee members, not the number of members. In this context, the role of an independent financial expert is significant.

While all public companies had four or more audit committee meetings in a year, the situation was radically different for private companies. Of those, 33 percent conducted only one audit committee meeting in a year. Regarding the performance of those audit committee members, two-thirds of the public companies surveyed confirmed they evaluate the performance of audit committee members every year.

All public company respondents also stated the chairman of their audit committee was appointed to receive regular whistle-blowing reports, and one-third also reported involving their general counsel in the process.

Internal Audit and Risk Management

Survey results in this area revealed two areas of concern. First, 76 percent of private companies reported the absence of an internal audit function (either internal or outsourced). Second, both public and private companies reported an inadequate focus on risk management. An overwhelming 90 percent of private companies and 75 percent of public companies reported the absence of a separate risk management function.

Only 25 percent of public and 14 percent of private companies confirmed the presence of a documented risk management framework. Yet 75 percent of public companies and 55 percent of private companies reported they assess their risks, albeit internally and informally. Though these informal reviews may be more appealing in terms of practical considerations, managing risk is most effective when conducted through a rigorous, repeatable process, which lends much-needed objectivity.

Executive Compensation

Only a handful of companies—25 percent of public and 15 percent of private companies—reported having established executive compensation policies. However, the problem appears to run deeper, with 75 percent of private companies also reporting the absence of a compensation committee. This committee has a clear role in ensuring executive compensation arrangements don't include irresistible incentives, which can potentially lure management to engage in dubious behavior to achieve targets.

Public and private companies diverge in the fact that three-quarters of public companies confirmed the presence of policies and procedures relating to compliance with the Foreign Corrupt Practices Act (FCPA). Private companies seem to be taking more time to warm up to the FCPA. Only 18 percent reported they established related compliance policies and procedures.

Shareholder Relationship Management

Public companies seemed to be more in favor of incorporating employee stock ownership plans (ESOPs), with 75 percent encouraging employee ownership. Private companies, on the other hand, revealed their fear of contemporaneous dilution; of respondents, only 15 percent have ESOPs.

The increasing level of importance on managing relationships with shareholders is a new paradigm in corporate governance. Our survey results show more than half of respondents hold regular, structured dialogues with shareholders in their company.

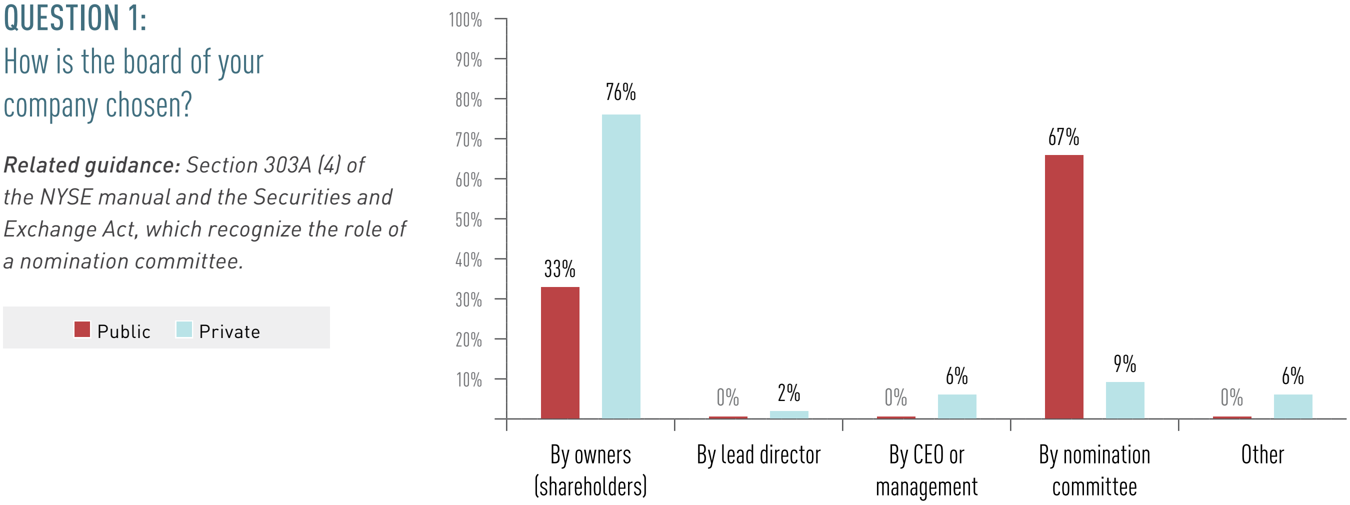
Conclusion

It's evident in the results of this first corporate governance survey that some practices are fairly well established, while others are evolving and in various stages of implementation. Inevitably, steps to institutionalize high standards of transparency—treating it as a fundamental criterion for governance—will result in standards, and those standards will raise the bar for all companies, both public and private. When that happens, well-governed companies will gain a competitive edge. This report makes the signposts for that advantage clear.

Boardroom Practices

QUESTION 1:
How is the board of your company chosen?

Related guidance: *Section 303A (4) of the NYSE manual and the Securities and Exchange Act, which recognize the role of a nomination committee.*



The board is the fundamental link between the shareholders and company management. Consequently, it's important board's directors are able, individually and collectively, to exercise independent judgment for shareholders' benefit.

Nearly 30 percent of the respondents from private companies revealed they don't have a formally appointed board. While 76 percent of the remaining respondents stated their boards were chosen by shareholders, 9 percent entrusted a nomination committee with the task of appointing their board, and 15 percent said their board was either composed of shareholders or chosen by their CEO or management. In summary, the practice of using a nomination committee seems to be lagging behind the selection by shareholders.

Some of the respondents from private companies added that being an owner was a prerequisite to being a director on their board. Other respondents reported they saw the benefits of injecting independent directors into their board.

In contrast, nearly 67 percent of public company respondents used a nomination committee to select their board. For the remaining public company respondents, shareholders played an active role in board formation.

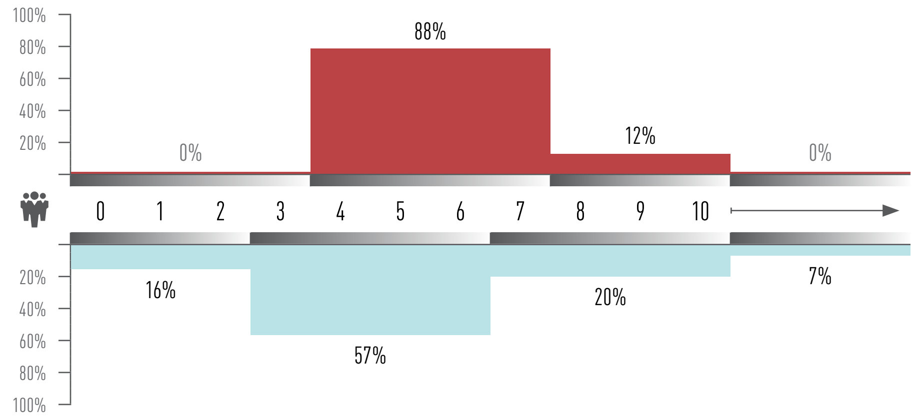
It's worth noting some corporate governance codes across the globe include the formation and charter of this nominating committee as a mandatory requirement. This recognizes the importance of the committee's role in allowing the board to function objectively. A nominating committee's charter should include its processes for identifying and evaluating candidates as well as the qualities and skills the nomination committee believes are necessary or desirable in board directors.

In response to widespread expectations for greater transparency, disclosures continue to evolve surrounding the processes adopted by nomination committees. However, there are and will remain those private companies that don't consider it practical—on account of their size—to form a nomination committee. In such cases, it's debatable whether the board's experience outweighs independence, and consequently, whether the lack of a nominating committee impairs their board's objectivity.

QUESTION 2:
What is the current size of your company's board?

Related guidance: *Some state laws prescribe a minimum number of directors, while others leave the size of the board to be set by the company's certificate of incorporation or bylaws.*

Public Private



Of private company respondents, 57 percent reported they have three to six directors. In comparison, 87.5 percent of public company respondents reported having four to seven directors.

Setting the right number of directors is a tricky issue. If all the directors, individually and combined, meet their fiduciary duties and provide value to the company, there may be no need to reduce the number based on an arbitrary best practice—but numbers aren't always an advantage.

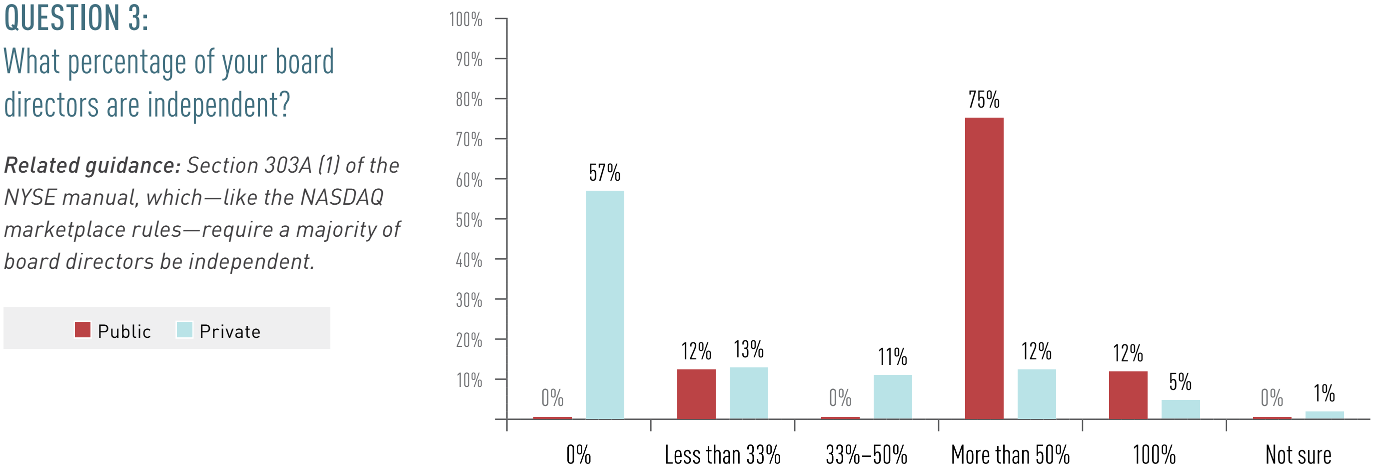
Although a larger board may ensure a wide range of perspectives and expertise, a very large board can become unwieldy. Too-large boards can end up delegating too much responsibility to an executive committee or permitting a small group of board directors to exercise substantial control. And if a company has so many directors that it impairs the ability of any one individual director to meaningfully participate in discussions, the company has too many directors from a practical perspective.

The data shows an interesting irony in companies with more than 10 directors. None of the public company respondents reported having more than 10 directors on their board (although one-eighth reported a board of eight to 10 directors), but 6.5 percent of the respondents from the relatively smaller private companies stated the headcount of their board was greater than 10. In terms of minimum headcount, none of the respondents from public companies reported a board size of less than four, but more than 16 percent of respondents from private companies function with a board of only one or two directors.

While all respondents—from both private and pubic companies—acknowledge the role of the board in their company, their approach and considerations in sizing the board vary.

QUESTION 3:
What percentage of your board directors are independent?

Related guidance: *Section 303A (1) of the NYSE manual, which—like the NASDAQ marketplace rules—require a majority of board directors be independent.*



Most global best practices require boards be a majority independent outside directors. However, this may be somewhat challenging for some private companies. Most important is that the board has substantial independence from management. Federal securities laws and rules for the NYSE require a strict standard of independence, precluding individuals who serve the company in a consulting or service capacity from also serving on the board.

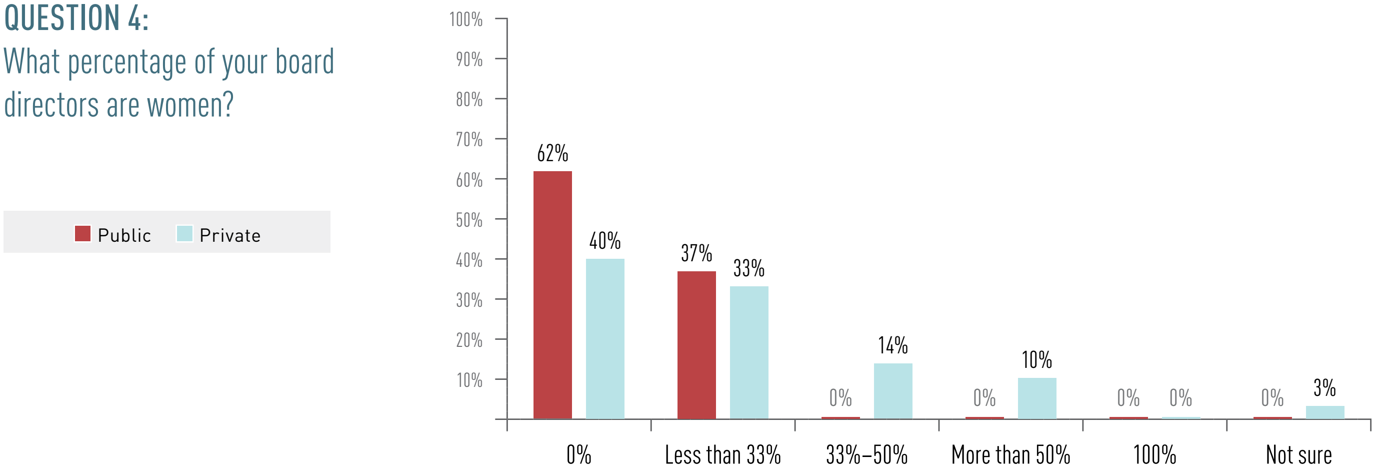
Of public company respondents, 75 percent stated that more than half their board was composed of independent directors, and 12.5 percent stated all directors were independent.

In contrast, more than half of respondents from private companies didn't have any independent directors on their board. Of the remaining respondents, 12 percent stated more than half their directors were independent, and only 5.5 percent stated all directors were independent.

Respondents of both private and public companies converged in that 13 percent of respondents in both categories reported less than one-third of their directors being independent. This means there's more work needed by a small section of public companies to achieve majority independence among their directors.

The general consensus among respondents was that independent directors improve the performance of a company through their objective view of the company's health and operations. Respondents also recognized true governance on the board isn't achieved through the number of independent directors alone. True independence is a state of mind and can't be codified through legislation. It's up to individual board directors to determine how independent they would like to be.

QUESTION 4:
What percentage of your board directors are women?



A 2009 study published in Harvard Business Review indicated that women drive nearly three-quarters of purchase decisions in the United States. Another 2007 study indicated that boards with higher numbers of women directors show a greater return on sales and a higher return on equity. According to a 2015 study, it will take until 2027 for women to inhabit 30 percent of board seats (globally) given the current rate at which they're assuming positions.

Having women on the board finds more favor with private companies, with 57 percent of those respondents stating their board provides such gender diversity. For nearly 10 percent of private company respondents, women constituted a majority on their board, while for slightly more than 14 percent, women constituted more than one-third but less than half the directors.

On the other hand, the boards of nearly 63 percent of public company respondents were all or nearly all men. For the remaining 37 percent, women constituted less than one-third of their board.

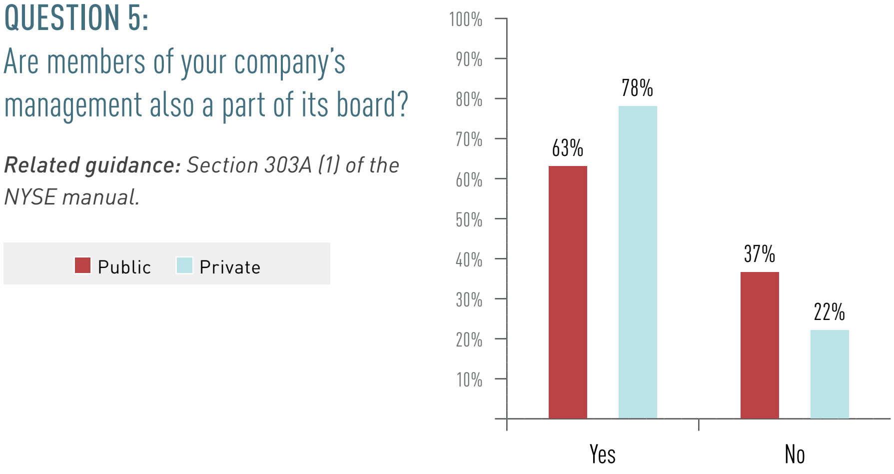
While US legislation doesn't prescribe a gender quota, most parts of Europe promote gender diversity through regulatory intervention. Norway has a gender quota, requiring companies to increase the proportion of women on their boards to 40 percent. France, Holland, Belgium, and Italy have similar quotas. Still, for any legislation to make a meaningful impact, it needs to be implemented in spirit rather than only in letter.

In conclusion, though companies with high standards of corporate governance are wholeheartedly embracing corporate gender strategies at the board level, gender parity could be decades away.

QUESTION 5:

Are members of your company's management also a part of its board?

Related guidance: *Section 303A (1) of the NYSE manual.*



In private companies, it isn't unusual for a board to be composed entirely of officers of the company. In the case of 88 percent of private and 63 percent of public company respondents, the CEO or other members of the management team also serve on the board.

There are three main categories of board directors:

- Inside directors, who are executives or management (including former executives)
- Affiliated directors, who aren't employed by the company but have other significant relationships or interests
- Independent directors, who are people without an existing relationship with the company

The permissible structure of the board of directors is set by state corporate law. Consequently, company boards vary from state to state. Most states provide companies a fair amount of flexibility in establishing their board.

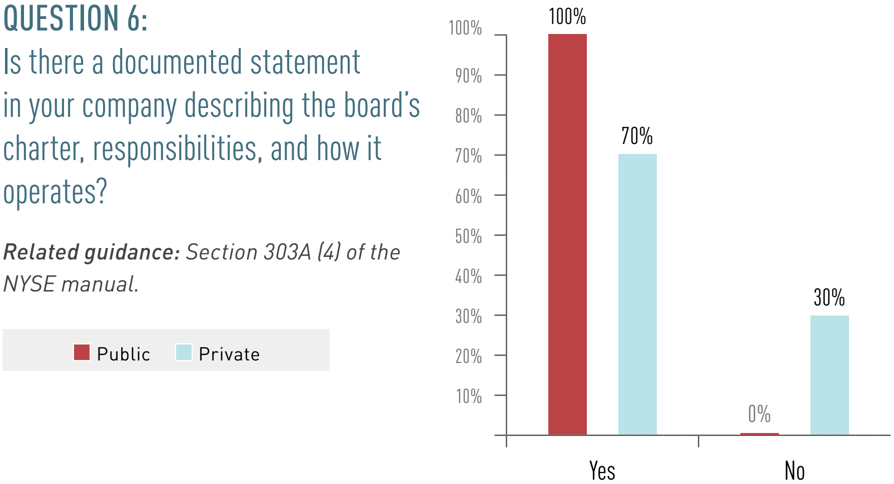
For private companies, it isn't unusual for the CEO to be the only director of a one-person board. Publicly traded companies, on the other hand, must adhere to specific rules set out in the Sarbanes-Oxley Act (SOX) as well as by the listing exchanges on which they're traded.

The precise requirements for board composition are largely dependent on the body in question. While specific details vary, the major US listing exchanges require companies have a majority of independent directors. However, a board can have even two or three inside board directors and still meet these requirements depending on the total number of directors.

QUESTION 6:

Is there a documented statement in your company describing the board's charter, responsibilities, and how it operates?

Related guidance: *Section 303A (4) of the NYSE manual.*



As a best practice, the charter for the board should be set by the nomination committee and include corporate governance guidelines. This charter should be reviewed each year and contain the board structure along with policies on:

- Responsibilities of the directors
- Moral and ethical conduct of the board
- The process for board meetings (including circulation of agenda)
- Induction and risk management sessions
- The basis and formation of standing committees
- Director compensation
- Succession planning
- Access to officers
- Employees and independent directors
- The board evaluation process
- Policies for attendance and interactions with media, investors, and the public
- Liabilities
- The process for appointment, rotation, and removal of directors
- Restrictions on board directorships

All respondents from public companies confirmed they have documented statements describing the functioning of their boards, and 70 percent of respondents from private companies disclosed the same position. Though the survey results generally show an appreciation for disclosures on the charter of the board, private companies see less merit in making such disclosures.

A substantial portion of the board's analysis and work may, in the case of public and relatively larger private companies, be done by standing board committees. Such committees may include:

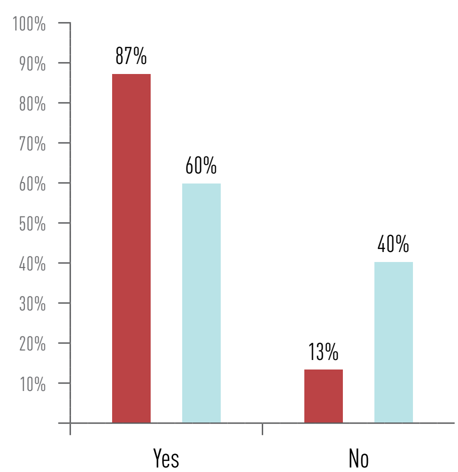
- Audit and finance
- People and compensation
- Restricted stock grants

- Nominating and corporate governance
- Executive
- Sustainability and corporate responsibility

From time to time, boards may also establish or maintain additional committees as appropriate.

As a best practice, boards should appoint committee members for these groups based on recommendations from the nominating and corporate governance committee, with consideration of the desires of individual directors. Every committee must have a charter that lists the rationale for its formation, its objectives, and its qualifications for membership as well as details on its operations and structure.

QUESTION 7:
Are the roles of the chair and chief executive in your company separate?



The board should be free to choose whether to separate the CEO's role from that of the chair in a way that seems best for the company at a given point in time.

The purpose of having a nonexecutive chair or board leader isn't to add another power center but instead to ensure organization of and accountability for critical independent director functions.

One of the primary grounds for separating the chair and CEO's roles is the potential conflict of interest that arises when the board considers an increase in executive pay. In this situation, when the CEO is also the chair, he or she may vote on and influence the board's decision, which could result in an abuse of the chair position.

The board's main role is to monitor the company's operations and ensure it's being run in conjunction with the company mandate and the will of the shareholders. Because the CEO is the management position responsible for driving operations, the combined chair-CEO role causes that individual to monitor his- or herself, once again opening the door for abuse of the position. For most companies, this is enough to justify having two separate people assume the roles of chair and CEO.

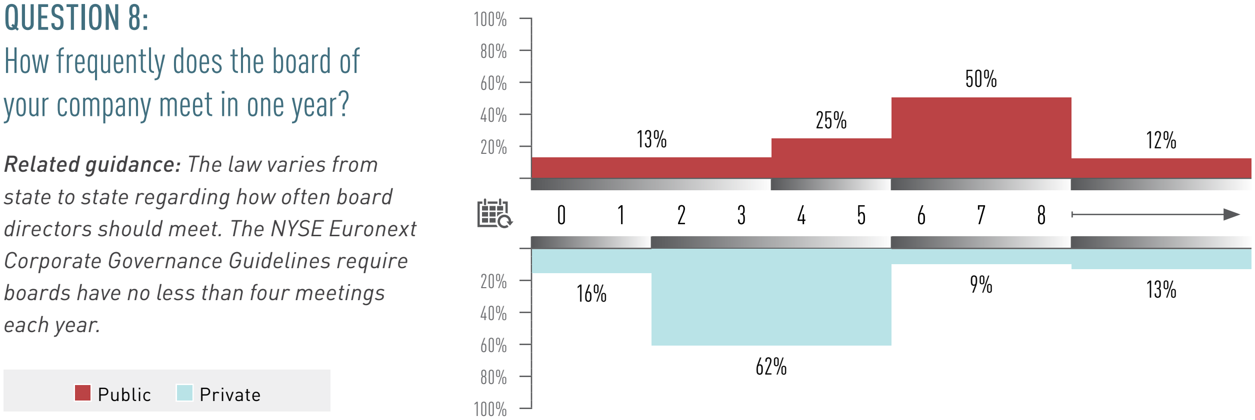
It's difficult to objectively assess and manage a CEO's performance—especially in crisis situations—when the chairman and CEO roles aren't separate. Boards should consider separating these two offices where practical, in keeping with the nature, size, and composition of their business.

Of public company respondents, 87 percent confirmed their companies have a separate chair and CEO. The same is true for 59 percent of private companies. This overwhelming majority said US companies see significant value in the objectivity that arises by separating the two roles.

QUESTION 8:

How frequently does the board of your company meet in one year?

Related guidance: *The law varies from state to state regarding how often board directors should meet. The NYSE Euronext Corporate Governance Guidelines require boards have no less than four meetings each year.*



Of private company respondents with operating boards, 62 percent said their board met between two and five times per year, while 23 percent stated their board met more than six times in a year. For 15 percent, their board met once a year. Of public company respondents, 25 percent said their board met between four and five times a year. The remaining respondents had six or more board meetings in a year. Still, it's ultimately the quality of board meetings—not the number—that determines their effectiveness.

It's also worth noting agenda transparency can be a catch-22. While transparency encourages a greater volume of information on any single board meeting agenda, this additional information can also make the agenda more confusing. While the case for more information is understandable, it's once again the value, not the quantity, that's important. The value of an agenda comes from good preparation and adequate time for deliberation, both of which are paramount.

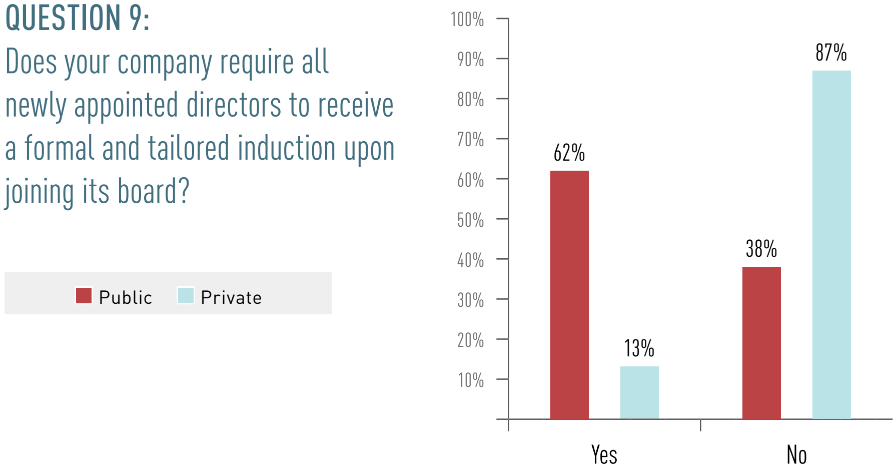
For directors to make meaningful contributions in board meetings, consider these elements as critical facilitators:

- Timeliness of circulating the meeting agenda
- Allocation of time segments to each agenda item
- Adequacy of preparatory and reference documents
- Attendance

State corporate laws set forth standards of conduct that apply to board directors. Loyalty and care are a director's two primary duties. The duty of loyalty requires directors to act in good faith and not in furtherance of their personal interests at the company's expense. The duty of care requires directors to take reasonable care and be prudent in managing the corporation's affairs.

QUESTION 9:

Does your company require all newly appointed directors to receive a formal and tailored induction upon joining its board?



New directors should have an initial orientation, preferably by management, to familiarize them with the intricacies of the company's business, strategic plans, compliance programs, and significant financial, accounting, and risk management issues. Apart from senior management, it's also a good practice to have internal and independent auditors play a role in the induction process.

While these practices help directors fulfill their responsibilities, it's equally important to have continuing educational programs that keep the board abreast of developments, risks, and critical issues related to the company's operations and industry. Such information may include a comparison between the company and its major competitors. The agenda for induction and ongoing education may also include periodic board visits to operating units, plants, and laboratories as a part of regularly scheduled meetings.

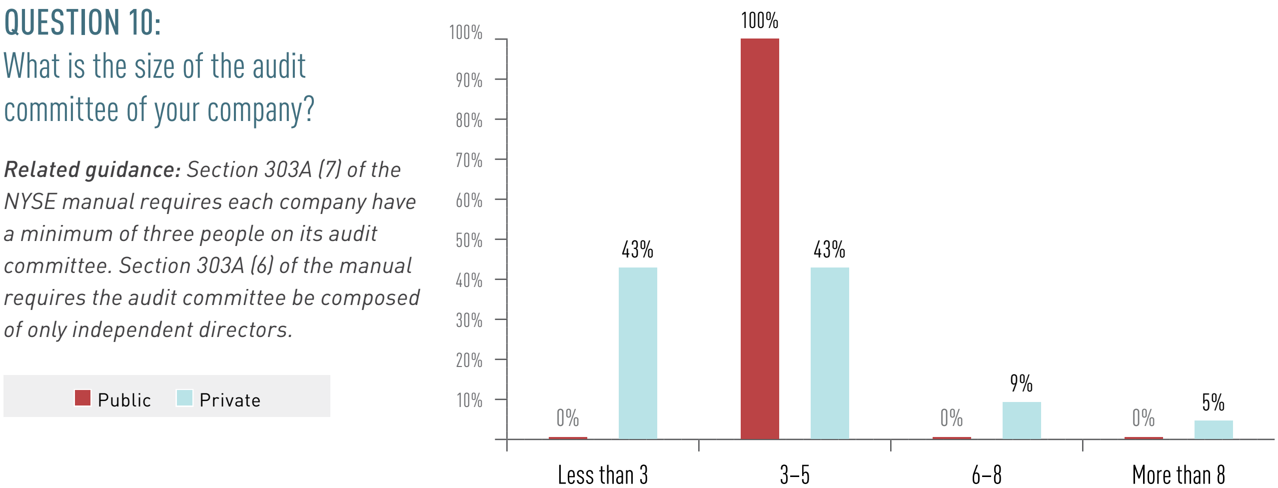
Of public company respondents, 62.5 percent confirmed the presence of structured induction programs for their board. Of private company respondents, only 13.5 percent reported having an induction program. This is a relatively simple process, yet companies—particularly private—struggle to get down to the basics of providing their board with a suitable induction.

We certainly aren't operating in a benign business or regulatory environment, and governance practices aren't static either. Good governance must be led by market forces rather than driven by legislation. For a board to be effective, it must have adequate information and knowledge about pertinent developments related to the company and its environment. Otherwise, board discussions will be paper meetings, conducted for the record, without tangible or perceivable value to shareholders.

Audit Committee Function

QUESTION 10:
What is the size of the audit committee of your company?

Related guidance: *Section 303A (7) of the NYSE manual requires each company have a minimum of three people on its audit committee. Section 303A (6) of the manual requires the audit committee be composed of only independent directors.*



Nearly 83 percent of the private companies in this survey lacked a formally constituted audit committee. It's somewhat ironic that an audit committee remains a distant reality for these companies, despite their pursuit of accountability, transparency, and objectivity.

Indeed, anecdotal evidence suggests fraud isn't perpetuated only at companies above a certain size. After all, companies charged with fraudulent reporting by the SEC have also included start-ups with no assets or revenue as well as much larger companies. Consequently, a strong audit committee is important for both growing and established companies, all of which benefit from the experience, oversight, and direction an audit committee provides.

The audit committee should be appointed by the board and must act under a written charter. This charter must be adopted and approved by the board, and a copy of it should be available on the corporate governance page of the company's Web site. The audit committee should review and reassess the adequacy of the charter at least once a year.

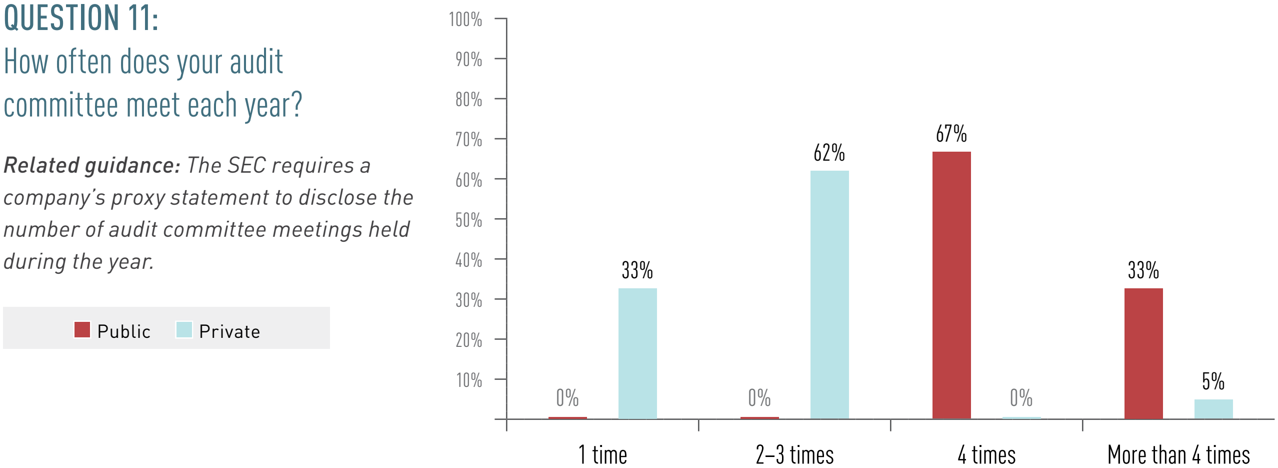
All respondents from public companies claimed they had between three and five members on their audit committee. In comparison, only 17 percent of private companies stated they have an audit committee. Of those private respondents with an audit committee, 58 percent have a committee with more than three members; 27 percent have three or less; 10 percent have between six and eight; and 5 percent have more than eight.

In the case of public entities, a majority of their audit committee should comprise independent directors, with each member of the committee becoming independent within one year of the initial public offering (IPO). Independence for audit committee purposes requires an individual to meet the NYSE and NASDAQ independence requirements as well as stricter independence requirements specified by SEC rules.

Again, headcount only goes so far. One of the most important aspects of establishing and maintaining an effective audit committee is making sure its members are well-suited to perform their duties.

QUESTION 11:
How often does your audit committee meet each year?

Related guidance: *The SEC requires a company's proxy statement to disclose the number of audit committee meetings held during the year.*



Audit committees should meet at least once every quarter. The SEC requires companies to disclose the number of audit committee meetings held during the previous year in their annual proxy statement. That requirement aside, audit committees should also meet to discuss the company's quarterly financial statements (Form 10-Q) and annual report (Form 10-K).

In monitoring a company's accounting and financial reporting processes and internal control systems, an audit committee should:

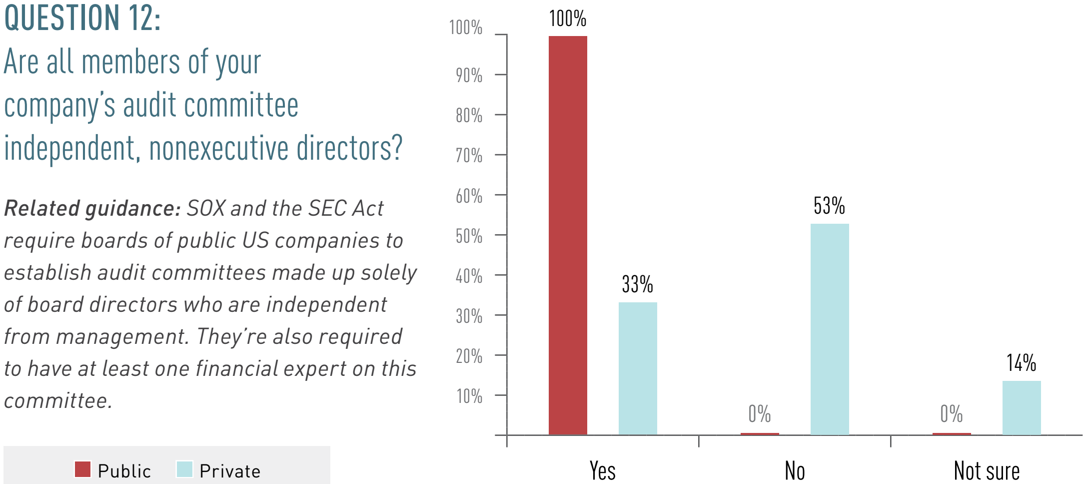
- Hold audit committee meetings without restrictions or time constraints (at least quarterly)
- Schedule audit committee meetings well in advance to coincide with completion of each quarter's financial statements and prior to finalizing the company's quarterly earnings release
- Distribute written materials for review sufficiently in advance of the meeting
- Meet separately with each key player involved in the financial reporting process (including members of management, the internal audit department, and the independent auditors) to review internal controls, the fullness and accuracy of the company's financial statements, the financial reporting process, and other matters

In addition, the audit committee should communicate openly and effectively (in and out of scheduled meetings) with management, the internal audit function, and independent auditors. It should also periodically report to the board on significant matters related to its responsibilities.

Nearly two-thirds of the public companies in our survey had one audit committee meeting every quarter. The remaining one-third exceeded that number, holding more than four such meetings in a year. Among private companies, 62 percent had two or three audit committee meetings in a year; 33 percent had one such meeting in a year; and the remainder met more than four times a year.

QUESTION 12:
Are all members of your company's audit committee independent, nonexecutive directors?

Related guidance: *SOX and the SEC Act require boards of public US companies to establish audit committees made up solely of board directors who are independent from management. They're also required to have at least one financial expert on this committee.*



Audit committees should have at least one independent director, and in the case of public entities, a majority of the committee should be independent directors. Each member of a public entity's committee must become independent within one year of the IPO.

Given this requirement, all audit committee members of the public companies in this survey were independent. One-third of private companies confirmed the same status. Private companies with fewer than three independent, nonexecutive directors on their audit committee fail the test of complete independence unless at least two of these members are independent.

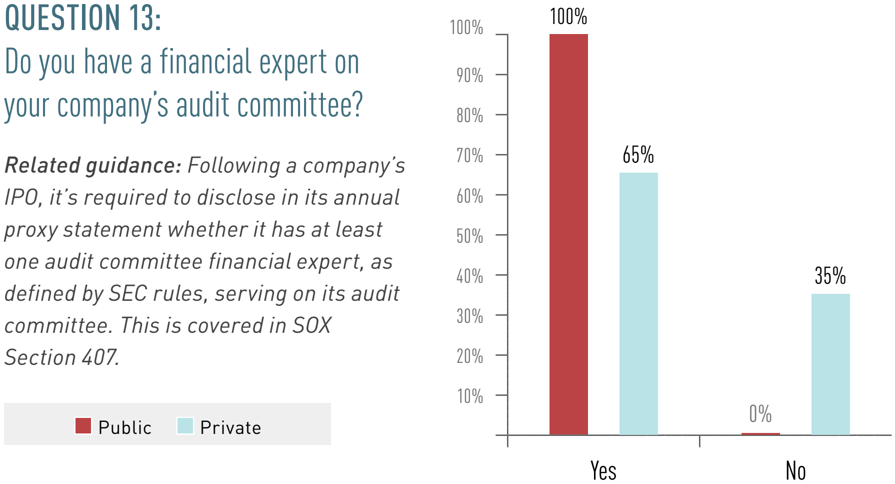
Individual audit committee members must meet the NYSE, NASDAQ, and stricter SEC independence requirements. For NASDAQ and NYSE companies, audit committees must include a minimum of three directors, each of whom must be independent and financially literate.

A director is considered independent if he or she has no relationship to the company that would interfere with the exercise of independent judgment in carrying out his or her responsibilities. The following individuals aren't deemed independent and therefore may not serve on a company's audit committee:

- Current employees of the company or its affiliates
- Individuals who have been employees of the company or its affiliates in any of the prior three fiscal years
- Immediate family members of a person currently employed (or employed within the past three fiscal years) as an executive officer of the company or its affiliates
- Directors who have had certain prohibited business relationships with the company in the prior three fiscal years
- Directors employed as executives of another entity in which any of the company's executives serve on the other entity's compensation committee (called cross-compensation committee links)

QUESTION 13:
Do you have a financial expert on your company's audit committee?

Related guidance: *Following a company's IPO, it's required to disclose in its annual proxy statement whether it has at least one audit committee financial expert, as defined by SEC rules, serving on its audit committee. This is covered in SOX Section 407.*



It's somewhat concerning that 35 percent of private companies in this survey neither identified an individual on their audit committee as one with recent and relevant financial experience nor specified the default option of collective financial experience. This reticence could mark increased risk to stakeholders at a time when it's universally acknowledged that audit committees need technically informed input.

According to respondents, the audit committees of all public companies in this survey have a financial expert. For context, note that the SEC issued a corrected final rule implementing SOX Section 407 in January 2003, which required a public company to disclose it has at least one financial expert on its audit committee or explain why it doesn't. Under this rule, it's up to the board to determine whether it should include a financial expert as part of the audit committee. Although this is framed as a disclosure rule, pressure from either the investment banking community or shareholders often requires boards to ensure a financial expert is on the audit committee.

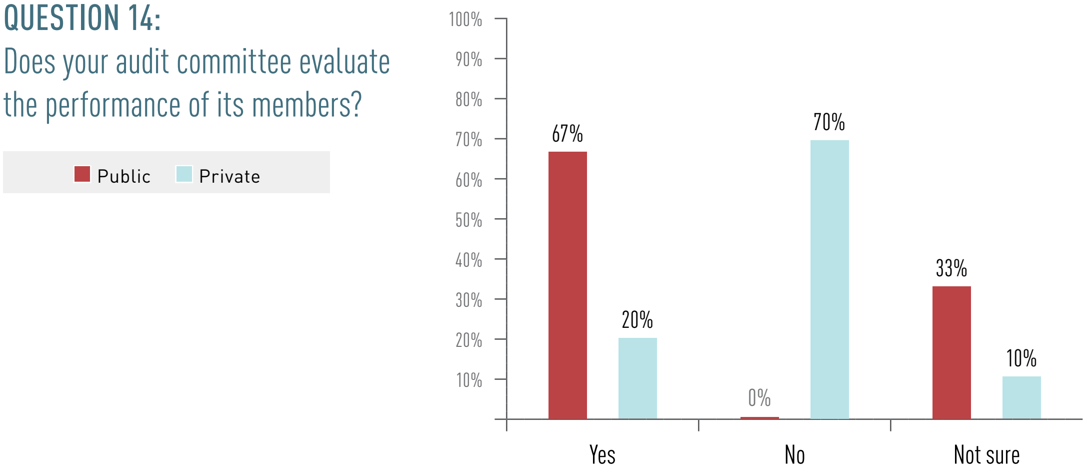
As a good practice, all audit committees—not just those of public companies—should have a financial expert who can analyze and evaluate financial statements with specific attention to accounting issues. These can range substantially in breadth and complexity across industry sectors.

In addition, each member of the audit committee must be able to read and understand fundamental financial statements, including the company's balance sheet, income statement, and statement of cash flows. At least one member of the audit committee must also have employment experience in finance or accounting, requisite professional certification in accounting, or comparable experience or background with financial oversight responsibilities. These requirements for the presence of financially literate members are imperative for audit committees to fulfill their responsibilities effectively while bringing value to the company.

In the present economic climate, audit committees face an increased risk of misstatement of accounts when they lack a nonexecutive director who has recent and relevant financial experience.

QUESTION 14:

Does your audit committee evaluate the performance of its members?



Apart from meeting the requirements of financial literacy, audit committee members should devote adequate time to understanding the company's industry environment and its implications for the financial information being reviewed. Committee members should be willing to interact with management, the internal audit department, and independent auditors. They shouldn't be satisfied until their questions are answered.

An audit committee must also subject itself to self-assessment. For this purpose, it should design a detailed questionnaire that covers each aspect of the committee's constitution as well as the performance of each function, including both the committee itself and its chairman. The questionnaire should be revisited regularly, typically once a year. Between these points, the audit committee may evaluate its effectiveness by a general discussion or a shorter version of the questionnaire.

When it comes to audit committee effectiveness, the contrast between the evaluation practices of private and public companies is stark. Two-thirds of public companies in the survey evaluated the performance of their audit committee members, but only 30 percent of private companies do the same.

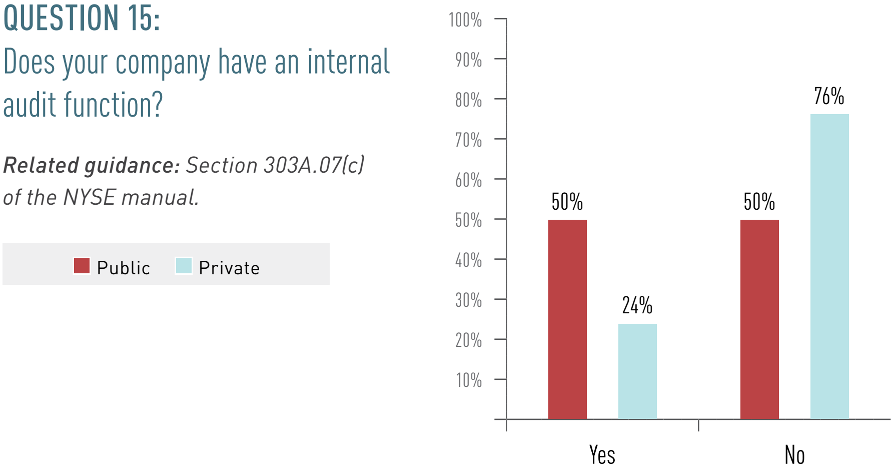
The prominence of audit committees in overseeing governance has increased, particularly over the past decade and a half. This heightened responsibility needs to manifest itself in a wider application of self-assessment and independent evaluation measures related to committee performance.

Internal Audit

QUESTION 15:

Does your company have an internal audit function?

Related guidance: *Section 303A.07(c) of the NYSE manual.*



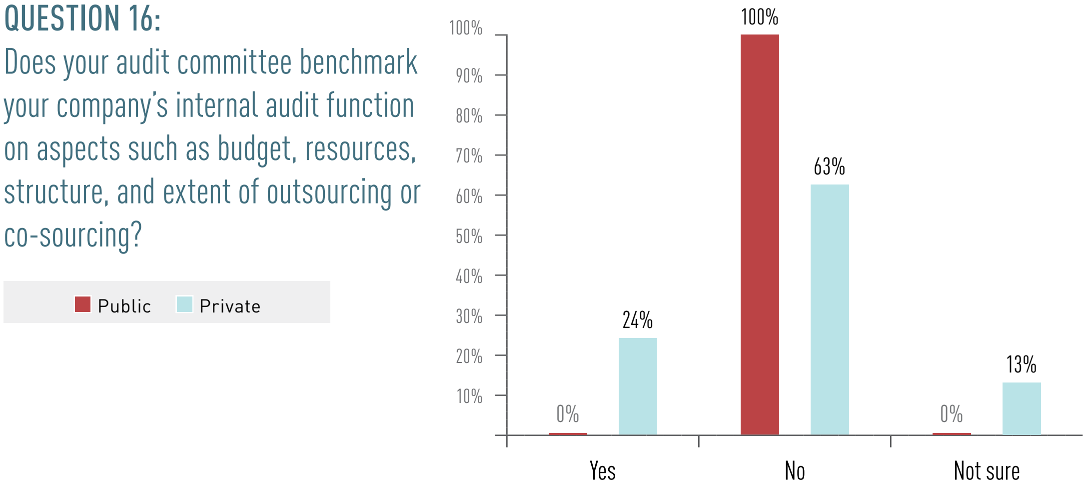
Almost 76 percent of private company respondents reported not having an internal audit function or its equivalent, such as an outsourced internal audit. This contrasts with public company respondents, half of which confirmed the existence of a dedicated internal audit function.

Internal audit is a valuable resource to management. It seeks to meet business objectives specifically relating to the efficiency and effectiveness of operations, reliability of financial reporting, compliance with applicable laws and regulations, and safeguarding of fixed assets. The audit committee is charged with monitoring the company's internal audit function with proactive measures, by reviewing its budget and staffing while also defining reporting obligations and ensuring the flow of communication between internal auditors, management, and independent auditors. The audit committee should also have regular discussions with internal audit personnel with respect to internal control structure, methods of risk assessment and risk mitigation, and other related issues.

Common reasons for not having a dedicated internal audit function can range from good oversight by management to highly centralized operations or significant executive director involvement. However, these explanations are overshadowed by the benefits of having an independent and objective internal audit function. Companies without an internal audit function should assess the need for one during the ensuing year and make a corresponding report for the board to review.

QUESTION 16:

Does your audit committee benchmark your company's internal audit function on aspects such as budget, resources, structure, and extent of outsourcing or co-sourcing?



Audit committees should periodically evaluate the effectiveness of their company's internal audit function (annually, if not throughout the year). In doing so, the audit committee can ensure the company receives a substantial benefit from investments made in its internal audit function.

Audit committees should benchmark their functionality on aspects related to their:

- Ability to meet the terms of the written charter
- Quality of identified risks and suggested remediation measures
- Objectivity demonstrated in outlook and approach
- Technical competency and proficiency of the internal audit team
- Quantum of resources
- Ability of the certified associated executive to command respect of the company's management, audit committee, and internal staff
- Value provided in terms of enhancing governance measures within the company

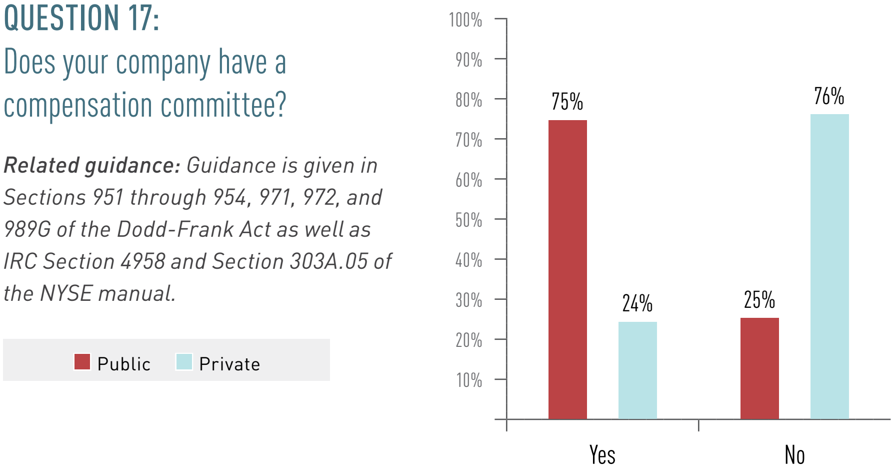
The audit committee should undertake such evaluations in a formal manner, which entails documenting the assessments or engaging external experts to do so.

Only 50 percent of public companies in the survey said they benchmarked their internal audit function and assessed its structure. Only one-fourth of private companies undertook such assessments.

Executive Compensation

QUESTION 17:
Does your company have a compensation committee?

Related guidance: *Guidance is given in Sections 951 through 954, 971, 972, and 989G of the Dodd-Frank Act as well as IRC Section 4958 and Section 303A.05 of the NYSE manual.*



Compensation committees are more relevant to publicly listed entities. In such settings, compensation committees should consist of nonemployee board directors, who are considered disinterested parties because they don't benefit from any compensation decisions made by the committee.

Compensation committees should approve the level of executive pay and benefits while ensuring their consistency with performance (both of the company and the individual) and the company's strategy. They should also:

- Approve executive pay and benefit programs
- Review policy and program design for both executive and nonexecutive pay and benefits
- Prepare the compensation committee report for the proxy statement (if publicly traded)
- Approve individual grants of stocks and other equity awards, including the number of shares, price per share, award period, and other relevant design issues

By fulfilling these responsibilities, the compensation committee ensures the appropriateness of executive pay and that the company's executive compensation programs attract, retain, and motivate topflight executives.

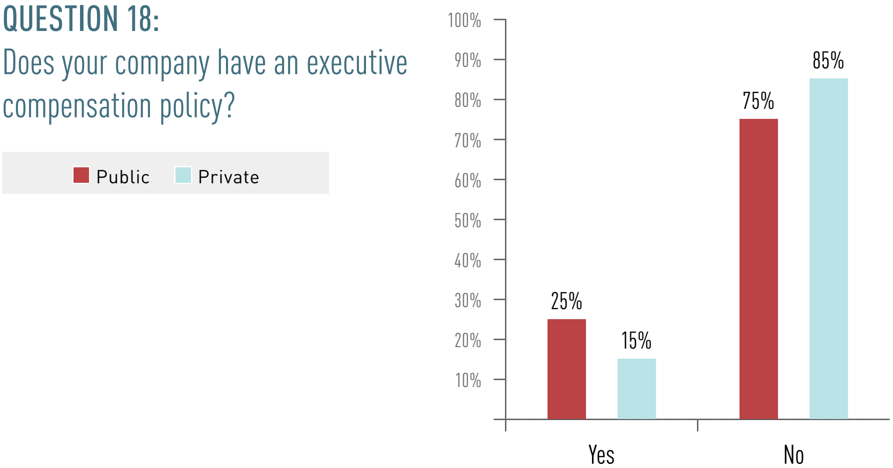
The survey responses from the public companies were encouraging; 75 percent of respondents confirmed the presence of a compensation committee in their company. The situation was entirely different in private companies, with only 24 percent of respondents stating they had a compensation committee.

The following table shows the areas of focus handled by public and private respondents' compensation committees.

AREAS OF FOCUS	PUBLIC	PRIVATE
Level of executive pay and benefits	100%	90%
Ensuring executive pay is consistent with performance	100%	77%
Executive and nonexecutive pay and benefits policy	67%	57%
Reviewing and approving grants of stocks	67%	43%

QUESTION 18:

Does your company have an executive compensation policy?



The board should be responsible for attracting and retaining a highly qualified chief executive and senior management team. It should also be responsible for seeing that executive pay and benefits are reasonable when compared with fair market value in the industry. Consequently, the board should be educated and updated annually about its executive compensation responsibilities.

In this respect, the board may choose to form a committee of disinterested directors to oversee executive compensation. To do so, it should approve a charter specifying the responsibilities of the executive compensation committee and requiring an annual report to the board so its directors remain aware of the committee's work. The CEO should be a nonvoting director, present only to provide and discuss information concerning the senior management team.

Executive compensation committees should consider engaging an independent consultant firm to provide education, advice, and comparability data. They should also recommend a compensation philosophy and incentive plan to the full board for approval. This philosophy and plan should provide a framework for determining base pay, incentives, and benefits for executives.

Despite the value an executive compensation committee can bring, only 25 percent of public and 15 percent of private companies in this survey had an established policy for executive compensation.

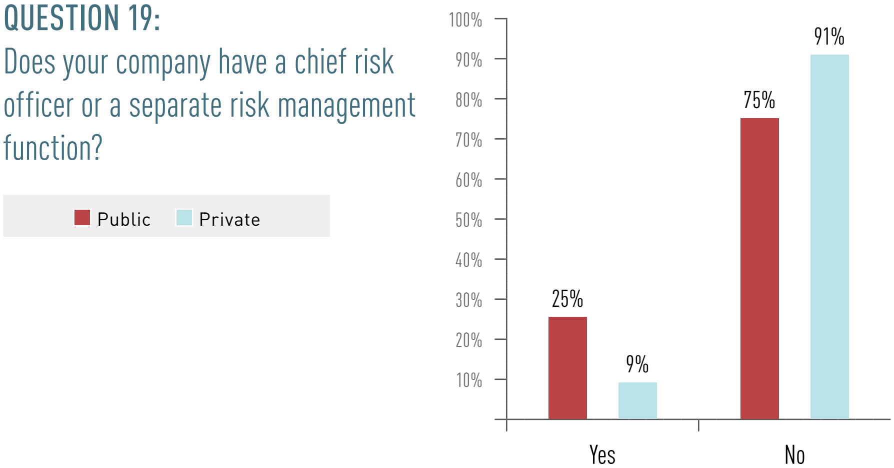
The table below shows what factors executive compensation policies covered for those respondents that did have one:

COVERAGE	PUBLIC	PRIVATE
Explanation on how executive compensation is linked to achieving the company's goals	100%	100%
Articulates that decisions for compensation are made by the board	100%	33%
The board's executive compensation oversight process	100%	39%
Define peer groups for comparison purposes and the board's targets	100%	39%
Describe benefits and deferred compensation so there's no ambiguity	100%	44%

Risk Management

QUESTION 19:

Does your company have a chief risk officer or a separate risk management function?



The role of an independent risk management function with a risk management head is indispensable. The purpose of this role is to identify events that could (negatively or positively) impact the company's ability to meet its mission and objectives. On one hand, the risk management function aims to effectively manage risks; on the other, it facilitates the company's ability to benefit from positive events.

The role of the risk management function is to advise the CEO and other members of management on setting the correct tone at the top of the company. That way, management can prioritize needs and make informed decisions. This function should provide company management with transparency into the risks to the overall enterprise, identified in three major categories: strategic and reputational, operational, and financial reporting and compliance.

The risk management function should:

- Integrate risk management into the business strategy and goal setting processes
- Provide an objective view of the company's risk posture and risk management performance
- Ensure business units have the appropriate tools, templates, and techniques to implement effective risk management within their respective areas

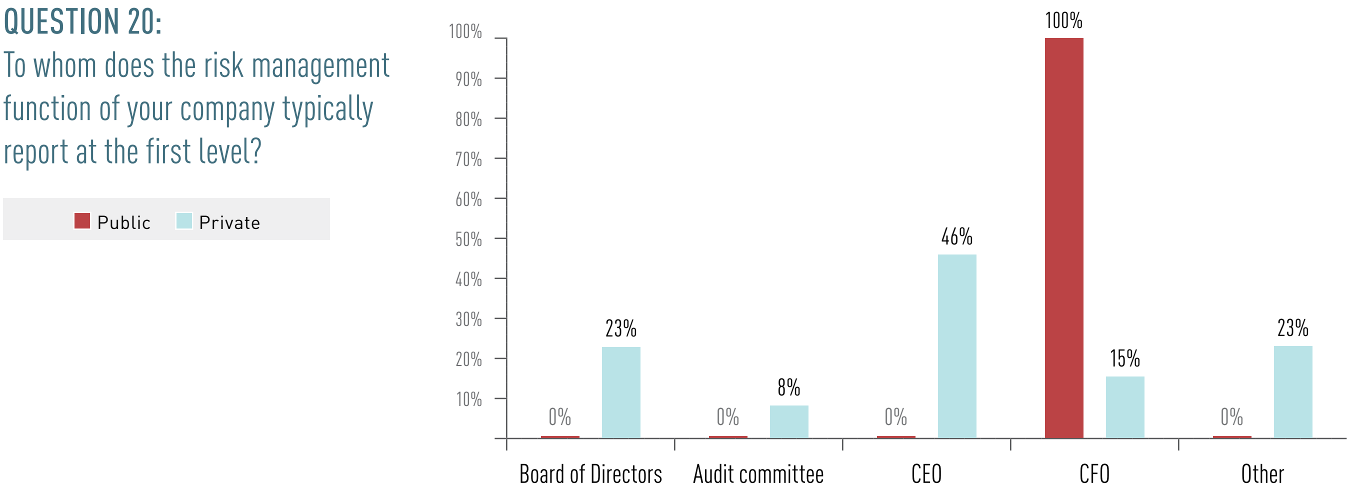
The results of this survey reveal a somewhat disappointing scenario: Only 25 percent of public and less than 10 percent of private companies confirmed the presence of a chief risk officer or a separate risk management function.

The shareholders and management teams of relatively smaller businesses are often their owners. As such, they may fill a number of diverse roles, which can quickly overwhelm certain priorities. It's difficult for individuals in these positions to distance themselves from management enough to isolate and mitigate the risks in each area they oversee. For the more than 90 percent of private businesses that lack a risk management function, take this survey as a word of caution.

It's generally advisable to use an enterprise-wide risk management method instead of approaching risk management by category. The reality is that enterprise risk management is more suited to a strategic, top-down, and holistic approach that incorporates market, credit, operational, and reputational risk. A centralized enterprise risk function can help companies of all sizes, shapes, and priorities define and align their risk appetite with their business strategy.

QUESTION 20:

To whom does the risk management function of your company typically report at the first level?



The reporting relationship of the risk management function is somewhat complex and obviously subjective.

Some clear patterns emerged in our survey, which showed that in all the public companies with a risk management function, first-level reporting was to the company's CFO. In contrast, among private companies with a risk management function, the largest portion—46 percent—reported to their CEO. In 23 percent of private companies, the risk management function reported to business owners.

There are bound to be significant differences in the role of a chief risk officer (CRO) based on the nature, size, and complexity of a company's business. As a company grows, the role of its risk management function becomes more formalized and more removed from day-to-day program management. This evolution is perfectly fine, but it tends to perplex those seeking a universal job description for the CRO function.

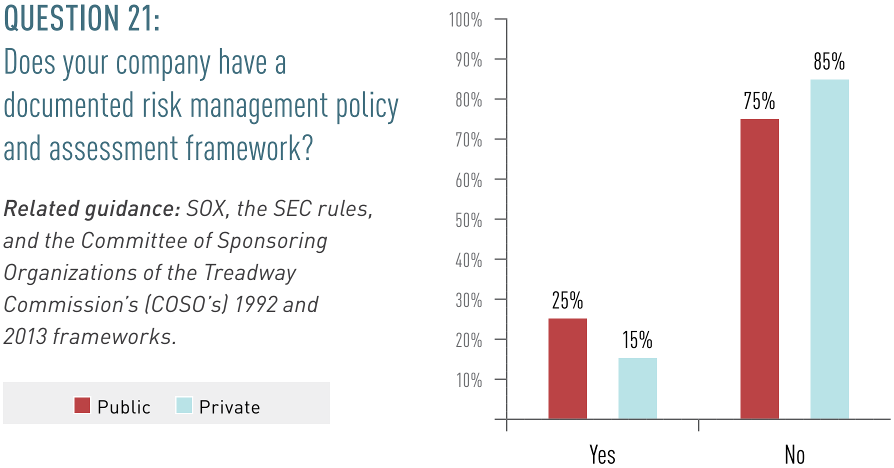
Over time, the CRO function has assumed profound proportions, with a large number of CROs reporting to the CEO or board of directors for their organizations. In some situations, CROs have reached a point where they have their say even in the business planning and strategy-setting stages. The general consensus is that the risk function shouldn't be viewed as a strictly compliance-related function where there are many other aspects attached to it.

Risk management is most effective when the CRO and CFO both report directly to the board. The CRO depends on the CEO on many counts, and although the two roles should work together on a day-to-day basis, the CRO's position shouldn't be controlled by the CEO. It's important for someone to play a contrarian role in an organization by protecting shareholders' interests. It isn't practical for a CRO to stand down a CEO when that CEO controls the CRO's career progression, salary, and bonus and may be driven to achieve performance goals at any cost.

QUESTION 21:

Does your company have a documented risk management policy and assessment framework?

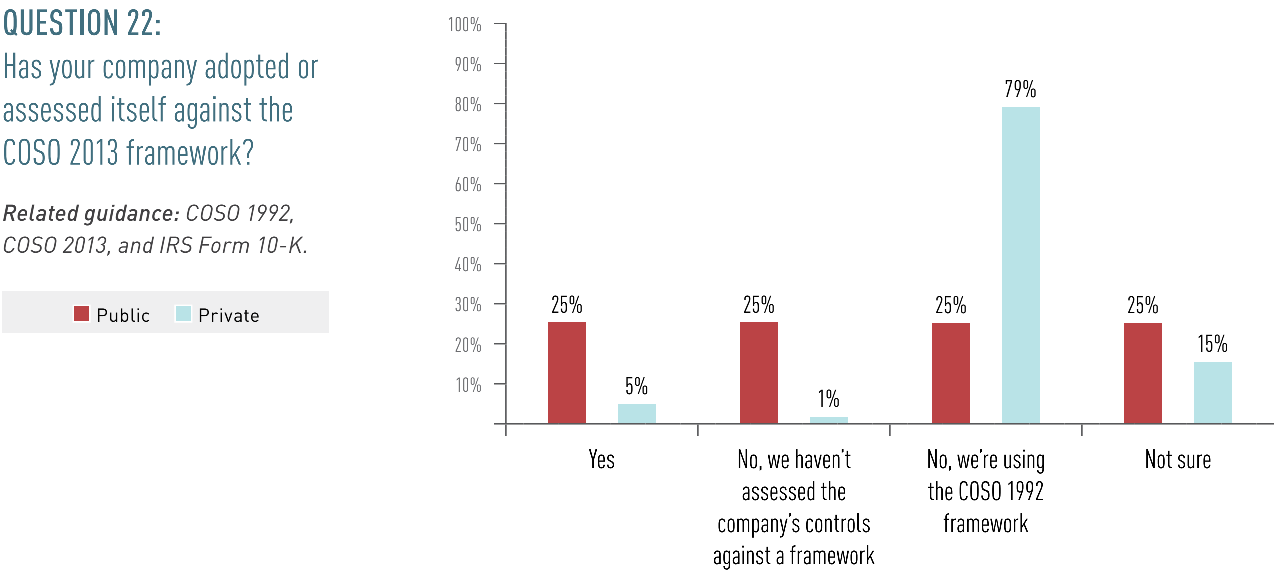
Related guidance: *SOX, the SEC rules, and the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) 1992 and 2013 frameworks.*



QUESTION 22:

Has your company adopted or assessed itself against the COSO 2013 framework?

Related guidance: *COSO 1992, COSO 2013, and IRS Form 10-K.*



In response to question 21, only 25 percent of public and 14 percent of private company respondents stated they had a documented risk management policy and assessment framework in place.

In response to question 22, 25 percent of public companies and 5 percent of private companies said they've adopted the COSO 2013 framework or assessed themselves against it. Others said they're still using the COSO 1992 framework—specifically 25 percent of the public companies and 79 percent of the private companies. The remainder either hadn't used the COSO framework at all or weren't sure whether their company had transitioned to the COSO 2013 framework.

Boards should assume the role of risk oversight in their company's risk management process. This requires the board to do all of the following:

- Obtain an understanding of the risks inherent in the corporate strategy and the risk appetite among management executing it
- Access useful information from internal and external sources about the critical assumptions underlying the strategy

- Be alert for dysfunctional behavior in the organization that can lead to excessive risk taking
- Provide input to executive management regarding critical risk issues on a timely basis

The board is also responsible for assessing and making disclosures about the process of identifying, evaluating, and managing significant risks. Processes and practices for raising risks to the appropriate levels should be communicated to all stakeholders. Meanwhile, boards should foster a mature risk culture, which includes sharing leading practices as they evolve.

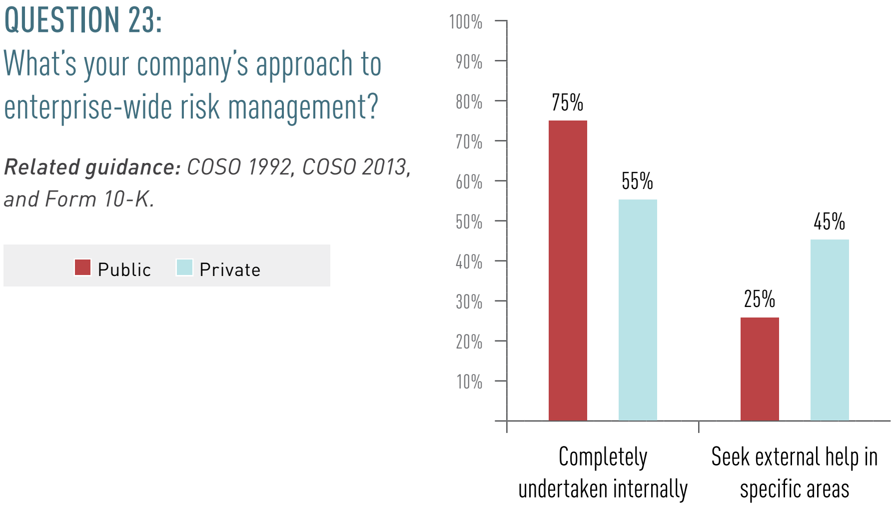
The SEC expects companies to be very specific in their disclosures about risk. The SEC also encourages its registrants to avoid stating generic risks that could apply to any business, instead focusing on comprehensive, transparent, and specific risks associated with their particular circumstances.

US public companies must comply with SOX in addition to the SEC rules, which require that management evaluate the effectiveness of the company's internal control over financial reporting based on a suitable, recognized control framework. The most recent version of the COSO framework is from 2013, and it also addresses several risk considerations relevant to working with third parties, a direct outcome of business models that have evolved to increasingly rely on third-party vendors.

QUESTION 23:

What's your company's approach to enterprise-wide risk management?

Related guidance: *COSO 1992, COSO 2013, and Form 10-K.*



Nearly three-fourths of the respondents from public companies and 55 percent of those from private companies assessed their risks internally, albeit with little or no external help. Public companies appear to have made investments in the resources necessary to spearhead and facilitate the institutionalization of an enterprise-wide risk management program; consequently, a larger proportion of these sought less external help.

While all public companies who sought external assistance have done so in three main areas (the identification, polarization, and ongoing monitoring of risks), a majority of private companies took a different approach. Nearly 62 percent of the private companies that responded sought assistance from external experts. A much lower proportion, 24 percent, have done so for polarization of risks; 31 percent did so to benchmark their mitigating measures with best practices; and 38 percent did so for ongoing monitoring of the risk identification and reporting process. Approximately 7 percent make decisions regarding the use of experts on a case-by-case basis.

Ultimately, three factors influence management's decisions regarding the nature and extent of external help: the degree of importance from a risk management perspective, the capability of internal resources, and budgetary considerations. At the same time, companies recognize the value external experts can bring. These include greater objectivity, efficient completion of the project, and the institutionalization of best practices for assessing risk mitigation measures.

The boards of nearly 42 percent of respondents from private companies identified a single point of contact to facilitate risk management in their companies, compared to one-third of the respondents from public companies. The remainder, in both cases, either entrust this to a risk or audit committee (mainly true of public companies) or engage several cross-functional groups (mainly true of private companies) that drive processes related to risk management.

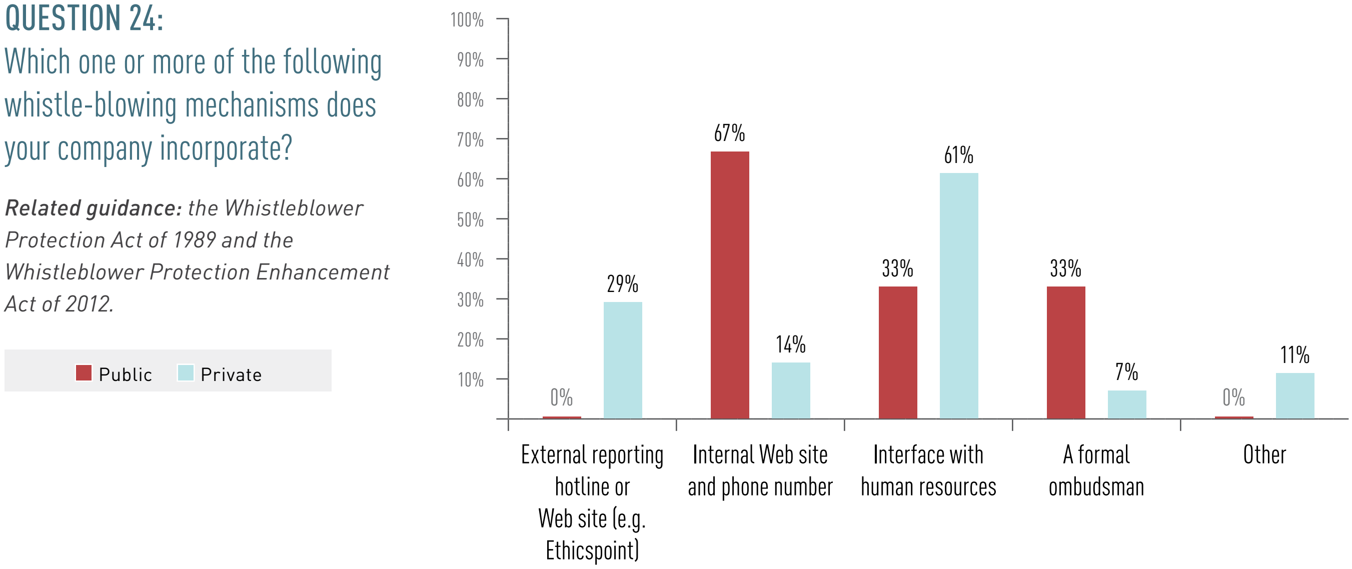
While all respondents from public companies said they performed risk assessments every quarter, 68 percent of private companies said they do so on an annual basis. Only a small faction, 7 percent, performed a risk assessment every quarter.

Whistle-Blowing

QUESTION 24:

Which one or more of the following whistle-blowing mechanisms does your company incorporate?

Related guidance: *the Whistleblower Protection Act of 1989 and the Whistleblower Protection Enhancement Act of 2012.*



Nearly two-thirds of public companies that participated in this survey set up details for whistle-blowers (including the phone number of a contact person) on their internal Web site, while one-third provided an interface with their human resources department or an ombudsman.

The situation was different among private companies. Sixty percent empowered their human resources function to play the lead role in reviewing and managing communications from whistle-blowers. Twenty-eight percent used an external reporting hotline or Web site, 14 percent used their internal Web site, and 10 percent either nominated their corporate attorney or assigned this role to people at supervisory levels.

While companies use a relatively wide variety of whistle-blowing frameworks, it's important that whatever framework is chosen ensures all employees feel supported enough to speak up in confidence and report matters they suspect may involve anything improper, unethical, or inappropriate.

A whistle-blowing policy should encourage the disclosure of matters including:

- Criminal offences
- Fraud
- Failure to comply with a legal obligation (such as a breach of a contractual or other common law obligation, statutory duty or requirement, or administrative requirement, including suspected fraud, malpractice, or a breach of the company's code of ethics)
- Miscarriage of justice
- Danger to the health and safety of any individual
- Damage to the environment
- Deliberate concealment of information tending to show any of the above

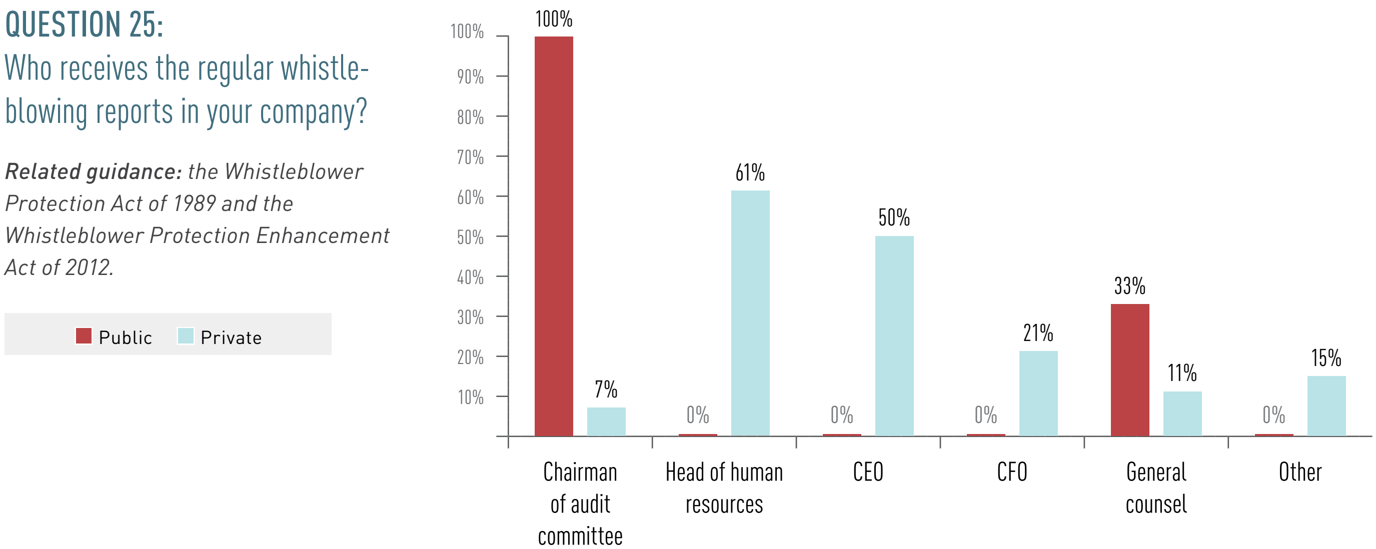
Such disclosures may be made by an employee, contractor, external person, or other entity that reasonably believes one or more of these matters is happening now, took place in the past, or is likely to happen in the future. The policy should also give the name of the person or persons who should be contacted if the whistle-blower finds something to speak of and to provide protection to the whistle-blower.

SOX protects employees who provide evidence of fraud against reprisals and discrimination. An employee aggrieved in this regard can seek redress by filing a complaint with the secretary of labor. If the allegations are true, the employee may be entitled to compensatory damages. SOX also inflicts criminal penalties for retaliation against whistle-blowers.

QUESTION 25:

Who receives the regular whistle-blowing reports in your company?

***Related guidance:** the Whistleblower Protection Act of 1989 and the Whistleblower Protection Enhancement Act of 2012.*



Given that whistle-blowers often fear putting themselves or their careers at risk, it's imperative companies ensure whistle-blowing is heard at the highest levels of leadership, which enables meaningful corrective action.

Ombudsmen with direct access to the audit committee or board can go a long way in this regard. In this sense, public company respondents showed the way: 100 percent appointed the head of their audit committee to receive regular whistle-blowing reports and one-third of these also involved their general counsel in the process. On the other hand, 61 percent of private companies appointed their head of human resources to receive regular whistle-blowing reports. Some also involved their CEO (50 percent), CFO (21 percent), and general counsel (10 percent) in the process.

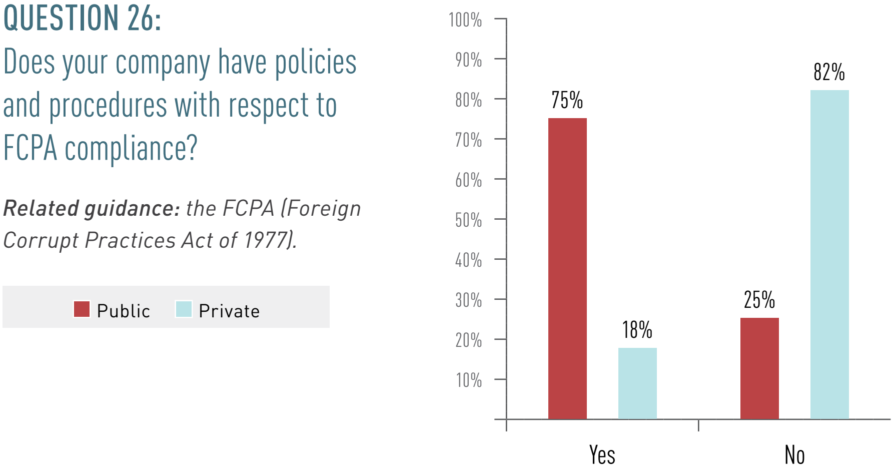
The ombudsman needs to be a board director whom employees can approach on a confidential basis. Typically, this is the chair of the audit committee. Equally as important as designating such a person is making sure employees and other stakeholders are aware of that person's role and the protocol for contacting them regarding whistle-blowing. A person in this role provides an additional degree of protection to the whistle-blower, further encouraging them to report any suspected wrongdoing on the part of management, an employee, or other stakeholders.

Companies need to balance two sometimes conflicting notions—a system that guarantees the reliability of whistle-blowing cases and policies that discourage employees from speaking out. Striking a balance is important because it not only ensures clear lines of communication for whistle-blowers but also increases the usefulness of whistle-blowing in driving meaningful change.

Compliance

QUESTION 26:
Does your company have policies and procedures with respect to FCPA compliance?

***Related guidance:** the FCPA (Foreign Corrupt Practices Act of 1977).*



The FCPA is a well-established piece of legislation that impacts every US company, including those doing business outside the United States.

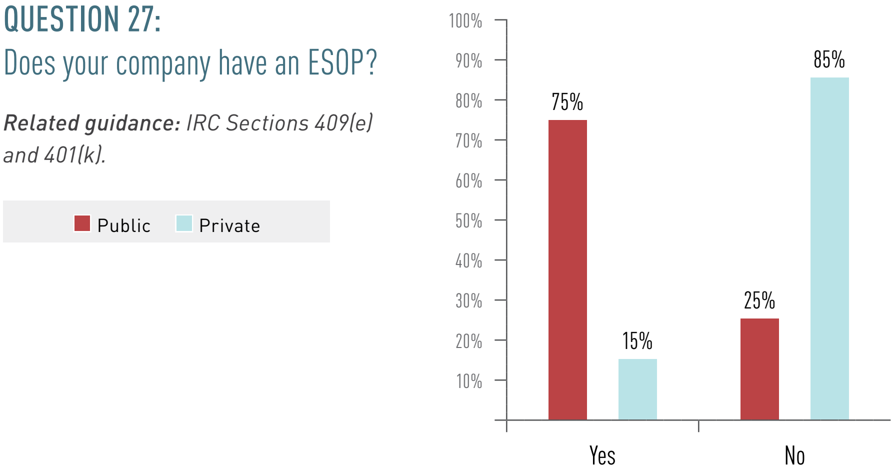
The FCPA's antibribery provisions make it a crime for any American—meaning any individual, business entity, or employee of an American entity—to offer or provide anything of value to a foreign government official with corrupt intent, whether to influence an award, continue business activity, or gain an unfair advantage. Even though the FCPA contains an exception for "facilitating payments" and small bribes to secure the performance of routine government action, many companies have voluntarily established a policy against facilitating payments. This is because facilitating payments follow the nature of bribes, and while the definition of *facilitating payment* under the FCPA is technical, companies need to be mindful of them, carefully assessing disbursements that border on facilitating payments or bribes.

Of public company respondents, 75 percent confirmed the presence of policies and procedures relating to FCPA compliance, compared to only 12 percent of private companies. FCPA compliance is equally relevant to many small and midsize US companies; consequently, private companies have significant ground to cover in institutionalizing stringent procedures to comply with this legislation, both in spirit and in form.

ESOPs and Shareholder Relationship Management

QUESTION 27:
Does your company have an ESOP?

Related guidance: *IRC Sections 409(e) and 401(k).*



Seventy-five percent of respondents from public companies and 15 percent of respondents from private companies said they have an ESOP.

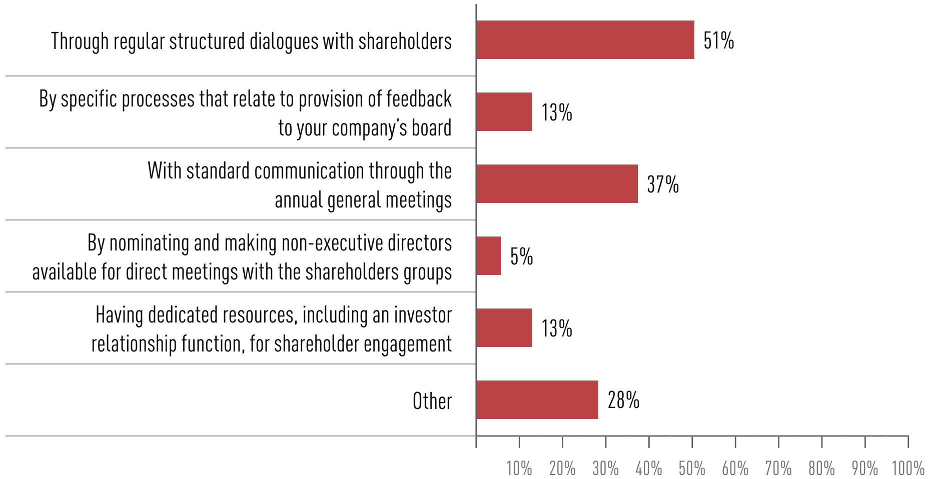
Depending on their specific considerations, companies may create ESOPs as employee retirement plans, for business continuity, financing, enhanced employee motivation, or a combination of these. There are specific tax benefits to employee stock ownership, and these plans appear to be more popular with public versus private companies. Apart from the tax advantages to ESOP sponsors, the relative ease in transferring shares likely led more public companies toward increased employee ownership.

With regard to the benefits of ESOPs, 58 percent of private companies either weren't sure of the extent to which ESOPs create a sense of belonging among employees or felt their impact was low. All respondents from public companies, however, felt ESOPs were an effective tool for retaining employees. It's possible that private companies are more circumspect when it comes to dilution of equity. This may be an aspect they're weighing against the tax and employee motivational benefits an ESOP can provide.

QUESTION 28:

How does your company seek to understand the views of its shareholders?

Related guidance: NYSE manual.



NYSE rules require listed companies to disclose the means by which shareholders may communicate with the presiding director or nonmanagement directors. These may be disclosed on the company's Web site or in its proxy or annual report.

The SEC also requires public companies to disclose and describe (in their proxy statement or Form 10-K) a process for shareholders to send communications to the board. If none exists, the company must state that no process exists and "state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a process."

More than half of respondents, 51 percent, had regular, structured discussions with their shareholders. A little over one-third, 36 percent, had standard communications at annual general meetings. Only 13 percent of the companies surveyed dedicated resources to shareholder engagement, and finally, just a handful of the companies, 5 percent, made their nonexecutive directors available for direct meetings with shareholder groups. Combined, this data signals more work is left to be done with regard to accessibility for shareholders.

Conclusion

Good corporate governance practices are just as important for the middle market as they are for Fortune 500 companies. To be effective, practices must be instituted at the top, and a strong board can influence the governance across an organization.

We hope you'll use the information in this survey to compare your organization's governance practices against companies of similar size and complexity. While some may take time to cultivate, others are relatively easy changes to begin making now—and they'll go a long way toward improving your organization's oversight and the effectiveness of its leaders.

Despite the quantitative nature of the data presented in this report, remember that substance in governance really is more important than form: More important than the number of directors on your board or audit committee or the number of meetings they hold per year is how well these practices affect change and provide direction. Still, a bit of form does help. Consider the topics and numbers in this report as a starting point for your middle-market organization's progress toward sound and effective governance.

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