SOUTHEAST
AUDIT COMMITTEE NETWORK

Summary of Themes

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Effective communication aids in crisis planning and managing investor expectations of capital allocation

On September 19, members of the Southeast Audit Committee Network (SEACN) met in Atlanta to discuss the board's role in preparing for and responding to crises and in overseeing capital allocation strategy. Christopher Grippa, partner, and Mark Kuehnert, executive director, both of EY's Fraud Investigations and Dispute Services practice, joined members to discuss recovery plans for natural disaster situations. In a members-only session, directors also discussed capital allocation strategies. Over dinner, Phil Denning, partner and co-head of ICR, Inc.'s special situations group, shared best practices for managing corporate communications during disruptive events. For a full list of meeting participants, please see page 5.[1]

Crises come in multiple forms and require planned communication to minimize disruption

Guest experts and members discussed considerations and recommendations for responding to the challenging scenarios that boards can face, including natural disaster response and recovery, activist investors, operational disruption, and reputational damage. Both the guests and SEACN members emphasized the importance of adequate planning before a crisis hits in order to effectively manage and communicate during and after the event.

While companies cannot predict the future, planning helps management and the board respond more effectively in the moment

Members stressed the primary importance of connecting with personnel and customers to ensure their safety, followed by concerns about damage to reputation, physical property, data security, and insurance recovery. Mr. Grippa commented, *"The first 48 hours are critical when there is a major disaster, and the treatment of these types of events depends on the scenario. Most items raised to the board are not run-of-the-mill."* How companies execute in a crisis depends on the event. *"Every disaster is different, and you can't plan for every specific disaster. You have to have backup plans that cover the aggregate,"* said one member.

One member said, *"Your crisis plan will never be enough, because a crisis will always come in ways you couldn't plan for; however, the fact that you planned provides helpful elements for dealing with the unexpected when it does occur."* Another member agreed: *"It is important to plan, to test, and for the board to feel comfortable with the company's crisis strategy long before a disaster occurs."* Guest experts noted the need for a designated crisis-response team comprised of the CEO and other leaders from across the business, including operations and public relations. Mr. Kuehnert said, *"Who is involved matters. You need*

[1] The Southeast Audit Committee Network is 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 organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance. This document 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 are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

a broader group to manage the company's response, not just a risk manager, to ensure that disruption is minimized and that the business keeps going."

As part of advance planning, guests advised that directors ensure that company insurance policies cover high areas of risk, including possible damage to physical property or the potential for business interruption. One member encouraged this approach, saying, "*Know where the holes in your policy are and make sure you are shoring up operations and contracts around those gaps, or negotiating in the contract for proper coverag*e." Several members cited the audit committee's role in reviewing and approving insurance coverage and noted that their audit committees reviewed insurance plans annually within the context of overall enterprise risk management.

Members offered tactical strategies for testing company readiness, including through table-top exercises involving management and the board and sometimes the wider company. For example, one member's company tested the ability and speed of contacting 12,000 employees: *"Through this exercise, we saw how elements of the plan broke down and thus learned how to fix the process; it was surprisingly difficult to execute."*

Planning is not enough – how management teams and boards respond and communicate in a crisis can have lasting ramifications

Mr. Denning spoke about the board's role in overseeing a crisis situation and the potential consequences of a communications misstep, including a loss of investor confidence, damage to brand reputation, impact on financial results and/or a hit to a company's market valuation. Developing an audience map was suggested so that the right message can be communicated quickly and effectively to the right target audience (e.g., investors, customers, employees, regulators). *"It is critical for a company to own the facts, show empathy toward those impacted by the crisis, hold responsible parties within the company accountable, and explain the remediation process clearly to the public," said Mr. Denning.* He referenced steps to eliminating "FEAR" as an overarching process used by ICR: *"F – facts, get them on the table; E – empathy, determine who will be the face of the company; A – accountability, identify actions to be taken and by whom; and R – remediation, address any issues and get back to the business at hand."* According to Mr. Denning, *"The best time to address crisis communications is at peace time."*

For many companies, dealing with an activist investor falls into the crisis category, although the board's response to an activist may be very different from its response to other crisis situations. One member asked Mr. Denning, *"What are best practices for engaging with activists? As directors, we're advised on different approaches."* Mr. Denning advised boards to engage, not ignore, pressure from an activist investor: *"Ignoring activists does not make them go away. It only gives them a talking point that can be used against you in the future. Engagement, however, looks different for each company. Ensure that you have the right people at the table to have a dialogue, and having multiple people in the room helps to interpret themes in the conversation from different perspectives."* Boards also need to test their crisis-readiness plans, their appetite for direct media engagement, and their ability to act promptly even though they may not have complete information.

Board oversight of capital allocation starts with strategy and includes stakeholder communication

SEACN members discussed the factors involved in determining how their companies allocate capital, including defining excess capital, organic and inorganic growth opportunities, and industry trends. The need for clear understanding of the composition and preferences of the investor base was deemed critical to decisions and communications, including how and when to return capital to shareholders.

Optimizing the company's balance sheet and leverage is part and parcel of the capital allocation conversation, although member opinions varied on what "optimal" may mean. Some members felt, for example, that on principle, companies should not borrow for share buybacks. Other members shared their view that companies with low levels of debt may serve their shareholders well by leveraging to buy shares that management believes are undervalued. Noting the complexities of these types of decisions, many of the members said that their boards look to advisers, such as investment banks or consultants, for input.

Boards want capital returned to shareholders in alignment with company strategy to ultimately attract the right investors

When it comes to returning capital to shareholders, timing, format (dividends or buybacks), and investor preferences, not just amount, require careful decisions because of the impact they have on current and future shareholders. As one member said, "*A company needs to make sure that the capital allocation strategy prepares the company for the right investors.*" Another member agreed, *"The short answer is that investors want a return on their investment; however, for the company, allocating capital is related to the company's strategy. It's different for each company. Asking, 'What is our strategy?' is an important component of determining how to return capital."*

One member shared an example: *"Part of your strategy is who your investors are and how that can change over time. For example, one company had hedge fund investors, but we wanted larger institutional investors, which are often linked to companies with dividends."* A few members pointed out the importance of targeting the right investor base for the company's strategy and how the policies of desired investors should be taken into account as well, particularly those who may require regular dividends from companies.

A consideration of stock buybacks is timing, which can be fraught with difficulties. To overcome the challenges of ad hoc purchasing, one member advised developing an automatic repurchasing program: *"Develop a grid, defining your value and the thresholds for buying shares or freezing repurchases. This program takes the stress out of determining when to buy."* Other members found this model useful in considering how to set a predetermined program for buybacks that would withstand scrutiny.

Effective communication is necessary to gain investor confidence

Through effective communication, companies can ensure that investors understand and support the medium- to long-term strategy determined by management and the board. One member said, *"As board members, we want the kind of investors that stick with us for the long term, and we have to communicate in a way that gives investors confidence in our strategy."* Directors agreed that as the capital return strategy evolves, companies must clearly articulate changes to their investors. One member noted, *"Over time,* *investors form a thesis on how your company returns capital. Questions arise when you want to change that thesis* [i.e., cutting back dividends]*. If you're going to make a step, shifting your return strategy, then you have to be clear and be bold in announcing that with investors."*

About this document

The Southeast Audit Committee Network is a select group of audit committee chairs from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

Summary of Themes 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 *Summary of Themes* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *Summary of Themes* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

Meeting participants

The following Southeast Audit Committee Network members attended all or part of the meeting:

- Maureen Breakiron-Evans, Cognizant
- Dallas Clement, SunTrust
- Curt Espeland, Lincoln Electric Holdings Inc. *
- Juan Figuereo, PVH Corp.
- Doug Johnson, Aflac
- Scott Kuechle, Esterline and Kaman Corporation
- Rick Mills, Commercial Metals Company
- Steve Raymund, Jabil Circuit
- David Walker, Chico's FAS, CommVault Systems, and CoreLogic
- Rick Williams, Crawford

*Participated on pre-meeting call only

EY was represented by the following:

- Sam Johnson, Vice Chair and Southeast Region Managing Partner
- Jim Estes, Southeast Region Managing Partner – Assurance
- Bryan Yokley, Georgia/Alabama/Tennessee Market Segment Leader, Assurance Partner