



Overseeing international risks and opportunities

The Midwest Audit Committee Network is a group of audit committee chairs drawn primarily from public companies headquartered in the Midwestern United States. On June 7, 2011, the network convened for its 11th meeting in Washington, DC, in conjunction with Ernst & Young's Global Growth Forum. The discussion focused on the audit committee's role in overseeing international risks and opportunities. This document synthesizes the key insights from the discussion.¹ For a full list of participants, please see Appendix 1.

Executive summary

As emerging markets develop and entice US companies to broaden their global footprints by promising growth, companies may soon find themselves “competing with everyone, from everywhere, for everything.”² Companies entering or operating in foreign markets invite risks that demand enhanced oversight at the board level. Members discussed how their management teams and boards have evolved to keep pace with their companies' expanding footprints. The discussion focused on four key areas:

- **Major opportunities and risks in international markets** (page 2)

The growth of emerging markets is enticing many US companies to look for growth abroad. Yet the risks companies encounter in these markets can pose major hurdles to success. Members highlighted strategic, operational, compliance-related, and political risks as the most challenging for directors.

- **Emerging management practices** (page 4)

Strong management in foreign locations is crucial to successful international expansion. Members shared two major keys to success in foreign locations: building resilient leadership teams by pairing US leaders with local talent and establishing close relationships with governments and local companies.

- **Board and audit committee practices for overseeing international market risks** (page 5)

Boards and audit committees, challenged by distance and unfamiliar risks in international markets, are seeking more education on market-specific risks, spending more time with global leaders and working closely with internal audit – all in an effort to provide better oversight to increasingly global companies.

- **Opportunities to establish a more global perspective and enhance board oversight** (page 8)

Boards are also developing a more global mindset that supports more informed oversight of expanding businesses. Members' boards are achieving this by holding board meetings outside the US and considering the addition of directors with more international experience.

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 during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from comments made by members before, during and after the meeting. Other unitalicized, unattributed quotations are drawn from audit committee chairs of other networks.

² Harold Sirkin, James Hemerling, and Arindam Bhattacharya, *Globality: Competing with Everyone from Everywhere for Everything*, (New York: Hachette Book Group USA, 2008), 1.



Major opportunities and risks in international markets

A recent Ernst and Young report predicted “70% of world growth over the next few years will come from emerging markets, with China and India accounting for 40% of that growth.”³ Members said the rapid growth of these and other markets necessitates doing business there in order to compete globally. One member noted, “*I don’t think we will be able to deliver what shareholders are expecting without going overseas.*”

Still, the opportunities in these markets are coupled with significant risks. Members discussed four major risks their boards and audit committees are focused on as their companies begin or continue to expand internationally: strategic, operational, compliance-related, and political risks.

Strategic risks

Results of a recent study at the London School of Economics showed that the global economic center of gravity – the average location of the planet’s economic activity – has been shifting east for the past 30 years, and is projected to be somewhere between India and China by 2050.⁴ Reinforcing this prediction, *McKinsey Quarterly* reported that “China, India, Brazil, Mexico, Russia, Turkey, and Indonesia are expected to contribute about 45 percent of global GDP growth in the coming decade.”⁵ This growth represents new market share and significant growth opportunities, but exposes companies to certain strategic pitfalls, including:

- **Difficulty determining required rate of return.** Business endeavors in new markets, often with undetermined risks, are “*difficult to value.*” Members discussed how the distinctions between emerging markets (e.g., Turkey, North Africa) and so-called emerged markets (e.g., China, India) complicate the required rate of return, challenging companies to define it and accurately enumerate the risks. In fact, at Ernst & Young’s recent Global Growth Forum, David Rubenstein⁶ contended that China has developed to the point that it no longer demands a risk premium above other developed markets.
- **Local competition.** Members said that when emerging-market governments have an “*allegiance to their local companies and business people,*” foreign companies could be at a competitive disadvantage. “A 2010 survey by the American Chamber of Commerce in China found that 38% of US companies feel unwelcome in the Chinese market, up from 23% just two years earlier,” the *Harvard Business Review* reported.⁷
- **Misjudgment of market needs.** One member described his company’s experience in Brazil: “*We took a US product and tweaked it a little for a new distribution channel. We got lulled into a false sense of security that we were taking a US product into a new country. We were selling the product to people it wasn’t designed for. It ended up costing the company \$10 or \$20 million.*”

³ Ernst & Young, *Tracking Global Trends: How Six Key Developments Are Shaping the Business World* (Ernst & Young Global Limited, 2011), 4.

⁴ Danny Quah, “*The Global Economy’s Shifting Centre of Gravity.*” *Global Policy* 2, no. 1 (2011): 3.

⁵ Yuval Atsmon, Ari Kertesz, and Ireena Vittal, “*Is Your Emerging-Market Strategy Local Enough?*” *McKinsey Quarterly*, April 2011.

⁶ David Rubenstein is a Co-Founder and Managing Director of The Carlyle Group, one of the world’s largest private equity firms.

⁷ Ian Bremmer and Evan A. Feigenbaum, “*Watch Out for Rising U.S.-China Competition.*” *Harvard Business Review*, April 1, 2011.



- **Repatriation of cash.** According to a recent estimate, more than \$1 trillion in US foreign capital is “parked” overseas for tax reasons.⁸ One member noted, *“The tax consequences of repatriation of capital have to be considered when you are thinking about international operations because they can be huge.”*

Operational risks

One member said, *“Operational risks are a given when you go abroad.”* Members observed a trend toward extending supply chains or creating more steps in the chain, and suggested this is magnifying operational risks. Members said these risks were underscored by the recent nuclear disaster in Japan and the interruption in supply chains this caused for their companies and countless others around the globe. Members focused on a number of operational risks:

- **Intellectual property.** Preservation of intellectual property is a major concern for companies entering markets such as China. One member explained, *“There is almost no protection for intellectual property rights in these markets.”* Another said, *“We’re bringing new technology into the market, but we’ve accepted that we can’t protect it.”*
- **Talent sourcing and retention.** Demand for labor in high-growth markets is increasing, and some companies are struggling to find and keep talent, particularly in the middle levels of the organization. One member explained, *“In the last five years the talent risk has become huge. We are losing a lot of people because they can leave our company and get paid double by another company just down the road ... [A major local market competitor] recently opened a plant not too far from ours where they are employing 200,000 people – that affects wage rates.”* In some cases, wage increases are causing companies to bring *“manufacturing back to the US because productivity in Asia has not kept up with the increasing wages.”*
- **Business interruption.** Countries lacking infrastructure to handle severe natural disasters can expose companies to significant business interruptions. One member said, *“[Natural disasters] can happen anywhere, but the concern we have in these countries is their ability to spring back after a natural disaster.”*

Compliance-related risk

Discussing potential compliance risks, one member said, *“There are less rules and regulations in [emerging] markets, and you have to expect you’re going to run into more compliance issues or an absence of regulation in these markets.”* Members described two major compliance-related risks:

- **Foreign Corrupt Practices Act (FCPA).** Several members noted that the FCPA *“has really increased the compliance risks in the past 10 years.”* Indeed, FCPA enforcement has increased. In 2010, the US Department of Justice and the Securities and Exchange Commission had a combined total of 74 FCPA enforcement actions, compared with 40 in 2009 and five in 2004.⁹ Additionally, eight of the top 10

⁸ The Intelligent Investor, *“Why Investors Can’t Get More Cash Out of US Companies,”* *The Wall Street Journal*, February 19, 2011.

⁹ Gibson Dunn, *2010 Year-End FCPA Update*, January 3, 2011.



monetary settlements in FCPA history were made in 2010.¹⁰ Members discussed the unique challenge of conducting business in markets where there are “gangs or families that you have to deal with in order to operate,” which can lead to significant FCPA risks. Additionally, members noted that the UK Bribery Act, which became effective July 1, 2011, will further increase the compliance risks for companies that have a presence in the United Kingdom.

- **Ethical differences.** One member commented, “Ethical [standards] are very different in some of these countries and a lot of time the board may not really understand [these differences] fully.” One member observed, “When there is management from that region in place, you can run into cultural issues about acceptable [business practices]. You can have people making really bad judgments. They may not look bad in their local country, but on a global company scale, they are bad and you have to exit them.”

Political risk

Many members pointed to recent events in Libya and Northern Africa as evidence of the political risks in emerging markets. One member said, “Turmoil in the Middle East is something the board has to think about - whether you have operations there or even near the area.” A recent report from the Eurasia Group described the post-financial crisis emergence of a new geopolitical world order “shaped not by a military balance but by an economic one,” and predicted significant changes: “We’ll see a shift in the highest levels of global conflict to the region where globalization and geopolitics collide with greatest force: for the past 20 years, the sharpest geopolitical tensions were to be found in the Middle East; we’ll now see a decisive and long-term shift of those tensions to Asia.”¹¹ For example, “Escalation of military tensions on the Korean Peninsula is one of the key geopolitical risks for Asia-Pacific in 2011.”¹²

Emerging management practices

Acknowledging that success in foreign markets is often dependent on effective management, members shared several management practices aimed at fostering that success.

Creating resilient management teams in foreign locations

Members agreed that finding the right people to lead foreign operations is crucial. One member said, “It is important to spend time creating the right management team because it is so important to success [in foreign markets].” Specific tactics include the following:

- **Designing management teams that blend local and US leadership.** One member said, “It’s important to have a nice blend of leadership – you need foreign nationals and US leaders. You cannot abdicate leadership to nationals. [US leadership] is not there to say ‘this is how we do it,’ but rather to listen to what is going on and keep the train on track. There is a tendency to hire nationals because we think they know how to do business in those markets better than us, but it’s still your brand and your risk and too often it’s handed over.”

¹⁰ Ibid.

¹¹ Eurasia Group, *Top Risks 2011*, January 4, 2011.

¹² International Business Times, “[Top political and economic risks for Asia next year](#),” December 16, 2010.



Recruiting local talent for senior leadership positions can be integral to a company's acceptance and success in local markets. One member said, *"We just recently brought in a senior manager that knows the language and has a lot of connections [in this market]."*

- **Encouraging global mobility.** As companies become more global, management teams need to be equally global. One member said, *"You have to move [senior leaders] around a lot. We make sure that top management spends time in China because we have a lot business there and, likewise, when we hire someone from China, we want them to come to the US to get a feel for how the company operates and the values we have."* Another added, *"You need to think about developing successors from all over the world. To do that you need to build leadership consistently so that a global leader could emerge."*
- **Establishing global ethical standards and compliance-training programs.** One member said, *"With foreign locations you have to establish boundaries for the leaders to align them ethically with the company, but you also have to give them enough room to do the work that will make your company successful in those markets."* While members acknowledge the inherent difficulties in doing so, they discussed the importance of implementing robust compliance-training programs that ensure there is consistent understanding of ethical and cultural expectations.

Building key relationships in foreign markets

Members said management is spending more time forging relationships in two key ways:

- **Building relationships with foreign governments.** Governmental relations are particularly important in countries where government holds significant power over private businesses. One member said, *"You have to understand governmental bodies. It's really important you build relationships there because if you don't understand the dynamics of how to work with the government, you won't have a chance in their countries."*
- **Developing partnerships to achieve specific objectives.** One member said many companies *"will take on a partnership with a local company so that in the short term there is a mutual dependency: we need their local-market expertise and they are learning how to do what we do."* The member went on to explain, *"Companies are putting [part of their competitive advantage] on the table, knowing that you're only buying time until you are no longer needed."*

Board and audit committee practices for overseeing international market risks

Distinctions between full board and audit committee responsibilities in overseeing international market risks can sometimes be unclear. One member advised, *"When in doubt, the audit committee should just take it ... until you can figure out who should own it."* Regardless of where oversight resides, members stressed the importance of *"explicitly assigning each responsibility to the full board or committee."* Members broadly agreed that *"the full board has responsibility for being aware of all of the risks from a strategy standpoint, and the audit committee has responsibility for ensuring there is a process to oversee the risks."*



Full-board oversight practices

Members described the following key areas for full-board oversight:

- **Ensuring strategic plans and risks are viewed concurrently.** Members expressed concern that strategic plans and the associated risks are often decoupled when presented to the board, and that management sometimes focuses too much on the “*vision*” of global expansion without adequately addressing the practicalities of execution or the potential risks. Members stressed that boards play an important role in ensuring management is “*focused on both vision and risks concurrently.*”
- **Seeking education on emerging risks and trends.** Companies with global footprints can have difficulty keeping up with risks that emerge in far-flung markets. Members suggested that boards stay current on emerging risks by enlisting the help of local market advisors, such as lawyers or external auditors, when new issues or risks surface. One member shared an example of how a recent event that affected a competitor in China triggered the board to ask for more information. In the end, the source of the risk was a cultural issue that the board would not have understood without seeking education.
- **Engaging with senior management in foreign operations.** Several members found that “*engaging with the people that have day-to-day oversight of [foreign] business locations can help the board understand what they are struggling with.*” One member suggested directors “*should talk to [international division leaders] in an executive session. Let them know you want to know what is going on, and [tell them] that they have your ear and you have their back.*”

Audit committee oversight practices

Members said the following roles were specific to audit committees:

- **Overseeing internal audit’s involvement in international activities.** When the network met in January 2011 to discuss the evolving role of internal audit, members suggested that more internal audit resources should be allocated to international operations, given the predominance of international market risk relative to risks in the United States.¹³ However, members explained, “*It is often difficult to keep local people in these positions since most go into [internal audit] for a short time before they move into an industry position.*”

Given the difficulty of finding and retaining strong foreign internal auditors, members agreed co-sourcing models are often effective. One member said, “*Co-sourcing internal audit in foreign markets works really well because you can bring in people that already know country, culture, and landscape really well, but it’s important to pair them with your own folks that need to learn the culture and country nuances.*” Still, another member warned that “*it is often hard for [internal]auditors to confront management in a market like China,*” and the audit committee needs to be aware of the limitations of co-sourcing in each market.

Rather than focus simply on reactive audit procedures, one member’s company established a “*risk and controls group*” – a spin-off of internal audit that proactively supports international expansion. The

¹³ Midwest Audit Committee Network, “[The Evolving Role of Internal Audit.](#)” *VantagePoint*, February 21, 2011.



member explained, “[The group] was designed to figure out what policies and procedures needed to be in place before going into a country and then be on the ground with management when they entered the country. This group would also go back regularly to make sure policies and procedures were being followed.”

- **Overseeing IT risks.** IT risks can become more pronounced as companies expand globally and expose themselves to more threats, yet many members said they are concerned they don’t have enough IT expertise to adequately oversee the risks. To combat this disadvantage, one member brought in an ethical hacker – an IT firm hired to hack into company systems to uncover weaknesses. The member said, “I wanted to verify what we were hearing [internally] about [the strength of] our IT systems.” To keep up with the changing IT environment, some companies “build ethical hacks into the internal audit plan” and stipulate that they should be performed “five or six times a year.”

The audit committee can promote better crisis-management programs abroad

One member said, “Successfully navigating [international] markets is not about identifying all the risks; it’s about adapting when something comes up. A company’s agility will matter more than anything else.”

Concerned that “management teams may not be ready to react in the crucial 24- to 48-hour period after something happens,” members discussed some of the ways the audit committee can ensure management is prepared to respond to crises outside the home market:

- **Ask detailed questions about scenario plans.** “Have management walk the audit committee or board through each of the scenarios. Ask management, ‘What are the five worst scenarios? What is the response for each of them? Who is responsible for each action? Where will we shift capacity? How will we protect our reputation?’” Another added, “You want to hear how they are going to implement actions with limited connectivity – you can’t rely on phones during these events.”
- **Insist on ‘fire drills.’** “You have to press management on how often they are practicing fire drills in these locations. If you don’t have these surprise practices, you are not going to be ready.”
- **Question the sound bites.** “There is a greater possibility of mishandling communication when you don’t know the nuances of how it might be received [in other markets]. Ask, ‘What are the sound bites for each scenario? Who is responsible for outside communication in each scenario?’”
- **Talk with the managers responsible for action in the event of a crisis.** “The audit committee should be talking to the people in the plant that these scenarios are designed for – not the business-continuity team. Do the people at the plant know what they are supposed to do, and can they answer your questions about the scenarios?”



Opportunities to establish a more global perspective and enhance board oversight

Standard & Poor's recently estimated that foreign revenue accounts for an average of 46.6%, or approximately \$8 trillion, of total revenue of companies in the S&P 500 index.¹⁴ Yet many boards lack foreign-national oversight: by one estimate, 55% of S&P 500 boards have no foreign directors.¹⁵ Moreover, "45% of the 359 non-American board members at S&P 500 companies are British or Canadian; another 24% are continental European. Barely 2% are Chinese or Japanese."¹⁶

Nearly every member said their boards are seeking a more global perspective in order to better understand the countries in which they are operating. Approaches include the following:

- **Adding foreign directors to the board.** Foreign directors broaden the board's perspective and enhance knowledge of international markets, but only if they are *"the right international people that have good connections and experience."* In fact, members said, *"the extent [of a director's] international experience is more important than [their] nationality."* One member explained, *"Having a [foreign national] on the board is enormously helpful. This director has local-market insight, is helpful politically with some of the local officials, and was responsible for bringing in our COO."* Some members suggested setting a goal, such as aiming *"to have X international directors on the board in five years."*

Still, logistical challenges like language, time differences, and extended travel can complicate foreign directors' participation in board meetings, and members said that video conferencing cannot wholly solve these logistical challenges because companies still need *"in-person meetings to create the collegiality you need on a board."*

- **Convening board meetings in foreign locations.** Several members said their boards meet outside the United States once a year, but are concerned that those meetings are typically held in Europe, rather than Asia. Still, members find international meetings beneficial: *"It is really helpful to see the operations, and we have a chance to meet the people at a lower level that we might not otherwise see at the board."*
- **Encouraging directors to serve on international boards.** One member said, *"The experience of serving on an international board is invaluable."* However, such experience does not come without challenges: *"The distance you have to travel is a real logistical issue and there can be some insularity to international boards."* Strikingly, many of the reasons that members said they didn't serve on foreign boards – language barriers, travel, time differences – are the same obstacles that many would like foreign directors to overcome in order to join US boards.

Conclusion

"Today, multinational really means 'multidimensional' – with a simultaneous focus on far-ranging markets and customers, a diverse work force, efficient and adaptable supply chains, and relationships with governments and communities at all levels."¹⁷ As corporations become more global and dynamic, they

¹⁴ Larry D. Spears, "Global Investing: Five Foreign Revenue Stocks That Will Boost Your Profits," *Money Morning*, February 14, 2011.

¹⁵ Craig Mellow, "It's Time to Recruit More Foreign Nationals as Directors," *Corporate Board Member*, August 5, 2010.

¹⁶ Ibid.

¹⁷ Sam Fouad, "The Walls Just Keep Tumbling Down," in *Emerging Economies, Tomorrow's Markets* (Ernst & Young Global Limited, 2011).



demand equally global and dynamic leadership, at the executive level and the board level. US boards are enhancing their global perspective by inviting foreign nationals to join the board and holding meetings outside of the US, but is that enough? With the increasing power of markets that are still quite “foreign” to many directors, boards may need to challenge their current composition, outside board service, and some of their traditional practices in order to become a truly international board, capable of overseeing companies that are competing in a global marketplace.

About this document

The Midwest Audit Committee Network is a 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.

The views expressed in this document represent those of the Midwest Audit Committee Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the US member firm of Ernst & Young LLP.

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Appendix 1: Participants at the network meeting

The following network members participated in the meeting:

- Dave Burritt, Audit Committee Chair, Lockheed Martin
- Howard Carver, Audit Committee Chair, Assurant
- Olivia Kirtley, Audit Committee Chair, U.S. Bancorp
- Laurette Koellner, Audit Committee Chair, Sara Lee
- David Landsittel, Audit Committee Chair, Molex
- Tom O’Neill, Audit Committee Chair, Archer Daniels Midland
- Donna Zarcone, Audit Committee Chair, CIGNA

The following members were unable to attend, but took part in discussions before and/or after the meeting:

- Blake Devitt, Audit Committee Chair, Baxter
- Cheryl Francis, Audit Committee Chair, Morningstar
- Sandy Helton, Audit Committee Chair, Covance
- Mike Monahan, Audit Committee Chair, CMS Energy
- George Off, Audit Committee Chair, Telephone and Data Systems
- Rich Roedel, Audit Committee Chair, Brightpoint
- David Schwartz, Audit Committee Chair, Walgreens
- John Shuey, Audit Committee Chair, Cooper Tire & Rubber Company
- Al Smith, Audit Committee Chair, Simon Property Group

The following Ernst & Young partners participated in the meeting:

- Jim Logothetis, Global Client Service Partner
- Kevin Cole, Managing Partner of Accounts and Business Development



Appendix 2: Questions audit committees might consider as they seek to enhance their oversight processes

- ?** How important are international-market opportunities to your company, and what impact will pursuing them have on the company's risk profile?
- ?** How are global risks affecting the board's governance role and the audit committee's role?
- ?** Where have the vulnerabilities or blind spots historically been as companies expanded internationally?
- ?** Has your company's management team adopted new practices in response to increased international risks or as it enters a new market?
- ?** How does your company structure its management teams in foreign operations?
- ?** Have recent events in Japan or the Middle East caused management to update crisis-management plans?
- ?** How have board oversight practices changed in light of globalization trends?
- ?** How does your board and audit committee gain insight into challenges and opportunities present in current or prospective foreign markets?
- ?** What practices has your audit committee adopted to ensure it is connected to foreign operations and the management teams there?
- ?** How does your board ensure a sufficiently global perspective?
- ?** Have there been changes in the process or people to support global oversight?
- ?** What benefits have been derived from international board members and what challenges does this present?