



Navigating a changing regulatory landscape

The North Central Audit Committee Network (NCACN) met on March 2, 2010, in Jupiter, FL. Discussion focused on how audit committees and boards are dealing with regulatory changes, including accounting changes and questions regarding conversion to International Financial Reporting Standards (IFRS) from US Generally Accepted Accounting Principles (GAAP), expanding disclosure requirements, and new legislation that could have a significant impact on companies and their governance. A meeting participant observed, *“It is a good time to reflect on the impact of accounting changes, regulatory changes, and legislation. As a company, are we ready for all of these things?”*¹ For a full list of participants, see Appendix 1 on page 10.

Members were joined by Kurt Hohl, Ernst & Young professional practice director, East Central sub-area. Prior to his time at Ernst & Young, Mr. Hohl spent eight years at the Securities and Exchange Commission (SEC) in the Division of Corporation Finance.

Executive summary

- **A wave of accounting and reporting changes is approaching, despite the delay in conversion to IFRS** (Pages 2-5)

NCACN members are giving little time and attention to IFRS because they believe conversion seems unlikely any time soon, yet discussion yielded a new sense of urgency regarding understanding the potential implications of the wave of change to US GAAP that will take place over the next few years, due to the convergence projects already underway between the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) aimed at bringing US GAAP and IFRS closer together.

- **Expanding disclosure requirements are part of a broader shareholder rights agenda** (Pages 5-8)

Audit committees and boards are reviewing a range of new SEC disclosure requirements as their companies prepare their proxy statements. While members do not expect the new disclosures will provide much added value to investors, they recognize these requirements are part of a broader shareholder rights agenda that could have significant impact on corporate governance.

- **In the face of rapid change, it is essential to remain focused on strategic issues and on the future** (Pages 8-9)

As audit committees and boards navigate the accounting and governance changes under way, they want to be sure core governance activities, especially activities related to forward-looking risk management and strategic planning, get due attention and that their companies are planning for growth.

¹ *VantagePoint* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or companies. Comments in italics represent statements members made during the meeting.



A wave of accounting and reporting changes is approaching, despite the delay in conversion to IFRS

Discussing the range of recently implemented and upcoming accounting changes impressed upon network members the need to ensure that management is properly prepared to handle those changes and that the audit committee and the full board understand their potential implications. Members cited IFRS-US GAAP convergence projects and changes to reporting in areas such as goodwill, fair value, revenue recognition, and variable interest entity (VIE) consolidation as particularly worthy of attention.

The potential impact of convergence cannot be overlooked

On February 24, 2010, the SEC issued a statement affirming commitment to the idea of a single global set of high-quality accounting standards, but a decision on when and if to implement IFRS in the US is not expected until 2011. The statement envisioned 2015 as the earliest possible date that US issuers would be required to report under IFRS and set forth a work plan for the SEC staff “to provide necessary information to the commission and to evaluate key transitional issues in transitioning to IFRS in order to drive the process.”²

Many companies have hesitated to invest too much in conversion preparation, fearing that IFRS could be what one meeting participant described as “*another metric system.*” That is, they imagine that the United States may elect not to convert to IFRS and that there may end up being two accounting standards: “*the US and the rest of the world.*” But meeting participants warned that letting the delay in conversion lull companies into a false sense of comfort was foolhardy because even without conversion, major accounting change is under way.

The convergence projects undertaken by the FASB and the IASB are changing existing accounting standards and producing new accounting standards with the goal of bringing IFRS and US GAAP closer together. Members question whether audit committees and company management are paying sufficient attention to these new standards. One observer suggested that the projects, many of which are due to be completed by 2011, are “changing much of what has been commonplace in financial reporting for the past 30 years,” and said that “the current projects will significantly affect ... all companies that report under U.S. GAAP or IFRS.”³ Among the changes are entirely new standards related to financial instruments, consolidation, derecognition, revenue recognition, financial statement presentation, and leases.⁴

A network member said, “*Convergence means compromise. That is why people question how much to invest in this now. People are suspicious that the [US] government won’t allow us to go to a looser, principles-based standard.*” According to one participant, the FASB has been surprised by the lack of resistance to these sweeping changes, but that lack of protest may be precisely because companies haven’t acknowledged the changes’ potential impact. A network member said companies often deal with accounting changes one-at-a-time, which may limit the scope of discussions on the range of changes that are coming.

² Alexandra Defelice and Matthew Lamoreaux, “[No IFRS Requirement Until 2015 or Later Under New SEC Timeline.](#)” *Journal of Accountancy*, February 24, 2010.

³ Matthew Lamoreaux, “[Countdown to Convergence.](#)” *Journal of Accountancy*, March 2010.

⁴ For a list of the projects and their target completion dates, see Financial Accounting Standards Board, “[Technical Plan and Project Updates](#)”



Network members note that the changes coming out of the convergence project include “high-profile” accounting issues that could significantly impact balance sheets and income statements. A meeting participant asserted, “*Even without conversion, [the] convergence [process] means there will be a whole lot of things we are going to be dealing with. The volume and speed will be more than accounting departments have ever dealt with.*”

While network members said their audit committees were not currently spending time discussing IFRS, another meeting participant cautioned, “*You can’t wait on the convergence projects, even if you can kick the IFRS can down the road, like the SEC has.*”

What does this mean for audit committees? One meeting participant cautioned against ringing the alarm bells, though network members said it’s important that audit committees stay on top of these changes so that they are not surprised by them when implementation is required. A meeting participant said, “*Not all of these will affect every company, and not all will be affected in the same way. But many companies have cut staff; accounting departments are leaner. Are we ready for this over a short period of time?*”

How can audit committees ensure their companies are prepared?

Members said that audit committees can ensure that management is preparing for these accounting and reporting changes by:

- Discussing the potential impact of changes as exposure drafts are released through 2010–11
- Ensuring the accounting and finance organizations are properly resourced
- Ensuring updates to financial systems will be IFRS compatible
- Using well-defined non-GAAP metrics for performance, including those used in compensation plans
- Considering the implications of the changes for new contractual agreements (e.g., debt covenants)
- Disclosing the potential impact of accounting changes to investors

Other recent accounting and reporting changes require committee attention

The recent accounting and reporting changes are forcing members’ audit committees to deal with things they “*have never experienced before.*” As audit committees prepare for 2010 reporting, they may want to discuss the following issues with management:

- **New revenue recognition accounting.** The FASB now gives companies more latitude to use some judgment and establish a fair value for individual elements of bundled arrangements, but that has prompted SEC staff to take a closer look at revenue recognition practices.⁵ These changes could have

⁵ Tammy Whitehouse, “[SEC Warns on New Interpretations of Revenue Rules](#),” *Compliance Week*, January 26, 2010.



significant effects on when revenue is recognized and may require process and infrastructure system changes, and involve significant judgment that could be challenged by regulators.

- **Ongoing issues and changes regarding fair value, including new fair value disclosures.** Fair value issues (for example, in the context of goodwill impairments) continue to be of particular concern: the FASB recently released a revised version of Subtopic 820-10 (formerly FAS 157, Fair Value Measurements). The revision “aims to make fair-value disclosures more robust by requiring companies to disaggregate more of the numbers they report.”⁶ In a discussion prior to the meeting, a network member stated, “We need to be very concerned, given economic uncertainty, about the proper way to analyze and account for estimates and reserves ... To the extent that these estimates are predicated on market indices, the question is, with such volatility, is there a solid basis for measuring long-lived assets?” The FASB’s proposals also call for additional disclosures about fair value measurements even beyond the current revisions. The SEC is also looking for additional discussion of any potential future goodwill impairments and uncertainties around key valuation assumptions included in the management discussion and analysis (MD&A).
- **Credit quality and loan losses.** In 2009, the FASB amended the guidance for measuring, recognizing, and presenting impairment of debt securities in the financial statements, requiring that impairment be recognized before the company can claim it is “probable” that an amount will be uncollectable.⁷
- **eXtensible Business Reporting Language (XBRL).** From mid-June 2009, large accelerated filers using US GAAP that file their primary financial statements, notes, and schedules with the SEC and that have a worldwide public float of over \$5 billion must submit those items in XBRL, an open-data standard for financial reporting. Other large accelerated filers will be required to submit financial statements in XBRL beginning in June 2010.⁸

At the meeting, members highlighted two other areas of change as particularly problematic:

- **FIN46R: consolidation of variable-interest entities (VIEs).** Last summer, the FASB revised FIN 46R, which covers consolidation of VIEs and what constitutes control of an entity.⁹ The revision was implemented in January 2010. According to one member, issues related to VIEs “*will be very challenging to deal with*” because, for example, companies often have minority interests in subsidiaries, but also provide loans to the entity, complicating the question of control.
- **Internal Revenue Service (IRS) Announcement 2010–9.** In its Announcement 2010–9, which deals with uncertain tax positions, the IRS has proposed requiring companies to “disclose uncertain tax positions in the form of a concise description of those positions and the maximum amount of US tax exposure if the taxpayer’s position is not sustained,”¹⁰ in their tax returns. One member remarked that

⁶ Marie Leone, “Fair Value: Eyes Wide Open,” *CFO.com*, January 22, 2010.

⁷ FASB Action Alert, [Summary of Board Decisions](#), April 2, 2009.

⁸ Ernst & Young, “SEC’s final XBRL rule.”

⁹ For an explanation of VIEs and issues of ownership and control, see Sarel Oberholster, “[The Independence of the Fed](#),” *Seeking Alpha*, March 7, 2010.

¹⁰ Douglas Shulman, [remarks to the New York State Bar Association Taxation Section Annual Meeting](#), January 26, 2010.



these disclosures in the tax return “*essentially provides a road map to the IRS,*” highlighting those positions where the tax treatment may not be black and white. Another member expressed concern that the requirement to disclose this information may cause the tax director to make different decisions in order to protect the company.

Rapid change can increase the chances of errors in reporting that result in restatement

Members note that the sheer number and diversity of accounting changes increase the chance of error and therefore “*really do increase your risk of restatement, which typically comes from things where folks had limited experience.*” These changes also come as the SEC is strengthening enforcement: it has hired a former prosecutor as the new head of enforcement, increased its cooperation with the Department of Justice, and improved processes at the Division of Corporation Finance, and this year alone, the IRS has hired 800 more professionals just to focus on international tax enforcement.¹¹

Expanding disclosure requirements are part of a broader shareholder rights agenda

On December 16, 2009, the SEC approved new rules expanding company disclosures regarding:

- The relationship of a company’s compensation policies and practices to risk management
- The background and qualifications of directors and nominees
- Legal actions involving a company’s executive officers, directors, and nominees
- Considerations of diversity when nominating candidates for the position of director
- Board leadership structure and the board’s role in risk oversight
- Stock and option awards to company executives and directors
- Potential conflicts of interest on the part of compensation consultants

The new rules, which became effective two days before the network meeting, on February 28, 2010, also require quicker reporting of shareholder voting results. According to SEC chairman Mary Schapiro, “Accountability is impossible without transparency ... By adopting these rules, we will improve the disclosure around risk, compensation, and corporate governance, thereby increasing accountability and directly benefiting investors.”¹²

Several members raised questions about the utility of the expanded disclosures: “*We threw our hands up [at our last board meeting] – what’s really the appropriate response?*” One member predicted, “*While we have to be responsive ... the impact will be to make proxy statements longer and longer, and the important information will just get buried.*”

¹¹ US Department of the Treasury, [Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance](#) (Washington, DC: Department of the Treasury, 2009), 11.

¹² Securities and Exchange Commission, “[SEC Approves Enhanced Disclosure About Risk, Compensation and Corporate Governance](#),” press release, December 16, 2009.



Director qualification disclosures hit close to home

In conversations prior to the meeting, several members questioned the merit and practicality of attempting to summarize their value as directors in a few paragraphs: “You can’t put it all on paper. You can’t describe your value to the board.” One member expressed uncertainty about the tone these disclosures should take: “I don’t want to turn board biographies into advertising documents ... The kind of people you most want in a governance role may say, ‘I don’t want to market myself. How do I describe how I make a difference?’” At the meeting, a network member stated, *“I would argue that I’m a better director for having been on the board of companies where we had some issues, challenges. None of that is in the director qualification disclosures. It is in the eye of the beholder what is important.”*

With the new disclosure rules having only recently taken effect, companies are at different stages of the process of complying with the new requirements. Members shared some tactical approaches to developing the qualification disclosures:

- **Leverage the annual director survey.** A network member said, *“We added another question to the directors’ questionnaire. Everyone wrote their own biography, then the corporate secretary took out one or two unique sentences from each to cite the reasons they are specifically valuable to the board.”*
- **Catalogue director experience to identify strengths and gaps.** Another member’s board took a slightly different approach: *“We developed a catalogue of experience. Each director checked off what experience they had in various areas, e.g., public relations, IT, finance, etc. Then we aggregated those to be sure we had most of them covered.”*

Risk disclosures are proving to be relatively limited and straightforward

Most boards have devoted substantial attention to improving risk oversight in recent years, and describing that oversight in new disclosures is relatively uncomplicated. Similarly, members see new disclosures regarding risks related to employee compensation as targeted at financial institutions. While some companies have adjusted compensation plans, for example by adding claw back provisions, most have determined that their compensation structures do not encourage excessive risk taking, and therefore they are not required to disclose specifics, choosing instead to state in the proxy that their compensation plans are designed in the best interests of shareholders, describe the process by which they reached that conclusion, or describe the internal controls around any potentially risky areas of compensation.

Disclosures will evolve over time

Members generally expressed skepticism that the new disclosures will be of much real value to shareholders or regulators. Several members agreed that companies will start with a *“minimalist”* approach, keeping the disclosures at a *“high level.”* As a result, one member suggested, *“You’ll see pretty generic disclosures ... There is a lot of extraneous data, and the lawyers are just wordsmithing. It is not going to be very meaningful.”* Because the disclosures are new to everyone, members expect some *“wiggle room”* in the first year. A network member observed, *“There are not enough proxies out yet to see what people are doing. [The situation] will refine itself over time.”*



Prior to the meeting, Tapestry Networks spoke with Jeff Stein, a partner at the law firm King & Spalding who advises companies on SEC reporting and compliance, about the expanding disclosure requirements. Mr. Stein suggested that for disclosures relating to risk oversight, the link between compensation and risk, and climate change, the SEC is primarily interested in “the process that helps the company determine whether [a risk] is reasonably likely or not and the potential impact ... The SEC is putting the onus on companies to say, ‘Here’s the process we go through to support this conclusion.’” He recommends audit committees “ask management, ‘Who are you talking to? Who are you benchmarking against within our peer group?’” Members expressed similar views at the meeting, noting that they expect a “*state of the art among peer groups*” to emerge as companies benchmark against each other and the SEC provides feedback on the initial drafts.

Investor influence is increasing, but board-shareholder engagement remains limited

Network members generally view the expanded disclosure rules as part of a broader agenda to give shareholders more direct influence over corporate governance. Key trends include:

- **A stronger investor voice in director elections.** Many companies have adopted majority voting and are moving to declassified boards. In July 2009, the SEC approved a New York Stock Exchange rule banning broker discretionary voting of proxy ballots for uncontested elections of directors.¹³ This year, the SEC is likely to consider implementing proxy access, which would allow investors to include in the proxy statement their own slate of directors for election. Ms. Schapiro said that she is hopeful the SEC will adopt a proxy access rule, and in a speech in December 2009, she said that the Commission was nearing a vote on the proposal.¹⁴ One member commented that “*proxy access will be the next big thing.*”
- **An expanded role for proxy advisory firms.** Board members, executives, and even some investors express concern about the growing influence of proxy advisory firms such as RiskMetrics (formerly Institutional Shareholders Services). It is generally agreed that RiskMetrics’ clients account for, on average, between 20 and 30% of proxy votes.¹⁵ In a conversation before the meeting, one member described how “RiskMetrics voted against our entire compensation committee a couple of years ago because we had made some modifications to the CEO’s employment agreement ... It’s easy to misstep.”
- **More investor engagement with board members.** One large investor with whom Tapestry Networks spoke as part of an outside research effort stated, “It is a better strategy to get directors to call shareholders because we feel better that directors are representing us.” However, few network members report that their boards have increased direct engagement with investors, preferring to have management be the voice of the company. Typically, members said their interactions are limited to “*reactive*” engagement because, as one member noted, “*When things are good, there is limited demand.*” Another network member contended, “*If you have significant shareholders who want to talk to board members, it raises questions as to what their view of management is. No board member is going to be as*

¹³ Sara Hansard, “[SEC reviewing director election process, Schapiro says.](#)” *InvestmentNews*, November 4, 2009.

¹⁴ Melissa Klein Aguilar, “[SEC’s Schapiro Details What’s Ahead For 2010.](#)” *Compliance Week*, February 5, 2010.

¹⁵ Ernst & Young and Tapestry Networks, “[The 2010 proxy season: a forewarning of what’s to come in 2011.](#)” *InSights*, January 2010, 8.



knowledgeable as top management.” Still, some members have fielded requests for directors to engage with major investors or proxy advisory firms and have suggested the interaction was worthwhile and may have earned *“some goodwill.”*

Several network members shared the view of one who observed that while these changes do not add up to a *“sea change”* in the influence of shareholders in corporate governance, *“the water level is rising and will continue to rise, bit by bit.”* In order to be effective in an advisory role, directors will need to be aware of investor agendas and potential issues, such as those related to compensation structures, which could raise red flags and get the attention of investor groups or proxy advisers. Members recommended questioning senior management and the investor relations team about the company’s outreach to key investor groups. Several members’ boards also periodically have equity analysts present to the board in order to ensure the board understands investors’ perspectives.

In the face of rapid change, it is essential to remain focused on strategic issues and on the future

A network member asserted, *“As board members, we are focusing more and more on all of these changes. We are getting pushed further and further away from the focus on running the business. The errors have been in running the business, not in the minutiae.”* One result of the increase in reporting changes, disclosures, and other compliance issues is that directors’ duties are taking up more of their time. Members generally agreed that they spend *“well past 35 days a year”* per board and that committee chairs spend substantially more time. But members emphasized the fact that their boards are striving to work smarter, not just harder. They noted a number of approaches boards and committees are taking in order to maintain an appropriate focus on forward-looking strategy:

- **Dedicated time for deep dives on risk and strategy.** Directors must ensure that there is enough time for key strategic discussions. A network member stated, *“It is not a good excuse to say compliance issues are pushing out strategic issues.”* Members have suggested having dedicated sessions for strategy and risk discussions to ensure ample time and attention is devoted to these conversations.
- **Greater use of executive sessions.** Members also suggested adding additional time for executive sessions and reported more give and take with the CEO and top management in these discussions recently than has been the case in the past. Some now hold executive sessions before and after board meetings, and several members noted that dinner on the evening before board meetings has become a de facto executive session with the CEO. One member said executive sessions at one board last for well over two hours. Another said, *“The driver becomes the executive session with the CEO. It tees up key issues, and [the CEO] is aware when it comes up on the agenda.”* Another said, *“Executive sessions with the CEO are much longer, and some are held without the CEO. We are spending time looking beyond the next three years’ plan: where are we going? Assignments come out of it, and it sets the agenda going forward.”*
- **Drawing on outside experts.** With so much change afoot, several members said they had brought legal experts to present to the board on governance changes. One member’s company spent 90 minutes discussing *“what’s likely to happen and how to get out in front of these [new rules].”* Members also



report hiring consultants to help facilitate strategic discussion among the board and to ensure key issues are being addressed. A member described the process: *“The board picked a consultant, and [that consultant] worked with management, management’s consultant, and the board. We all came together with a list of strategic issues and a list of strategic risks to follow up on.”*

Conclusion

NCACN members came away from the discussion on March 2 with a new sense of urgency regarding the potential impact of current accounting and reporting changes. Although the SEC has delayed commitment to conversion to IFRS, a “*tsunami*” of accounting changes is coming via the convergence projects, and members worry that management and their auditors may not be doing enough to address these changes, and if they are, they may not be sufficiently updating the audit committee. Audit committees may need to proactively raise these issues with management so they can get assurance that management is prepared to deal with the potential implications.

Meanwhile, boards must not let the governance changes and new disclosure rules distract them from core governance activities and strategic oversight. Of the new developments, members are particularly interested in the requirement that directors justify their place on the board, and in shareholder rights initiatives. Audit committees and boards often decry the amount of time spent on “*check-the-box*” compliance activities, yet directors recognize there will always be new issues emerging that require their time and focus, even though these matters might seem to add little value. In this environment, members are seeking ways to ensure their boards can retain a focus on strategy, devote attention to oversight on risks to the business, and keep looking ahead: in other words, ensuring that boards can continue to serve the best interests of the same shareholders that the array of potentially distracting governance changes are meant to empower.

About this document

The North Central Audit Committee Network is a select group of audit committee chairs drawn from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

VantagePoint is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Meeting participants

The members of the network present at the meeting were:

- Bill MacDonald, Audit Committee Chair, American Greetings Corporation
- Dave McCammon, Audit Committee Chair, Pulte Homes
- Mike Monahan, Audit Committee Chair, CMS Energy Company
- George Schaefer, Audit Committee Chair, WellPoint and Ashland
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Jim Vandenberghe, Audit Committee Chair, Federal-Mogul

Ernst & Young participants in the meeting included:

- Mary Kane Betsill, East Central Assurance Managing Partner, Ernst & Young
- Kurt Hohl, Professional Practice Director, East Central sub-area, Ernst & Young
- Al Paulus, Director of Professional Practice – Auditing, Ernst & Young
- Mike Ventling, Vice Chair and North Central Managing Partner, Ernst & Young

The following members participated in teleconferences on the same topics following the meeting. Comments from those calls have been incorporated in this issue of *VantagePoint*.

- Jim Boland, Audit Committee Chair, Goodyear Tire & Rubber Company and Sherwin Williams
- Glenn Eisenberg, Audit Committee Chair, Family Dollar Stores
- Bill Lawrence, Audit Committee Chair, Brush Engineered Materials
- Richard Wallman, Audit Committee Chair, Convergys Corporation



Appendix 2: Questions for audit committees

- ?** What conversations has the audit committee had with management about the impact of accounting changes on 2010 financial statements? How can the committee ensure that accounting policies do not unnecessarily influence management's behavior? What changes are likely to have the greatest impact? Are there particular areas of concern for the audit committee?
- ?** What should audit committee members be asking their external auditors about the current and proposed changes in standards? What should auditors be discussing proactively with clients?
- ?** How does lack of clarity around conversion to IFRS impact your company? What implications will this have for the audit committee?
- ?** How has management's drafting of proxy disclosures accommodated the new SEC requirements? What has changed from previous years' proxy disclosures?
- ?** How does the board plan to review the expanded proxy disclosure statements? What role will the audit committee play? Are there particular proxy disclosures that will require additional board attention?
- ?** How does your board stay informed about regulatory and legislative changes, such as the new SEC disclosure requirements? What role can outside experts (e.g., accountants, lawyers, consultants) play in helping committee members stay current?
- ?** Has your board discussed the potential impact of governance changes on your company? Are there any issues of particular concern?
- ?** Do you expect governance reforms to change the relationship between the board and shareholders?
- ?** How would you describe your company's approach to interacting with proxy advisory firms? How is this approach evolving over time?
- ?** What impact, if any, has economic and regulatory uncertainty had on the board's and audit committee's priorities? What has been the impact on the board's relationships with key executives?
- ?** How much time is the board spending on forward-looking strategy? Do you believe this is the right amount of time? How do you expect it to change over the next 12 months?
- ?** How can the board ensure that management is focused not only on key risks, but also on opportunities?