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Boards turn to the talent agenda

We all know and experience daily how innovation and new technology are disrupting established business models. This extraordinary business transformation is happening at high speed and resulting in fundamental changes to traditional approaches to strategy and risk-management oversight.

Boards of directors are being called on to help identify where their company’s true value lies and help determine how it will drive innovation, create new products and services, and future-proof the business before market signals show missed opportunities.

Leading boards are recognizing that when it comes to growth and innovation, the risks and rewards associated with an organization’s talent may be the most critical area of all. Talent strategies and the ability to transform an organization’s workforce play a critical role in positioning companies to successfully navigate market and technology changes.

From building a culture where innovation thrives, to defining the company’s purpose, to investing in retraining workers to meet the demands of evolving business models, a company’s people strategy is increasingly emerging as critical to competitive strength and long-term value creation.

How are boards responding?

Many forward-thinking boards are adopting a broader view of understanding a company’s talent strategy and mitigating human-capital risk. While these boards and, in particular, compensation committees remain focused on developing senior leaders and building a diverse talent pipeline to fill key executive roles, many are also expanding their oversight to key talent indicators for the overall workforce.

For example, directors seek to understand and challenge:

• Whether the company’s culture truly represents its values and promotes ethical behavior
• Whether compensation programs are equitable, balance risk and reward, and align with company culture
• How companies are investing in employee development, growth, wellness and engagement
• How companies are upholding diversity and inclusion goals at the board and executive management level
Talent-related opportunities and risks

Organizations confront a variety of risks associated with securing the talent necessary to achieve business objectives. For instance, alternative workforce models and the increased usage of contingent workers are having a growing impact on how businesses operate.

In response to these changes, we are seeing some boards expand their view of the talent strategy to identify and oversee the associated opportunities and risks. The appropriate alignment of a company’s workforce demographics to ever-evolving business strategies is critical. It is also essential to understand the value of the company’s labor force and returns on human capital investments. Leading boards find that competitive advantage is now created through strategic workforce management and how it is allocated and aligned to the company’s strategy and ability to create new products, services and businesses.

This is where investment in employee training – and retraining – comes into play. Having a flexible, well-trained workforce is key to an organization’s ability to capitalize on changes in customer buying patterns and emerging technology. Companies must be able to pivot quickly in response to new technologies or competitive disruption. Some organizations have addressed this need by partnering with either local or online universities to retrain their current talent pool in new skills. This training allows the company to retain high-performing employees whose current skillset may be becoming obsolete, and it may provide a higher return on investment than having to hire and onboard a new workforce.

Employee turnover presents a significant cost for any organization. Between termination costs, costs to cover the vacancy including overtime or staffing agencies, and lost productivity as new employees get up to speed, turnover can be a big risk. As a result, many boards want to be aware of the company’s engagement and retention strategies.

Leading boards are recognizing that when it comes to growth and innovation, the risks and rewards associated with an organization’s talent may be the most critical area of all.

Many boards are also focused on how the organization’s governance, protocols and compensation structures incentivize ethical behavior and support the company’s culture and values. Employee experience and culture can have both direct and indirect financial impacts on talent attrition costs and employer brand value. Recent high-profile cases related to pay incentive structures are potent reminders of what is at stake. A healthy corporate culture built on integrity, engagement, diversity and inclusivity is a foundational catalyst of growth, innovation and talent retention. Furthermore, today’s employees are three times more likely to stay with a purpose-driven company. People want to work for a company they can believe in, so organizations that clearly state and pursue their purpose are at an advantage in the talent marketplace.

In addition, technology and new workforce models centered around contingent workers are driving new types of compliance risks, including privacy, cybersecurity and pay equity. The “gig economy” is driving a growth in new types of labor arrangements, some of which regulators have not fully addressed. Beyond regulatory concerns, this model presents more immediate concerns, such as how organizations protect their intellectual property from the chance a contingent worker will share it with a competitor.

Metrics for the board to consider

As boards continue to use metrics in their oversight function, we are seeing some ask for specific strategic human capital metrics, including:

- Employee engagement scores
- Employee training and development spends
- Number of new competency-targeted jobs filled
- Attrition rate
- Total revenue/total reward cost
- Diversity and inclusion goals
Long-term investors understand that human capital enabled by a strong culture will facilitate a long-term competitive advantage.

**Investor interest**

Investors are focused on the people agenda as well. More than a quarter of the 55 institutional investors we talked to in late 2016 cited workforce management (or some aspect thereof) as an engagement priority heading into 2017. As a result, boards should anticipate questions from investors in this area.

For these investors, how a company manages and values human capital speaks to the company’s culture and represents potential competitive advantages as well as potential litigation, operational and reputational risks. Investors are looking at a broad range of practices (e.g., employee development, compensation and engagement, health and safety, diversity, labor relations, and supply-chain labor standards). They are engaging companies directly to better understand how companies are assessing and prioritizing human capital as a long-term value driver — and how boards are overseeing related performance.

Additionally, in an economy of monetary capital abundance, growth strategies are increasingly important, and long-term-oriented investors will likely be looking for future growth prospects and a high return on patient investments, rather than immediate monetary returns. Long-term investors understand that human capital enabled by a strong culture will facilitate a long-term competitive advantage, and that investing in a company’s workforce may yield stronger returns over the long run than other short-term means of deploying cash.

**Conclusion**

Workforce management and the people agenda have become fundamental differentiators for long-term success. Today’s businesses face a considerable risk related to their human capital investments, which could grant them the flexibility to adjust to market and competitive forces — or cause them to fall behind. Leading boards recognize this as a strategic opportunity and are expanding their oversight accordingly to help position their organizations to both survive and thrive for years to come.

**Questions for the board to consider**

- Does the company have a clear purpose that will drive both employee engagement and customer loyalty?
- Does the company have the right culture to enable its people? And how is the compensation program supporting that culture?
- What are the company’s talent needs now and in the future? And what is management’s plan to meet those needs?
- Do the board and C-suite set the tone at the top for embracing diversity? And how does the company support recruiting, developing and promoting a diverse workforce?
- Does the board’s skillset include talent management? How is responsibility for talent oversight assigned?
- How informed is the board regarding key talent indicators, such as employee engagement, access to training and development, workforce diversity, and key employee turnover?
2017 proxy season review

Amid regulatory and legislative uncertainty, investors remain committed to holding boards, and themselves, to higher levels of accountability, transparency and engagement. The 2017 proxy season is marked by the launch of a historic US stewardship code and the emergence of proxy access as standard practice across large companies.

These developments unite many leading investors behind common governance and stewardship principles and encourage other investors to take a more active approach to stewardship responsibilities. They also grant investors more influence over the companies they own.

Where’s the focus this year?

Board diversity and gender pay equity are key themes in 2017. Investors and boards recognize diversity as a critical element to enhancing board effectiveness and corporate talent agendas. Environmental sustainability is also increasingly in the spotlight, with many investors viewing companies’ approaches to climate risk management through the lens of long-term value creation. Some investors are challenging unequal voting structures and virtual shareholder meetings based on signals that those practices may be on the rise. Meanwhile, investor support for director elections and executive pay programs is holding strong as companies continue to enhance their investor communications – both in the proxy and through direct engagement.

This report is based on the EY Center for Board Matters proprietary corporate governance database and ongoing conversations with investors and directors.1

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Investors and boards recognize diversity as a critical element to enhancing board effectiveness and corporate talent agendas. Climate risk management is also in the spotlight.
Six key board takeaways

1. Leading investors commit to new US stewardship code

Thirty-eight US and international investors with an aggregate of more than $20 trillion invested in the US equity markets are now signatories to the Framework for US Stewardship and Governance. While such codes are increasingly common in many large global markets, the framework is the first of its kind in the US.2

Launched in January 2017 and taking effect in January 2018, this historic, voluntary framework includes a set of stewardship principles for institutional investors, which call for transparency around investors’ philosophy on corporate governance, proxy voting, and engagement guidelines and activities. The principles also encourage investors to attempt to resolve differences with companies through engagement, further instituting direct engagement as a critical component of company-investor relationships.

The framework also unites some of the world’s largest investors behind key corporate governance principles for US-listed companies. As a result, companies may face increased pressure to come in line with leading practices related to board accountability to shareholders, shareholder voting rights, board leadership structures, board effectiveness practices and the alignment of pay with long-term strategy.

Key board takeaway

The framework reflects that key investors are not blindly following the recommendations of proxy advisory firms and may also signal increased investor engagement and transparency around corporate governance. Commitments around investor transparency will likely provide boards a clearer window into investors’ governance views and priorities – which may also increase investor expectations that companies proactively research and understand their perspectives.
2. Proxy access now mainstream across large companies

Over the past three years, proxy access—a provision that companies fought against for decades—has become the norm at large companies. Now, 60% of S&P 500 companies have proxy access bylaws, up from less than 1% in 2014. Most proxy access bylaws (88%) allow a group of up to 20 investors that have collectively held at least 3% of the stock for three years to nominate up to 20%-25% of the board (usually providing for at least two nominees).

While this sweeping change has been driven largely by the submission of shareholder proposals, this year a majority of companies facing the proposal have willingly embraced the reform: half of more than 100 companies that received shareholder proposals to adopt proxy access agreed to enact a proxy access bylaw. Notably, shareholders’ ability to submit proxy access proposals is currently being challenged (see “2017 shareholder proposal landscape” on page 12). To date, investors have yet to use this new board accountability tool, which many have insisted will serve as a last resort.

3. Board diversity and gender pay equity emerge as key themes

As the proxy season began, a statue of a girl staring down the Wall Street bull served as a symbol of investors’ commitment to increasing gender diversity in the boardroom and the C-suite. The arrival of the statue launched State Street Global Advisors’ new guidance designed to increase the number of women on corporate boards. The firm is among many leading investors that are prioritizing gender diversity as they engage with and evaluate boards this year.

Just over half of the 55 investors EY spoke with in advance of the proxy season included diversity, particularly gender diversity, as a board priority in 2017, and proposals asking boards to report on and increase their board diversity are among the top shareholder proposals submitted this year. As of 2016, only 18% of S&P 1500 directorships were held by women.

Gender pay equity has also emerged as a key focus, with nearly 30 high-profile companies facing shareholder proposals asking them to report on the pay gap between male and female employees (in some cases across race and ethnicity) and the company’s plan to close that gap. Around half were withdrawn as the companies reached agreements with the proponents. This year’s campaign, which includes financial services and consumer companies, comes on the heels of a similar shareholder proposal campaign targeting technology companies last year, which resulted in six leading tech giants agreeing to report on gender pay equity.

**Key board takeaway**

Investors are armed with a new power to directly influence the boards of the companies they own. Board communications should clearly demonstrate how the skills and experience of the company’s directors make them most capable to oversee the company’s strategy and risks. The company should also explain the board’s approach to board assessments and how it is recruiting diverse directors.

**Key board takeaway**

Boards lacking gender diversity that are not taking action to add women directors may face increased opposition when it comes to director re-elections. In addition to strengthening cognitive diversity and, according to numerous studies, enhancing corporate performance, board diversity helps set the tone at the top for the diverse talent the company seeks to attract. And gender pay equity is critical to securing and advancing top performers in an increasingly competitive war on talent. Boards should ensure that they are challenging themselves to recruit diverse directors and actively overseeing how pay programs across the workforce are supporting and enhancing diversity.
4. Environmental sustainability — particularly climate risk — is in the spotlight

Mainstream investors are increasingly outspoken in their view that a company’s integration of environmental risks and opportunities into its strategic planning is an indicator for whether the company is positioned to generate sustainable value over the long term — and climate risk has emerged as a key area of focus. For example, BlackRock and State Street, two of the world’s largest asset managers, have made clear that environmental issues are integral to their stewardship activities and have publicly announced that climate risk will be a focus of their company engagements this year.5 And in a major shift, Fidelity Investments in 2017 revised its proxy voting guidelines to say it may support shareholder proposals calling for reports on sustainability, renewable energy and environmental impact issues.6

Given concern that the expected transition to a low-carbon economy may trigger disruptive changes across a number of industries as well as the global financial system, how companies are managing — and how boards are overseeing — climate-related risks and opportunities is becoming a consistent theme across investor engagement priorities. Nearly a third of the 55 investors we spoke with in advance of the proxy season included climate change as a board priority in 2017.7

This year’s shareholder proposal landscape provides a clear window into investors’ evolving views around climate risk. Support for shareholder proposals requesting that companies report on how they are assessing climate risk (e.g., an analysis of financial and strategic impacts resulting from potential carbon restrictions) has climbed from 7% in 2011 to 43% so far in 2017. Notably, so far three of the proposals secured majority support for the first time, including two proposals at energy companies that exceeded 60% support. This marks a historic shift — and aligns investor support with recommendations from the Task Force on Climate-related Financial Disclosures and the World Business Council for Sustainable Development.

5. Unequal voting structures and virtual shareholder meetings come under fire

Unequal voting structures are under increased scrutiny this year. Following concerns raised by the Council of Institutional Investors, both FTSE Russell and S&P Dow Jones Indices have announced they are conducting consultations regarding the inclusion in their indices of companies with non-voting share classes.8 “One share, one vote” has long been the mantra of most investors, who believe that voting power in the hands of company insiders can lower board accountability and increase governance-related risks.

Also under scrutiny is the practice of companies holding virtual-only shareholder meetings, which appear to be on the rise with 5% of S&P 500 companies holding such meetings so far this year, up from 3% in 2016. While the number of companies holding virtual meetings is small, the growing trend has alarmed some investors who believe they deny shareholders the opportunity to engage company leaders in-person, and may shield companies from direct accountability and criticism.9

Key board takeaway

Environmental sustainability can be a critical part of long-term risk management. Boards should make sure they are integrating company-specific sustainability risks — as well as related opportunities — into oversight of strategy. Board communications should explain how the board is increasing its sustainability expertise and institutionalizing sustainability oversight.
6. Companies continue to enhance investor communications

Investor communications continue to evolve as more companies recognize the opportunity to secure investor support and build trust through enhanced proxy statement disclosures and direct engagement with shareholders.

Proxy statements have become communication tools that serve as an extension of corporate engagement efforts and a formal record of a board’s priorities and governance philosophy. Effective proxy statements are improving readability through enhanced formatting and graphics, demonstrating board engagement and effectiveness, and addressing key interests of institutional investors.

Company-investor engagement on governance topics — and disclosure of these efforts in the proxy statement — also continues to grow. The portion of S&P 500 companies disclosing engagement has grown from 6% in 2010 to 72% in 2017. And directors are getting increasingly involved in this engagement. This year, 29% of companies that disclosed engagement with investors noted director involvement. This is up from 25% last year.

Key board takeaway

Proxy disclosures are an efficient way to take the company’s targeted governance message to a broad audience of investors and other stakeholders. Through direct engagement, companies are better positioned to proactively respond to investor concerns and secure investor support. Boards should ensure they are taking advantage of these communication opportunities as appropriate.

S&P 500 proxy disclosure trends
Notable elements of 446 proxy statements for S&P 500 companies available as of 12 June 2017

- Letter to shareholders from (or Q&A with) board or independent board leadership discussing governance topics
- Proxy statement executive summary
- Disclosures related to investor engagement
- Director skills matrix connecting individual directors to the qualifications sought across the board
- Graphics to highlight different aspects of board diversity (e.g., gender, race/ethnicity, geography, tenure, skills)

Emerging proxy trends include:

- Discussion of key committee activities in the prior year
- Section highlighting the board’s approach to refreshment and recent board changes
- Details regarding the board assessment process — including evaluation topics and outcomes
- Description of a typical board meeting
2017 shareholder proposal landscape

As the 2017 proxy season concludes, the future of shareholder proposals is uncertain. As part of an effort to roll back financial regulation, Congress is considering changes that would sharply curb the ability of investors to put forward such proposals. In the meantime, shareholder proposals continue to play a leading role in shaping the governance landscape and highlighting both long-standing and emerging areas of focus for a number of investors.

We are tracking more than 850 shareholder proposals submitted for meetings through June 30, 2017, which is around the same level as what we tracked over the same period last year. While proxy access proposals are the most submitted proposal topic for the third year running, proposals on environmental and social topics account for the largest category of proposals submitted, at 49% of the total, up from 41% in 2016 and 43% in 2015. The dominance of these topics is largely driven by proposals related to environmental sustainability (which account for 14% of all shareholder proposal topics submitted), corporate lobbying and political spending, and pay inequality and other corporate diversity topics.

### Regulatory and legislative uncertainty reigns

With significant regulatory and policy changes on the table across a number of areas this proxy season, boards and investors alike seek to better understand the potential implications for the capital markets and corporate governance. Among the key policy areas impacting public companies and investors are the potential for tax reform, the future of trade agreements and the outlook on capital formation. Other topics related more directly to public company reporting include SEC initiatives related to disclosure effectiveness, non-GAAP reporting, enforcement, boardroom diversity disclosures, cybersecurity, and Dodd-Frank rule-making and related repeal efforts (which touch upon the ability of shareholders to file proposals, universal proxies, say-on-pay, clawbacks, SEC rule-making and the regulation of proxy advisory firms, among other things). Until there are concrete changes, extraordinary uncertainty remains for companies and investors.

<table>
<thead>
<tr>
<th>Most common shareholder proposals submitted in 2017</th>
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<tbody>
<tr>
<td>Proposal</td>
</tr>
<tr>
<td>Adopt/amend proxy access</td>
</tr>
<tr>
<td>Review/report on lobbying activities</td>
</tr>
<tr>
<td>Appoint independent board chair</td>
</tr>
<tr>
<td>Review/report on political spending</td>
</tr>
<tr>
<td>Address human rights</td>
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<tr>
<td>Review/report on greenhouse gas emissions</td>
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<tr>
<td>Review/report on pay inequality</td>
</tr>
<tr>
<td>Address corporate EEO/diversity</td>
</tr>
<tr>
<td>Report on sustainability</td>
</tr>
<tr>
<td>Review/report on climate-related risks</td>
</tr>
</tbody>
</table>
Questions for boards to consider

- How does the board stay informed about key shareholders’ engagement priorities, governance philosophies and views of the company’s governance practices?

- How is the board making sure that director qualifications align with the company’s long-term strategy and key risks, and that regular refreshment increases board diversity and relevant director expertise? How is the board communicating this to investors?

- Are environmental and social considerations integrated into the company’s long-term strategy – and is the company communicating that to investors? How is the board institutionalizing sustainability oversight?

- If the board lacks diversity, how is it actively challenging this status quo? If the board is diverse, how is it promoting inclusiveness to fully leverage cognitive diversity?

- Is the company optimizing the proxy statement as an investor communications tool?

- How does the board oversee the talent agenda and confirm that gender and racial pay equity, workforce diversity and company culture are positioning the company to attract the workforce of the future?

Endnotes

1. All data is from EY’s proprietary corporate governance database, which covers more than 3,000 companies listed in the US. Shareholder proposal data is based on meetings through 30 June 2017. Vote results for 2017 are as available for meetings through 2 June. All other data is full-year.


3. In November 2016, an investor publicly announced its intention to use proxy access, but the move was halted when the company argued that the investor was in violation of the company’s bylaw.


5. See EXPLORING ESG: A Practitioner’s Perspective, CEO Larry Fink’s 2017 letter to CEOs and Engagement priorities for 2017-2018, BlackRock; and Climate Change Risk Oversight Framework for Directors and Active Stewardship, Sustainable Value, State Street Global Advisors.


7. See 2017 proxy season preview, EY Center for Board Matters, January 2017.


10. See also Guidelines for Protecting and Enhancing Online Shareholder Participation in Annual Meetings, June 2012, created by the Best Practices Working Group for Online Shareholder Participation in Annual Meetings, which includes retail and institutional investors, public company representatives and proxy and legal service providers.

11. See also EY SEC Outlook 2017: What public companies should expect.
Independent directors: new class of 2016

Today’s boards are navigating disruptive changes, a dynamic geopolitical and regulatory environment, shifting consumer and workforce demographics, and shareholder activist activity amid a push by leading investors for a more long-term strategic focus. These demands highlight the critical role boards play in helping companies manage risk and seize strategic opportunities.

To see how boards are keeping current and strategically aligning board composition to company needs, we reviewed the qualifications and characteristics of independent directors who were elected to Fortune 100 boards for the first time in 2016 (Fortune 100 Class of 2016). We also looked at some of the same data for the Russell 3000, and we highlight those findings at the end of this report.

Most companies refreshed board composition in the past year

This report highlights five key findings about the Fortune 100 Class of 2016, but first it’s worth noting that nearly 60% of Fortune 100 companies added at least one independent director following the company’s 2015 annual meeting. These boards added an average of 1.8 directors — and close to one-fifth of these boards added three or more directors.

1. The Fortune 100 Class of 2016 brings a wide range of strengths into the boardroom

Based on the qualifications highlighted in corporate disclosures, expertise in corporate finance or accounting was most frequently cited. More than half of directors assigned to the audit committee were recognized as financial experts. Companies also highlighted leadership positions in multinational corporations, managing global operations or detailed knowledge of certain markets of particular interest to company strategy. Board experience (public or private) or corporate governance expertise also was commonly cited.

Top 10 skills and expertise of Fortune 100 Class of 2016

Based on portion of total skills cited for each of the top 10 categories

1. Corporate finance, accounting
2. International business
3. Board service (public and private), corporate governance experience
4. Industry
5. Strategy
6. Marketing or business development
7. Technology
8. Risk oversight
9. Government, public policy, regulatory
10. Transactional finance (M&A, private equity, investment banking)

A majority of the Fortune 100 Class of 2016 directors bringing expertise in these areas are women.
2. The Fortune 100 Class of 2016 enhances gender diversity

Nearly 40% of the Fortune 100 Class of 2016 are women, compared to less than a quarter of incumbents and less than one-fifth of the exiting directors. Newly appointed women directors also are slightly younger than male counterparts (age 57, compared to 59).

3. Only about half of the Fortune 100 Class of 2016 are current or former CEOs

While experience as a CEO is often cited as a historical first cut for search firms, about half of the Fortune 100 class of 2016 have non-CEO backgrounds as corporate executives or have non-corporate backgrounds (e.g., scientists, academics and former government officials). Ten percent worked at an institutional investor, an experience which was highlighted to communicate the company’s interest in shareholder perspectives. Another 9% were described as bringing experience in innovation or having the capability to drive innovation. It’s also notable that 17% of the entering class appear to be joining a public company board for the first time.

4. The Fortune 100 Class of 2016 tends to be younger than their director counterparts

The average age of entering directors was 58, compared to 64 for incumbents and 68 for the exiting group. Although most directors are between 50 and 67, nearly 10% of the entering class was under 50, compared to 1% of incumbent directors. Over half of exiting directors were age 68 or older.

17% of the entering class appear to be joining a public company board for the first time.
5. Members of the Fortune 100 Class of 2016 are mainly being added to audit committees

Entering directors are more likely to join the audit committee during their first year on the board. While the committee service of incumbent directors appears to be fairly evenly distributed, the exiting group was most likely to hold positions on the nominating and governance committees.

How does the Russell 3000 Class of 2016 compare?

Significantly fewer Russell 3000 companies added at least one independent director following the company’s 2015 annual meeting, and those that did added fewer independent directors. The Russell 3000 Class of 2016 independent directors tend to be slightly younger than the Fortune 100 Class of 2016, and when it comes to key committee membership, they’re also most likely to join the audit committee in their first year on the board. Just around a quarter is female, however, showing that smaller company boards have a steeper climb ahead to achieve gender parity.

### Distribution of Fortune 100 key committee membership

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<thead>
<tr>
<th></th>
<th>Entering</th>
<th>Incumbent</th>
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<tbody>
<tr>
<td>Audit</td>
<td>40%</td>
<td>33%</td>
</tr>
<tr>
<td>Compensation</td>
<td>26%</td>
<td>32%</td>
</tr>
<tr>
<td>Nominating and governance</td>
<td>34%</td>
<td>34%</td>
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</table>

### Questions for the nominating and governance committee to consider

- How current and relevant are the skills of incumbent directors to the company’s long-term strategy?
- Given increasing attention to director qualifications, including by shareholder activists, do existing company disclosures effectively communicate the strengths of incumbent directors?
- How diverse is the board – defined as including considerations such as age, gender, race, ethnicity, nationality – in addition to skills and expertise?
- How can the board’s existing succession planning efforts and approach to considering director candidates be enhanced?

### Key committee membership (% of new directors)

<table>
<thead>
<tr>
<th></th>
<th>Russell 3000</th>
<th>Fortune 100</th>
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<tbody>
<tr>
<td>Audit</td>
<td>38%</td>
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<td>34%</td>
</tr>
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</table>

### Other statistics

- Boards that added a director last year (% of companies): Russell 3000 43%, Fortune 100 58%
- Average new directors per refreshing board: Russell 3000 1.5, Fortune 100 1.8
- Portion of refreshing boards that added three or more directors: Russell 3000 9%, Fortune 100 18%
- Gender (% of new female directors): Russell 3000 26%, Fortune 100 39%
- Age group (% of new directors):
  - 68+: Russell 3000 8%, Fortune 100 2%
  - 60 to 67: Russell 3000 32%, Fortune 100 44%
  - 50 to 59: Russell 3000 44%, Fortune 100 45%
  - Under 50: Russell 3000 16%, Fortune 100 9%
What you need to know

- SEC Chief Accountant Wesley Bricker provided guidance for audit committees in a recent speech on how they can effectively discharge their oversight responsibilities.
- Among the audit committee responsibilities he highlighted are two that we believe are especially important right now – understanding the financial reporting risks related to implementing new accounting standards on revenue recognition, leases and credit losses and supporting controls over a company’s use of non-GAAP financial measures.
- He also discussed the importance of understanding changes in the business and operating environments, setting a positive tone at the top to support internal control over financial reporting, overseeing the external audit and making sure the committee isn’t overloaded, among other topics.

Overview

Securities and Exchange Commission (SEC) Chief Accountant Wesley Bricker discussed how audit committees can effectively discharge their oversight responsibilities in a recent speech at the University of Tennessee’s C. Warren Neel Corporate Governance Center.¹

“Audit committees also play a critical role in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company’s culture and internal control over financial reporting ...”

— Wesley Bricker

Mr. Bricker highlighted seven areas in which audit committees can improve in their oversight of a company’s financial reporting, echoing comments he and other SEC officials have made in recent years.

“Audit committees also play a critical role in contributing to financial statement credibility through their oversight and resulting impact on the integrity of a company’s culture and internal control over financial reporting (ICFR), the quality of financial reporting, and the quality of audits performed on behalf of investors,” he said.
Key considerations

Understand the business and operating environment

“Audit committees should understand the businesses they serve and the impact of the operating environment – the economic, technological, and societal changes – on corporate strategies,” he said, citing the following risks:

- “Changes in the operating environment can result in changes in competitive pressures and different financial reporting risks.”
- “Significant and rapid expansion of operations can strain controls and increase the risk of breakdown in controls.”
- “Entering into industries, business areas or transactions with which an entity has little experience may introduce new risks associated with financial reporting, including ICFR.”
- “The implementation of new GAAP standards may affect risks in preparing financial statements, particularly if implementation planning or execution is lacking.”

Promote board diversity

Mr. Bricker noted that investors have expressed “strong interest” in board composition, including with regard to diversity.² He said that “diversity of thoughts diminishes the extent of group thinking, and diversity of relevant skills ... enhances the audit committee’s ability to monitor financial reporting.” He added that “[g]iven the importance of diversity to audit committee effectiveness, there is an opportunity to increase the level of diversity on US boards and audit committees.”

Promote board diversity

Mr. Bricker noted that investors have expressed “strong interest” in board composition, including with regard to diversity.² He said that “diversity of thoughts diminishes the extent of group thinking, and diversity of relevant skills ... enhances the audit committee’s ability to monitor financial reporting.” He added that “[g]iven the importance of diversity to audit committee effectiveness, there is an opportunity to increase the level of diversity on US boards and audit committees.”

How we see it

In our view, diversity underpins good business. Research by EY and others demonstrates a link between board diversity and economic results. Investors also tell us that board diversity is a priority for them.

Balance the audit committee workload and keep current on financial reporting developments

Mr. Bricker expressed concerns about the capacity of audit committees to balance their workloads, given all of the demands on their time. He said boards should also consider whether they are identifying and managing any risks of audit committee overload.

“When audit committees may be equipped to play a role in overseeing risks that extend beyond financial reporting, such as cybersecurity and portions of enterprise risk management, I believe it is important for audit committees to not lose focus on their core roles and responsibilities,” he said.

Mr. Bricker said audit committees should also consider providing training programs to help their members stay current on accounting and financial reporting developments, especially new accounting standards that have a significant effect.

Set a positive tone at the top and culture

A strong control environment is especially important because new accounting standards require management to make more judgments than they have in the past. He said audit committees may directly affect the control environment, which influences the behavior of management and other personnel. He also noted that tone at the top is a key element of the internal control framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

How we see it

Right now, we are especially concerned about implementation of the new revenue recognition standard. While most public companies we have surveyed have started implementing the standard, many of them are at risk of not successfully completing implementation by the effective date (i.e., 1 January 2018 for calendar-year public companies). Audit committees should actively engage in discussions with management and the auditor about the company’s progress.
Mr. Bricker said audit committees should oversee a company’s use of non-GAAP financial measures.

“One way audit committees can focus on tone and culture is by working with management to obtain a clear and common understanding of what tone means, why tone is important, and what mechanisms are in place to assess the adequacy of control environment, including across any relevant divisions and geographies,” he said. Mr. Bricker also suggested that it is critical for audit committees to discuss tone with the external auditor.

Understand disclosure controls and procedures over non-GAAP financial measures

“Audit committees are well positioned to exercise healthy oversight by understanding management’s process and controls to calculate the non-GAAP and other key operational measures,” Mr. Bricker said. That oversight should include understanding:

- Procedures in place over the accuracy of the calculation and the consistency of the measures with those provided in prior periods
- Any non-GAAP policies in place, and if no policies exist, why that is the case
- The individual(s) in the organization responsible for administering any non-GAAP policy and “how many times have they approved changes in reporting” as well as the reasons for such changes

Mr. Bricker’s comments were consistent with his remarks at the 2016 AICPA National Conference on Current SEC and PCAOB Developments.

Monitor corporate objectives that could conflict with effective oversight of external auditors

Mr. Bricker said audit committees should work with other board committees to make sure important corporate objectives, such as cost reduction plans, are not implemented in ways that might adversely affect management’s financial reporting responsibilities or inappropriately limit the scope of the external audit, the engagement terms or the auditor’s compensation.

“The audit committee responsibilities under the listing standards include the authority and responsibility to directly oversee auditor engagement terms (including proposed scope) and compensation,” he said. Repeating comments made in a previous speech, Mr. Bricker added that “[s]ome of management’s standard procurement policies and processes may not be appropriately designed if used in the audit committee’s selection, retention and compensation decisions for the external auditor.”

Consider enhanced voluntary reporting

Mr. Bricker pointed to the SEC’s 2015 concept release about possible revisions to audit committee disclosure requirements and to a recent survey of Fortune 100 audit committees that demonstrated significant growth in voluntary disclosures in the past several years to encourage audit committees to “continue to consider reviewing their audit committee disclosures and consider whether providing additional insight into how the audit committee executes its responsibilities would make the disclosures more effective in communicating with investors.”

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