

West Audit Committee Network - North Chapter

February 2019

WACN
North

SUMMARY of THEMES

Audit committee effectiveness, trends in corporate governance, and an uncertain geopolitical environment

Audit chairs strive to adopt effective practices for running their committees and are interested in staying abreast of trends in shareholder activism and corporate litigation. At the same time, the geopolitical environment is creating new risks for audit committees to consider. Members of the North Chapter of the West Audit Committee Network (WACN) discussed these topics on February 20 in Palo Alto.

Members share effective audit committee practices

In a discussion about running effective audit committees, members exchanged ideas in four areas: committee membership, meeting preparation, executive sessions, and reports to the full board. Highlights included:

- **Composing a committee with the right expertise.** WACN members desire diversity of thought and experience on their audit committees, but do not want to sacrifice financial expertise. One said, *“It is imperative to have at least two members of the audit committee that have been a CFO or an audit partner, so that there is the ability to have engaging discussions.”* Another added, *“I think you should aspire to have all members of the audit committee be financial experts.”* Others advocated for having directors with operational expertise, especially experience as a CEO. Members also considered the tradeoffs of having a sitting executive—with current perspectives but a demanding schedule—serve on an audit committee. One suggested, *“A crisis will arise at their day job at some point during a board meeting and they will have to get up and that’s okay. It’s worth having them at the table.”*
- **Preparing for effective meetings.** Many members use a point person within management to help with the committee’s agenda and strategy. One said that the best fit for the role depends on the person and his or her stature: *“It’s situational. I’ve worked with the chief accounting officer, the CFO, and the head of internal audit. The only requirement is that you work with someone who is in the flow of things, so they can ensure that not only the charter responsibilities are being covered, but also that the new and developing issues get added.”* Members also discussed the nature of their preparations with management. One discussed in-depth, pre-meeting calls between the audit chair and several managers: *“It gives me a sense of what’s important to them and what they are worried about and it helps organize*

the content process.” Another cautioned against addressing too much of the committee’s business in advance: *“A lot of decision making can happen outside of the meeting. It gives a pass to other committee members. The chair shouldn’t always take the ball and run with it—the committee needs to engage on these issues.”*

- **Leveraging executive sessions.** Most members’ in-person audit committee meetings wind down with a cascading set of executive sessions—typically with the CFO, chief audit executive, and external audit team—and conclude with a private session for just committee members. One member discussed adding executive sessions with additional executives: *“I’ve started a rotation of some executives—for example, the head of sales, the head of product development. It’s good for them to have exposure to the audit committee. We ask them about channel issues and product security, and emphasize what their work means to the audit committee. It’s a little fear and a little education.”* Some members cautioned that executive sessions should not distort the regular workings of the committee. One said, *“I think hearing the full discussion is an important part of educating people on the finance team—they should sit in on the committee meeting and hear the questions and answers. I reserve private sessions strictly for events that are sensitive in nature, like an investigation.”*
- **Reporting to the full board.** Audit chairs explored their approaches to synthesizing committee discussions and delivering an engaging summary of key themes to the full board. One member said, *“The only thing the board needs to know is that nothing is wrong. If I have something to flag, I keep it to 10 minutes max.”* Another added, *“I try to say, here is an area we are concerned about, we did a deep dive, and then I throw out some numbers that I know will draw interest.”*

Trends in corporate governance

Over dinner, members discussed investor issues, litigation trends, and board composition with David Berger and Katherine Henderson of Wilson Sonsini Goodrich & Rosati. Highlights from the lively conversation included:

- **Dealing with investors.** Activist investors continue to put pressure on companies in a range of different ways. *“Over the last 10 years the way people invest has changed dramatically; the top 10 institutional investors own about 80% of the companies in the S&P 500,”* said Mr. Berger. He continued, *“The practical effect of this concentrated ownership base is that it allows an activist investor to obtain majority support for an idea or a change in management or the board simply by obtaining the support of just a handful of large institutional investors. Similarly, if an activist can convince these investors that a company should be sold or taken private then a board is limited in its ability to respond because the ownership of most large companies is so concentrated.”* Members discussed the challenges of having an activist investor join a company’s board. A silver lining, Mr. Berger noted, is *“direct access to the shareholder and the party in charge.”*

- **Liability exposure and board minutes.** Members raised concerns about potential liability in cases where they must sign off on disclosures about the company’s non-financial accomplishments, such as becoming carbon neutral. Ms. Henderson said, *“The courts really want to see that you are actively monitoring and addressing issues that are raised, getting answers to questions and pushing management to get you those answers. You are entitled to rely upon management but make sure you get to a place where you are satisfied with explanations provided by management, including as to non-financial goals.”* One way to track this is with meticulous board minutes. There was some debate on the level of detail desired. One member said, *“We don’t want our minutes to look like a diary. We record the key themes and 3-4 sentences on each.”* Ms. Henderson challenged, *“If you get sued years later, you will want to have an accurate record of the discussions, and you will want the minutes to be reasonably granular. In particular, if you are pushing for more detail or challenging management during a board meeting, it will be helpful for the minutes to document that process to show that you did your job as a director. Remember that years later the minutes will be the only contemporaneous evidence of what you did as a director to comply with your fiduciary duties.”*
- **Striving for board diversity.** Members were especially interested in the California mandate that public companies add female directors.¹ Mr. Berger stated, *“I personally think the law is valid although my view is a minority view among most practitioners and many legal scholars. Many will argue the law is unconstitutional.”* Members and guests agreed that most companies would not be willing to challenge the mandate; an act that could make for bad and viral publicity. One member said, *“The notion that we would have to nominate unqualified people to hit these mandates is outrageous. Companies should just do the right thing and hire from the large pool of highly qualified women to be corporate directors.”* Another member noted that this mandate is changing the way one company is thinking about succession planning: *“We are looking to fill a seat now and have a great candidate in place but he’s male, so we are thinking we can’t do it because we need more women to hit the quota.”*

Opportunities and risks presented by the geopolitical environment

Longview Global Advisors’ DJ Peterson and EY’s Jon Shames joined members for a discussion about geopolitics. Dr. Peterson said the macro trends in the geopolitical environment are all about *“trade, trade, and more trade.”* Mr. Shames contended it is actually, *“China, China, China.”* Members discussed the implications of these two issues:

- **Structural differences between the United States and China.** Whether or not the United States and China strike a major trade deal, Dr. Peterson sees the overall relationship evolving into a strategic and ideological competition similar to that of the United States and Soviet Union during the Cold War. Dr. Peterson explained, *“The Chinese see the last century as an aberration. They are looking to reclaim their rightful place in world.”* Within

the US foreign policy community, China's aspirations are increasingly viewed as being less benign, a trend that is unlikely to change soon. Dr. Peterson emphasized, *"There are a whole range of forces in play. The upcoming US presidential election won't change this. If anything, the candidates will compete to show who can be tougher on China."* Uncertainty over tariffs is causing many members' companies to question their footprint in China. One said, *"We are trying to figure out if and where to shift our manufacturing operations in Southeast Asia. What new risk do you deal with when you move away from a known risk? That is what we are wrestling with now."* Another member voiced concerns about joint ventures: *"Are joint ventures the way to go in China? I haven't seen many successful Western companies without one but the fear of IP transfer is heightened."*

- **Inequity in society.** Dr. Peterson said that growing inequality and insecurity are causing people to fear the future and question the benefits of the status quo: *"In the next 18 months this will be a big issue shaping the way forward for the US. Pay attention to a range of issues—job disruption, privacy, antitrust, inclusion, profit-shifting, and taxation. A theme of fairness is emerging and equity will be especially important to business leaders."* Mr. Shames added, *"The rise of nationalism and populism leaves confusion about what the right answer is and how to treat people. There is a dichotomy of rich and poor and we are seeing companies caught in the middle."* Dr. Peterson added that social media is an important catalyst as it puts information—true or not—upfront, and bypasses traditional media to redirect and accelerate the debate.
- **A new role for the corporation.** Political dysfunction creates a leadership void that offers an opportunity for businesses to address issues of importance to their stakeholders, but filling that void carries risk. Mr. Shames suggested, *"Complexity and uncertainty are here to stay. Companies are doing all these great things, getting no credit, and instead being criticized for things they never considered. I think companies need a new model. They need to change the paradigm around and be more proactive on leading change."*

Mr. Shames advised members that in this complex environment, companies should be more strategic about managing political risk. He emphasized that the focus should be on resilience: *"Globalization is here to stay and it's a topic that needs to be higher on boardroom agendas. Make sure you are having discussions about how geopolitics will impact the future of your companies."*

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Meeting participants

- Skip Battle, Expedia
- Judy Bruner, Seagate Technology and Varian Medical Systems
- Henry DeNero, Western Digital
- Jeff Epstein, Twilio
- Earl Fry, Hawaiian Holdings
- Mark Garrett, Cisco and Pure Storage
- Steve Gomo, Micron Technology
- Jeri Hilleman, NovoCure
- Bala Iyer, Power Integrations and SkyWorks Solutions
- Sue James, Coherent
- Ed Lamb, Real Industry (*South member*)
- Lou Lavigne, DocuSign and Zynga
- Cathy Lego, Cypress Semiconductor
- Mary Pat McCarthy, Palo Alto Networks
- Steve Orlando, Molina Healthcare (*South member*)
- Malia Wasson, Columbia Sportswear

EY was represented by:

- Lee Dutra, San Francisco Office Managing Partner and West Region Center for Board Matters Leader
- Kay Matthews, Vice Chair and West Region Managing Partner
- Todd Moody, West Region Markets and Accounts Managing Partner

Endnotes

¹ J. R. Lanis, ["An Overview of California's New Law Mandating Women on Corporate Boards,"](#) *The Recorder*, November 12, 2018.