West Audit Committee Network - South Chapter

January 2019

WACN South

SUMMARY of THEMES

Audit committee effectiveness and evaluation; an uncertain geopolitical environment

Audit chairs strive to adopt effective practices for running their committees and are interested in discovering new tools for evaluating board members. At the same time, the geopolitical environment is creating a number of new risks for audit committees to consider. Members of the South Chapter of the West Audit Committee Network (WACN) discussed these topics on January 16 in Santa Monica.

Members share effective audit committee practices

Members exchanged views on effective audit committee practices. Four areas dominated the conversation: committee membership, meeting logistics, materials and presentations, and executive sessions.

- **Composing a committee with the right expertise.** As one member suggested, *"Audit committee effectiveness starts with the membership."* Members desire diversity of thought and experience on their committees. One said, *"Of course we need financial expertise on the audit committee, but it is important not to fill too many spots that way. Different lenses help drive dialogue."* Members also advocated mapping members' skills to business risks: *"It's important to ask yourself 'what are the biggest risks to be concerned about in this industry and do I have someone with that expertise on the audit committee?'"* However, it can be challenging to onboard new committee members, especially when they lack financial expertise. To ease this transition, members suggested an enhanced training program that includes a detailed review of historic issues, off-cycle meetings with the finance team and external auditor, and debriefs between the chair and the new committee member following meetings.
- **Running effective meetings.** Some members' audit committees meet five times per year while others meet three times per quarter, depending on whether board meetings, which are almost always preceded by audit committee meetings, are scheduled at a time when the committee can review earnings releases and SEC filings. While many audit committees discuss these documents by telephone, some members expressed a preference for meeting in person. One said, *"I despise telephonic meetings. I think it elevates risk tremendously. We avoid them, especially for filings."* Others said that telephonic meetings, especially those that take advantage of video technology, can be a good alternative to in-

person meetings so long as the chair focuses on keeping all of the committee members engaged. Members also noted the differences in how boards structure their meetings. *"I like boards that have committee meetings consecutively, so you can listen in on other committees,"* said one member. Another member shared a different process: *"Scheduling consecutive meetings became a headache on one of my boards so we tried a different approach and saw success. We made sure all committee materials were available for the full board to review in advance and allocated just 15 minutes per committee chair for report outs."*

- **Working with management to improve materials and presentations.** Members shared approaches to streamlining the materials that management provides to the audit committee. One member said, *"The amount of material grows and grows. The chair needs to grab the bull by the horns and tell management to cut the less pertinent information or move it to the appendix."* These challenges also spill over into audit committee meetings, where some managers need to be coached against offering scripted presentations. One member said, *"First time presenters are especially tricky to coach because you don't want them to feel uncomfortable expressing their concerns, but you also need their communication style to be effective for you."* Another noted, *"I have a process of setting pre-meeting calls with each presenter a week out. Once the materials are finalized, I screen them and have a call with all of the presenters to work through my comments before sending the deck to the full committee."*
- **Leveraging executive sessions.** Most members end each in-person audit committee meeting with a cascading set of executive sessions—typically with the CFO, chief audit executive, external audit team, and sometimes other executives—and conclude with a private session for just committee members. *"You have to have executive sessions at every meeting or you make management nervous when you do have one,"* said one member. Some members cautioned that executive sessions should not distort the regular workings of the committee. One said, *"On one of my boards, executive sessions were taking up half of our allotted time together. Management was holding back in the meeting because they wanted air time in the executive session. So we changed the format and told management we assume you can cover your agenda in the room. We still have executive sessions for sensitive issues but find now that management usually has nothing further to cover."*

Board composition and evaluations are changing, gradually

Over dinner, members discussed board composition and evaluation with George Anderson of Spencer Stuart. Mr. Anderson drew on the results of the 2018 Spencer Stuart Board Index to guide his conversation with directors.[1]

- **Board composition.** Mr. Anderson began by noting, *"In 2018, 428 directors joined boards in the S&P 500, a number that we have not seen since before the financial crisis. Although back to pre-crisis levels, the composition of boards is different. Being a CEO or having* *public company board experience is no longer required as only 35% of the 428 directors were CEO or equivalent; 33% were first-time directors. We are seeing many younger, tech-savvy, sitting operating executives join boards."* Boards are also gradually becoming more diverse. Mr. Anderson said that 51% of first-time directors were people of color or women.

Members were especially interested in the California mandate that public companies add female directors.[2] *"For large-cap and prominent mid-cap companies there won't be much impact because they have already been thinking about gender diversity for years,"* Mr. Anderson said. A few members noted that the law has changed the way their boards think about succession planning. One said, *"This law is shifting the pipeline discussion and causing diversity to rise further to the top of the skills list than it otherwise might have."* Mr. Anderson stressed the importance of proactive board succession planning; this helps a board avoid a situation where it looks for all desirable attributes in each new director. *"If you plan ahead, you can hit those targets over time,"* he said. He added that many boards have recently targeted young, innovative executives and encouraged members to be patient and prepared for some *"bumps in the road"* integrating disruptive directors.

- **Director evaluations.** Members generally support a process to periodically collect feedback on each individual director. One member said, *"Boards assume evaluation feedback will be negative but if it's done well, it can be a very positive experience,"* said one member. Another added, *"If my peers think I am not doing my job well, it's very valuable feedback. I am not entitled to serve until an age limit, I serve at the pleasure of the board."* Mr. Anderson shared some good practices for director evaluations: *"Of directors surveyed, 38% have some form of a feedback process. It's important to keep the process simple. Lead reviews with the most important contributions and then follow with any recommendations for improvement. Also, have a conversation with each director. Discussion is richer and more human."* He added that including a brief description of the process in the proxy is beneficial to investors. Members agreed that assessing directors' performance and addressing underperformance are both important and difficult to do.

Opportunities and risks presented by the geopolitical environment

Longview Global Advisors' DJ Peterson and EY's Kyle Lawless joined members for a discussion about geopolitics. Dr. Peterson emphasized three key points to provide a broad lens for business leaders to interpret events in 2019:

- **Movement away from open borders and free trade.** *"For the last 30 years the US has promoted openness; belief in free trade, migration, and labor arbitrage has been the dominant ideology in business and politics. That era has come to an end so boards must consider the changing opportunities and costs and benefits of economic openness,"* said Dr. Peterson. He is not optimistic about the likelihood of a major trade deal between the US and China; he sees the overall relationship evolving into a strategic and ideological competition similar to that of the US and Soviet Union during the Cold War. Many members' companies do business in China, though some are starting to rethink their footprint there. One said, *"We are reevaluating China as a central hub that we outsource to and bringing a lot of our business back into Mexico. It was a function of trade wars, tariffs, and labor differentials. But this shift may not be temporary in nature."*

- **Challenges for liberal democracies.** Dr. Peterson discussed the political dysfunction in the US and the United Kingdom noting, *"There is so much uncertainty. When will the US government re-open and what does the agreement look like to get it there? Brexit? There is no plan there. Parliament voted down the Prime Minister's plan with no vision for an alternative."* This political turmoil has allowed China to present an alternative to the liberal democratic model, generating opportunities and uneasiness for Western businesses. *"There was this idea that over time China would liberalize and become more like the US but that hasn't happened. Maintaining a constructive policy relationship with China is important, but at this point few business leaders want to publicly advocate for this,"* said Mr. Peterson.
- **Inequity in society.** Dr. Peterson said that growing inequality is causing disgruntled people to seek solutions in populist messages: *"As long as people have opportunities they will overlook inequality in society. Once those opportunities are gone, societies run into problems."* He 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. Political dysfunction creates a leadership void that offers an opportunity for businesses to step and address issues of importance to their stakeholders, but filling that void carries risk. Mr. Lawless recommended that companies consult with their public affairs professionals to assess the opportunities and risks of speaking out on important issues.

Mr. Lawless said that the world businesses have grown in for over 70 years is changing and there is a growing imperative for companies to develop more strategic approaches to managing political risk. Lawless said companies are using a range of practices to manage emerging risks in the current political environment, including scenario planning and better collaboration across businesses and regions, which can be difficult for large companies: *"The challenge is often organizational. Internal silos and competition must be broken down to develop a holistic and collaborative approach. Tap into your employees on the ground globally. They are the eyes and ears of your business. Train them to think about these political risks."* Mr. Lawless described the journey EY sees companies on in adopting more strategic approaches to managing political risk and emphasized that the focus should be on resilience, not the ability to predict outcomes. *"You can't predict what will happen, but you can plan how you would respond to different outcomes."* He concluded by suggesting board members ask management teams what the top political risks they are watching, who within the organization is 'responsible' for managing political risks, and how much consideration political risk is given in the organization's enterprise risk management process.

Meeting participants

- Kimberly Alexy, FireEye, Inc.
- Rich Dozer, Knight-Swift Transportation
- Leslie Heisz, Edwards Lifesciences
- Steve Page, AeroVironment
- Barry Pearl, Magellan Midstream Partners *(Southwest ACN member)*
- Dick Poladian, Occidental Petroleum and Public Storage
- Mike Stein, Aimco
- Stephanie Streeter, Kohl's
- Wendy Webb, Wynn Resorts

EY was represented by:

- Lee Dutra, San Francisco Office Managing Partner and West Region Center for Board Matters Leader
- Todd Moody, West Region Markets and Accounts Managing Partner
- Mike Verbeck, West Region Assurance Managing Partner

Endnotes

---

[1] Spencer Stuart, *2018 Spencer Stuart United States Board Index* (New York: Spencer Stuart, 2018).

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