Focus on the future

Audit committees and boards have been under a great deal of pressure the last few years. The challenging economic environment is one cause, but significant pressure is also a result of audit committee agendas that have expanded to include such time-consuming and complex issues as risk management, board diversity, succession planning, potential changes to accounting standards and new regulatory proposals that could change the face of corporate governance. In this issue we hear one audit committee chair’s first-hand views on these topics. This edition also reviews recent activities by the U.S. Securities and Exchange Commission (SEC), examines some leading practices for succession planning and contemplates the future of audit committees.

In this issue

From the chair
One audit committee chair’s perspective on planning for the future, board diversity and other current issues

Eileen Mallesch, a former CFO and current Audit Committee Chair for two public companies, shares her thoughts on the board’s role in managing risk and supporting growth. She also shares her views on succession planning, the business case for diversity and more.

We hope you find this and other issues of BoardMatters Quarterly helpful. If you have feedback or ideas for future topics, please contact Sara Brandfon at sara.brandfon@ey.com.

06 Ready for year-end?
Understanding the SEC’s priorities helps companies as they head into year-end financial reporting.

08 Making succession planning a success
CEO succession planning is critical to the success of a company. Find out what leading practices boards are using.

10 What’s next for audit committees?
Audit committees have changed a lot over the last decade. We look at five ways audit committees are likely to evolve in the next few years.
From the chair

One audit committee chair's perspective on planning for the future, board diversity and other current issues

We recently sat down with Eileen Mallesch, Audit Committee Chair for Bob Evans Farms and State Auto Financial Corporation, to talk about several issues of importance to her and other board members. She shared her thoughts on risk, succession planning, supporting business growth, board diversity and more. Following are excerpts from her discussion with Diane Larsen, a partner at Ernst & Young LLP and our Americas Assurance Markets Leader.

The audit committee's role in addressing risk and supporting growth

Diane Larsen: Can you start by reflecting on your role as audit committee chair in the last three years? What’s been the most significant change you’ve seen and what do you think the focus will be moving forward?

Eileen Mallesch: I would say first and foremost, the biggest change is the heightened sense of urgency around establishing a robust risk management approach, particularly as it relates to emerging risks. It’s been on the top of the agenda for audit committees for the last three years and will continue to be in 2012. In addition to risk management, strategy and business development should be top agenda items in 2012 for boards and audit committees. It’s important to understand management's approach to risk, but it’s a death knell if you do not consider the other side of what’s called the risk coin, and that’s risk aversion.

Although the pace of the economic recovery has been very slow and bumpy, we still need CEOs and boards to have the courage to make acquisitions, innovate and develop new products. Apple is an outstanding example of an organization that continues to come up with innovative products and designs and proves that you can have great growth and profitability, even in this environment.

DL: In terms of risk, it seems some companies struggle with focusing not only on financial risks but also on operational and reputational risks, including questions about who will take ownership of oversight.

EM: It is important to note that oversight of enterprise risk management rests with the entire board. Ultimately, the responsibility for risk management and its internal controls has to permeate the entire organization. I don’t take comfort just because a company has a chief risk officer. My test is how the company is demonstrating that risk management has been operationalized. It is too easy to fall into a silo risk management mindset that fails to bridge risks within the organizational processes.
“We need CEOs and boards to have the courage to make acquisitions, innovate and develop new products.”

**DL:** There was a time when companies only asked senior-level executives about risks. In recent years, as organizations have been getting larger and more global, many are realizing that staying at that C-suite level might not be enough. They recognize that they need to consider the real operators down on the ground, right?

**EM:** Absolutely. I’m sure it’s no surprise that at Bob Evans, food safety is the number one risk, and it doesn’t make a difference if the C-suite or the next level down is all over understanding it; it’s a mind-set that must translate to the front-line associates who are out in the restaurants on a day-to-day basis. You want to ensure the right processes are in place and that people are following those processes as part of enterprise risk management.

**DL:** Great example. If you have a food failure, some sort of issue on the ground or a product recall, there will be financial repercussions, but there is reputational risk as well.

**EM:** That is correct; food safety is also one of the elements of reputational risk for the company.

**The role of the CFO**

**DL:** I’ve always encouraged audit committees not only to think about their risks but also to evaluate whether or not they have people with the right skills to address those risks.

**EM:** Businesses have a life cycle, and they’re changing constantly. To use the role of CFO as an example, there are periods in the life of a business when you need a CFO who is very strategic. Other times, you may need one who is more process oriented. It’s a challenge for most companies, especially if they’re smaller and not able to bring in talent, develop them and have a robust succession plan that sources talent across the organization. In contrast, larger companies, such as GE for example, are better able to develop that deep talent inside the organization. A smaller company probably has to go externally to fill some of its key roles. Bob Evans just went through this situation when the long-tenured CFO retired. The CEO/Chairman and the board discussed where the company was on its journey and what type of CFO would best meet the needs of the organization ... and the conclusion was a strategic CFO.

**DL:** It sounds like the audit committee played a major role in that.

**EM:** The CEO/Chairman created a special committee of the chairs of the audit, nominating and corporate governance, finance, and compensation committees, and we all interviewed the candidate. However, it is important to note that the CEO owned the CFO hiring process, and he led the process with, in my view, a best practice by leveraging the experiences of this committee to provide perspective. There has to be chemistry between the CEO and CFO. A business can be taken to new heights when the CFO and the CEO are deeply aligned in
You may not necessarily have all the talent that you need embedded within the company, but it doesn’t prevent you from developing a great leadership development process.

Succession planning

**DL:** Are you spending time focused on succession planning?

**EM:** Absolutely. Succession planning is the board’s key responsibility. Leading succession practices focus on leadership development across the organization. The company will benefit in governance and in investor circles and will be able to retain the best talent. If you’re on the board of a Russell 2000 company, you sometimes have to go externally. You may not necessarily have all the talent that you need embedded within the company, but it doesn’t prevent you from developing a great leadership development process.

The boards I serve discuss succession issues on a quarterly basis. You have to consider where you are today and where the company is going. The CEO you need today may differ from the one you need for the next step in the strategic journey of the organization.

**DL:** What about getting to know the internal pool? Do you ask different individuals to meet with the audit committee?

**EM:** I’m very passionate that the time commitment for audit committee members is not just for the formal quarterly meetings or earnings release meetings or reviewing 10-Qs and the 10-K. It’s really about interacting with the organization and getting a real sense if individuals are walking the talk of what you’re hearing at the board level. We bring in department leaders and their support staff. It’s a win on so many levels. Not only do you get a sense of how the tone at the top is cascading down, but also you get a sense of succession planning and where there’s talent within the organization.

Making the case for diversity

**DL:** So, to shift gears, I want to talk a bit about the importance of diversity on boards. Can you share your perspective and your own experience as a female board member?

**EM:** I recently read in CFO magazine that in 2011, only 6.9% of audit committees are chaired by women.¹ So there’s clearly a lot of work to be done. I recognize that I have been asked on the candidate slates by virtue of being a woman; however, I had to demonstrate my capabilities to get the role. I’m also not shy about saying why I’ve transitioned my career from active CFO to one of serving on public boards. I’m a passionate advocate of diversity on all boards.
because I believe the company performs better because of it. And my definition of diversity is multi-gender, multi-skilled, multinational, multi-ethnic and multi-generational.

Earlier this year I participated in The Wall Street Journal’s Women in the Economy program, and representatives from McKinsey & Company provided a really compelling position for diversity and the power of women in the economy and what that means for greater growth and profits in the business. They demonstrated that there’s a business case for diversity. I think that’s the only way that you’ll start to see real diversity take hold, and I think stakeholders even want to see that now. I am proud that Bob Evans Farms and State Auto Financial have diversity on their boards.

There are organizations that are pushing the envelope to say that if you don’t have diversity represented in your C-suite or on your board, you will not see me choose to invest in you. That’s why I’m optimistic. I think we’re going in the right direction. I think it will be a win-win for everyone, stakeholders and businesses.

Considering the regulatory landscape

DL: Could I get your perspective on the current regulatory environment, specifically related to the recent PCAOB concept release on audit firm rotation and on the auditor’s reporting model?

EM: I applaud that the PCAOB is working hard to further bolster audit credibility, especially after the most recent financial crisis. However, as a former CFO, I’m inclined to respectfully disagree with the auditor rotation proposal as one of the solutions. Getting new auditors up to speed is costly, and it puts further pressure on already stressed finance teams. The lead partner moving off an account after five consecutive years adequately addresses the independence concerns.

Regarding the changes to audit reports, I support elements of the proposal, specifically auditor assurance on other information outside the financial statements. I welcome assurance on earnings releases, non-GAAP information and the MD&A. I know it’ll probably cost more, however, the last line of defense is the audit committee for these items, and I would greatly appreciate a deeper partnership with the independent auditor on this.

---

Eileen Mallesch is the Audit Committee Chair for Bob Evans Farms and State Auto Financial Corporation. She can be reached at emallesch@hotmail.com.

Diane Larsen is an audit partner at Ernst & Young LLP and can be reached at diane.larsen@ey.com.

---

Ready for year-end?

Amid the steady flow of accounting change, companies need to keep their eye on current reporting matters

Understanding the SEC’s current hot topics

Understanding the current focus of the SEC can help companies as they head into the year-end financial reporting season. While each company’s circumstances are different, the economic conditions in which they operate and their financial reporting challenges are often similar.

While the SEC staff continues to comment on familiar topics, such as significant estimates, revenue recognition, segment disclosures, impairment and financial instruments, it increased its focus on several other areas in 2011.

Foreign operations

The SEC increased its attention on disclosures about liquidity, risk factors and results of operations for companies with foreign operations. Particular attention has been paid to a company’s disclosures when specific foreign operations have a disproportionate effect on the financial statements relative to the company’s size.

Questions have been raised about the tax effects of operating in foreign jurisdictions, including the effect on liquidity of permanently reinvesting foreign earnings. The SEC also has asked companies to provide more detailed disclosures about any exposure they may have to European sovereign debt.

Publicly available company information

The SEC expanded its review of whether information disclosed in a company’s SEC filings is consistent with other public information, such as a company’s earnings calls or its website.

For example, if the SEC perceives any discrepancy between how a company’s business is described in its segment footnote and in public information beyond its filings, the SEC often asks for an explanation and may request additional information in order to evaluate the company’s identification of operating segments.

Non-GAAP financial measures

Greater focus has been put on non-GAAP financial measures. The SEC staff has been asking companies to enhance disclosures in their press releases and filings to describe how a non-GAAP measure is useful to investors and to challenge the appropriateness of presenting such a measure when a company is unable to demonstrate that it is useful.

Accounting change

Meanwhile, standard setters continue to work on proposals to change accounting and auditing rules. In November, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards)
issued their revised exposure draft on revenue recognition. Companies should carefully review the revised proposal. The Boards made several changes to their original proposal that could have significant effects on some transactions. Stay tuned for further developments from the Boards as they continue to jointly and separately work on consolidations, financial instruments and insurance contracts. In addition, they plan to issue their revised proposal on leases in the first half of 2012.

**Regulatory activity**

In December, James Kroeker, SEC Chief Accountant, announced that the SEC staff will need additional time to complete work on its recommendation to the commissioners regarding the possible incorporation of IFRS into the US financial reporting system. While the SEC staff’s recommendation had been expected in 2011, Mr. Kroeker provided no new timetable for a decision by the commissioners. Rather, he indicated that the SEC staff will proceed “carefully and thoughtfully, being guided by an ideal that produces the maximum benefit for the investing public and the capital markets.” He further noted that he was “encouraged about the potential prospects of IFRS incorporation,” especially as he considered the input received on the May 2011 staff paper exploring a potential incorporation approach, i.e., “condorsement.”

In October, the Public Company Accounting Oversight Board issued a proposal to improve transparency by requiring the disclosure of the engagement partner’s name along with certain key participants in public company audits. Comments were due by 9 January 2012.

Following its October 2010 green paper, *Audit Policy: Lessons from the Crisis*, the European Commission proposed regulations that would have a significant effect on the European and global audit environment. The proposals, which must be approved by the member states of the European Union and the European Parliament, include mandatory auditor rotation after six years and separation of audit and non-audit activities of the largest firms into separate entities. Consideration of these matters will take an extended period of time.

**Questions for the audit committee to consider**

- Has the audit committee reviewed sensitive year-end accounting and reporting matters with management and the auditors?
- Are the company’s publicly available communications about the business consistent with its segment disclosures in the financial statements?
- Does the company have all of the resources that it needs to analyze and begin to implement the new guidance expected to result from the Boards’ joint projects?
When it comes to CEO succession planning, the stakes are high. Inadequate planning can lead to prolonged and expensive executive searches, downward pressure on stock prices, loss of strategic momentum and investor confidence, and a successor who is out of step with the company’s strategy and culture. Recent high-profile CEO transitions have highlighted these risks and prompted a renewed focus on succession planning at the board level.

The focus has continued to sharpen following action by the SEC, which, in 2009, recognized succession planning as an appropriate subject for shareholder proposals. The SEC called it “one of the board’s key functions,” critical to ensuring that a company “is not adversely affected due to a vacancy in leadership.” The SEC deemed succession planning to be a risk management issue – a critical development for audit and risk committees.

As it turns out, shareholder proposals seeking disclosure on the succession planning process have been largely successful.

In particular, proponents have focused on high-profile companies, companies with long-tenured CEOs, those with family control or those with CEOs closely identified with company prospects.

Proposals that came to a vote in the past two years received relatively high levels of voting support. However, only 2 of 15 resolutions submitted in 2011 made it to a vote, as shareholders and management found common ground through substantive dialogue focused on developing the leadership pipeline, integrating succession planning with the strategic plan and compensation program, and putting the board in the driver’s seat.
Ultimately, the process of succession planning helps develop talent, strengthen skills and reinforce strategic goals across the organization.

Planning for the future

Making long-term and emergency succession plans is a fundamental board responsibility, one that should be addressed on a regular basis, regardless of CEO health and tenure. The board should drive the process with appropriate CEO input and disclose key features of the succession planning policy to shareholders (excluding candidate names or other sensitive data).

Ultimately, the process of succession planning helps develop talent, strengthen skills and reinforce strategic goals across the organization by:

- Identifying upcoming leaders and having the board interact with them to directly assess the talent
- Customizing leadership development goals linked to the long-term strategic plan
- Tying compensation to leadership development

Finally, boards should consider evaluating their succession planning practices not only to mitigate the risks associated with CEO transitions but also to capitalize on strategic and developmental opportunities.

Questions for boards and audit committees to consider:

- Does the board discuss long-term and emergency succession planning regularly, regardless of CEO health and tenure?
- Does the board reassess the succession plan as the company’s long-term corporate strategy shifts?
- Does the board have a process for assessing and developing internal candidates at least two ranks down?
- Does the company’s executive compensation program include incentives tied to succession planning and leadership development?


2 Support for the seven shareholder proposals seeking disclosure on succession planning that came to a vote in the last two years averaged just under 30% of votes cast.

What’s next for audit committees?

Forward View by Tapestry Networks

Nearly a decade ago, the Sarbanes-Oxley Act significantly expanded the duties and obligations of audit committees, leading to a complete overhaul of how many audit committees operate and select members. More recently, financial and economic turmoil in the markets created new challenges for audit committees, which are faced with an ever-expanding agenda as issues such as enterprise risk management and information technology demand more oversight.

One audit chair recently described today's audit committee this way, “The audit committee is now viewed as a powerful, important committee [of the board] that can scale issues of any kind. It has become the workhorse of the board. It meets more often, so it has fresher data ... and it has more familiarity with management, so it’s able to make quicker judgments on things.”

The audit committee of the future: five things to look for

Across our audit committee networks, audit chairs are talking about how trends, such as technological change, expansion into emerging markets and pressures to create sustainable businesses are shaping their committees’ composition, priorities and use of resources. Drawing on these insights, Tapestry Networks identified the following ways in which audit committees will evolve over the next three to five years and beyond.

1. Public company boards and audit committees will undergo a transformation.

As companies face more complex and more global issues, boards will evolve too. They will become increasingly diverse to counter concern that non-diverse boards may be susceptible to groupthink. Additionally, companies will cast a wider net when recruiting directors, especially given the challenges directors face when simultaneously holding down multiple board roles and/or an executive role. Finally, specialization will likely become more critical to boards and audit committees than it is today, particularly on issues such as information technology and international market risks.

Forward View is prepared by Tapestry Networks. Views expressed by Tapestry Networks are those of Tapestry Networks and not necessarily of any Ernst & Young member firm. Tapestry Networks convenes seven audit committee networks sponsored by Ernst & Young that collectively consist of nearly 150 individuals, who chair more than 200 audit committees and sit on over 300 boards at some of the world’s most admired companies. Ernst & Young refers to the global organization of member firms of Ernst & Young Global Ltd., each of which is a separate legal entity. Ernst & Young LLP is a client-serving member firm in the US.

Used by permission of Tapestry Networks. This article may not be reproduced, distributed, displayed or published without the express written consent of Ernst & Young LLP and Tapestry Networks.
American boards have traditionally focused on the shareholder as the primary stakeholder; however, some directors are starting to question this approach. They believe boards will broaden their focus to include other stakeholders, particularly as companies expand into markets in which employee and community needs command greater attention than they do in the United States.

Issues such as sustainability may take on greater importance, and US companies will be asked (possibly required) to report on environmental, social and ethical issues in a more comprehensive way. Oversight of reporting on these matters will likely find its way onto the audit committee agenda, especially as disclosure requirements increase and the risks of miscommunication to stakeholders become more evident. At the same time, shareholders will be under pressure from regulators and the investing public to increase their interaction with boards and audit committees.

Audit committees recognize the need for diligent oversight of regulatory compliance and financial controls, yet question the value of “checking boxes.” Consent agendas, pre-reading with limited presentation and other techniques to fulfill routine oversight and compliance responsibilities will be used to make committees run more efficiently. This will allow additional time on the audit committee’s (and the board’s) agenda for deep dives into key risks, the evaluation and sometimes mentoring of senior and high-potential executives, as well as discussions about strategic priorities. This will require audit committees to be more flexible as they deal with unscheduled matters and urgent issues.

This shift is already reflected in the changing role of audit chairs, who often meet more frequently with members of management and the external auditor between audit committee meetings to ensure continuity on critical issues. A likely challenge that many audit chairs fear is that audit committees will be blown off course by the need to launch investigations into whistle-blower complaints incentivized by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Investors seeking to understand a company’s health and future prospects are relying more on qualitative information, such as management’s discussion and analysis. This is especially true as financial statements and
Accounting have become more complex. Meanwhile, companies are using real-time communication tools and social media to communicate with financial stakeholders, at an alarmingly fast pace. Some investors believe the move to XBRL will transform how the market uses financial information.

These shifts will give rise to broader audit committee oversight of financial communications that are organized less around the quarterly filings schedule and more on ensuring a comprehensive, fair and understandable representation of company performance to the market throughout the year.

Audit committees will use more resources given the new demands.

Audit committee chairs talk frequently about their reliance on the CFO, internal audit and the external auditor, as well as the need for increasingly sophisticated insight from these and other experts on matters relevant to the audit committee. Many also note the difficulty of staying on top of issues from outside the company, such as changing regulations, technology trends and market-specific issues.

Some have started to engage independent advisory councils to provide guidance to management and the board. Others use third-party advisors on an ad hoc basis to draw on specific expertise related to a pending transaction or an annual strategy or risk review. One audit chair recently suggested MBAs could be hired to do postgraduate clerkships for boards just as they do for private equity-owned companies.

Looking ahead

Audit committee chairs recognize that the demands of serving on an audit committee have expanded significantly and show no signs of abating. Yet they also recognize the value that they provide as the committee with the broadest set of responsibilities.

As companies continue to push themselves to adapt in a volatile and complex economic environment, audit committees and boards will use a wider variety of resources and tactics to focus more on strategic issues than on compliance-related activities. They also will become more flexible in their approach to oversight in order to meet the demands of today’s capital markets.