About the 2011 Audit Committee Chair Advisory Council

With a focus on the common goal of a sustainable and profitable Corporate America, the National Association of Corporate Directors (NACD) and its content partner KPMG LLP hosted this 2011 Audit Committee Chair Advisory Council, bringing together experienced audit committee chairs from Fortune 250 companies and key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance generally – and audit committee oversight in particular.

This third annual meeting – held on October 18 in Washington, DC – provided participants the opportunity to engage in frank, informal discussions regarding their expectations for audit committee oversight, and to share observations and insights on strengthening financial reporting integrity and transparency. The goal of the Advisory Council is threefold:

– Improve communications and build trust between Corporate America and its key stakeholders
– Give voice to the director community
– Identify ways to take audit committee and board oversight to the “next level”

NACD believes that the frank, open dialogue facilitated by this Advisory Council is vital to advancing the overarching goal of all boards, investors, and regulators: a sustainable, profitable, and thriving Corporate America.
2011 Annual Meeting Participants

Eddie Adair  
Audit Committee Chair  
Tech Data Corp.

Jim Bachmann  
Audit Committee Chair  
Nationwide Insurance

Joseph Bronson  
Audit Committee Chair  
Jacobs Engineering Group

Meredith Cross  
Director  
SEC Division of Corporate Finance

Gerald M. Czarnecki  
Audit Committee Chair  
State Farm

Kenneth Daly  
President and CEO  
National Association of Corporate Directors

Cynthia Fornelli  
Executive Director  
Center for Audit Quality

Peter Gleason  
Chief Financial Officer and Managing Director  
National Association of Corporate Directors

Mary Pat McCarthy  
U.S. Vice Chair  
KPMG LLP  
Executive Director  
KPMG’s Audit Committee Institute

Larry Smith  
Member  
Financial Accounting Standards Board (FASB)

Mike Starr  
Deputy Chief Accountant  
SEC

Richard Tilghman  
Audit Committee Chair  
Sysco Corp

Rosalie Wolf  
Audit Committee Chair  
TIAA-CREF

Ann Yerger  
Executive Director  
Council of Institutional Investors

Dan Goelzer  
Member  
Public Company Accounting Oversight Board (PCAOB)

Patrick S. McGurn  
Special Counsel  
Institutional Shareholder Services

George Munoz  
Audit Committee Chair  
Marriott International

Chuck Noski  
Audit Committee Chair  
Microsoft

Michael Passarella  
Audit Committee Chair  
Unum Group

David Schwartz  
Audit Committee Chair  
Walgreen

A list of National Audit Committee Chair Advisory Council delegates is provided on page 9.
Executive Summary

NACD’s third annual Audit Committee Chair Advisory Council brought together audit committee chairs from major U.S. corporations with key regulators and stakeholders—including the Securities and Exchange Commission (SEC), Financial Accounting Standards Board (FASB), Public Company Accounting Oversight Board (PCAOB), investor groups, and others—to share views on a range of key issues impacting financial reporting and audit committee oversight.

As detailed in the following pages, this open dialogue highlighted a number of challenges, priorities, and perspectives driving audit committee, regulator, and stakeholder agendas. Among the prominent themes:

- **From the investor perspective**, the 2011 proxy season was relatively positive for directors and boards.
- **The SEC continues to move forward on Dodd-Frank rulemaking.**
- **On accounting changes and convergence of accounting standards**, the SEC reiterated its target of 2011 to decide on an approach to IFRS implementation.
- **Disclosure overload** continues to be a major frustration for all parties.
- **Current PCAOB activities stand to largely impact audit committee** oversight processes.
- **The rapidly changing technological environment** highlights the need for directors to understand information technology (IT) oversight and the associated risks.

The Advisory Council also recommended specific action items, detailed in the document.
2011 Audit Committee Chair Advisory Council

Summary of Proceedings

The following summary has been prepared to capture the spirit of the day’s discussion, as well as key messages and general perspectives. NACD is sharing this summary with audit committee members and the governance community throughout the country to help guide audit committees and inform the ongoing dialogue on important financial reporting, audit, and governance issues going forward.

Participants discussed each of these topics in some detail, with audit chairs, investors, and regulators providing perspectives on the challenges facing audit committees in each of these areas, as well as opportunities to strengthen audit committee oversight.

Investor views and outlook for 2012

Investors view 2011 as a “relatively positive proxy season” for corporations, with no-votes and withhold votes down, shareholder resolutions at a “low watermark,” and generally reduced activism – as reflected in ISS’s final US Postseason Report: ¹

– Investors endorsed companies' pay programs with 92.1 percent support on average
– Proxy contests at U.S. companies fell sharply: Only nine contested meetings went to a shareholder vote during the first half of 2011, compared to 14 and 25 for the same periods in 2010 and 2009, respectively
– Shareholders voted-down management “say-on-pay” proposals at only 1.6 percent of the total Russell 3000 that reported vote results, involving only 38 companies (through September)
– The number of directors at Russell 3000 firms failing to garner majority support fell by nearly half (say-on-pay votes gave shareholders an alternative to votes against compensation committee members).

Areas that did attract increased attention or support in 2011 – including greater frequency of pay advisory votes, board declassification, resolutions on environmental and social issues, and disclosures on corporate political spending – may require increased board focus in 2012.

Indeed, disclosure of corporate political contributions was highlighted as a key area of interest to investors, particularly in light of the Citizen’s United case (affirming the right of corporations to make unlimited political contributions). Investors want to know how much, and by what method, companies are donating to political candidates or causes.

Citing a need for “robust oversight” in this area, some investors are urging corporations to adopt a policy of “no donations” and to resist the pressures of “pay-to-play.” The takeaway for boards, noted one investor representative, is to have a clear policy in place regarding political and charitable donation disclosures.

On the SEC’s radar

An SEC update to the Advisory Council highlighted a number of issues high on the Commission’s agenda with key implications for audit committee oversight – including Dodd-Frank rulemaking on conflict mineral disclosures, executive compensation clawbacks, and median-pay calculations, as well as offshore cash and the use of non-GAAP metrics in SEC filings.

As companies sharpen their focus on the potential impact of Dodd-Frank rules requiring disclosure of “conflict minerals” in their products or supply chains, the SEC still plans to issue final rules in 2011, noting:

- The Commission is not inclined to define how companies assert a reasonable country of origin inquiry (RCOI), but will expect them to show due diligence in RCOI assurance, and may tie RCOI to an existing standard – e.g., OECD or UN Sanctions Committee of Experts standard.
- Auditors could be the provider of RCOI assurance

The “clawback” provision under Dodd-Frank – which would require the recovery of certain executive compensation in the event of a financial restatement caused by error or fraud – continues to be a key area of focus for the SEC. Concerns were raised that restatement issues might not reach the board due to their potential impact on executives’ pay. While not suggesting more “process,” Advisory Council delegates agreed on the importance of ensuring a clear, unambiguous tone at the top and expectation that all relevant facts are considered when making a restatement decision. While oversight of clawbacks can be assigned to a different committee or the full board, it is the unique responsibility of the audit committee to ensure financial accuracy and transparency.

Participants noted that the clawback provision raises some problematic questions:

- Do companies have the systems to implement this?
- What are the metrics being used?
- If earnings per share (EPS) is used, can it create measurement challenges related to shares outstanding, timing, and other inputs to the EPS metric?

These and other “what-if” factors – such as host country regulations, former-employee status, circumstances in which the board might exercise discretion – may prove thorny when implementing the provisions.

The SEC update also touched on an important development related to the calculation of “median pay,” another Dodd-Frank provision. In lieu of potentially expensive, cumbersome calculations to disclose and compare the CEO’s pay with the median pay of the company’s employees, the SEC may consider allowing statistical sampling as a more efficient approach.

In addition to carrying out mandates from Dodd-Frank, the SEC is examining material disclosures regarding cash held offshore as a result of the intention to permanently reinvest the earnings offshore and avoid U.S. tax on unrepatriated foreign earnings. This area is generating considerable scrutiny by regulators and legislators as they consider policies and incentives for repatriation of corporate income earned abroad.

Lastly, the use of non-GAAP metrics in corporate disclosures and other financial information is also on the SEC’s radar: Noting it had “adjusted course” some time ago to be more flexible in allowing for the use of non-GAAP information in SEC filings, the SEC staff is cautioning companies on using non-GAAP metrics too loosely (including measures that are not rational, such as earnings adjusted for significant operating items), or referencing non-GAAP information
outside of its filings – e.g., in earnings statements – with no correlation to its financial statements or reconciliation to GAAP. While the problem is not widespread, the goal of current SEC activity is to dissuade of the use of questionable financial reporting metrics to distort earnings. To this end, as one participant noted, management should explain to the board the process used to calculate the non-GAAP numbers, with the goal of ensuring accuracy, consistency, and reasonableness.

**Accounting changes and convergence**

The SEC is still on target for establishing an approach to **IFRS implementation in the U.S.** by 2011. Citing the May 2011 staff paper that explores a “condorsement” approach to IFRS adoption – in which FASB would cease creating new standards and gradually adopt/endorse IASB standards – the SEC has noted the possibility of an extended transition period – perhaps five to seven years. Part of this gradual process will be to identify and begin eliminating the differences between U.S. GAAP and IFRS – recognizing that not all differences can be eliminated (e.g., LIFO and treatment of R&D expenses).

**FASB’s convergence projects** continue to move forward (in conjunction with the IASB), with a focus on its “big four” projects: revenue recognition, lease accounting, financial instruments, and insurance accounting. Of the four projects, lease accounting – as one of the largest off-balance-sheet items for companies – is likely to have the greatest impact on corporate accounting, while changes to revenue recognition standards are likely to impact certain industries (e.g., telecommunications) more than others.

Auditors emphasized the need to consider the potential **impact of accounting changes on IT systems.** For example, changes related to lease accounting are expected to have a large impact on corporate IT and financial reporting systems. In order to avoid “Y2K-like scrambles,” Advisory Council delegates discussed that both audit committees and management should begin identifying what the company needs for implementation – including processes and resources.

**“Disclosure overload”**

The Advisory Council as a group expressed frustration and concern about the volume of disclosures required in SEC filings. Participants noted the ongoing problem of “disclosure overload,” which is compounded by the widespread use of boilerplate disclosures and driven largely by the fear of litigation. “Telling investors that ‘if the company doesn’t sell products its performance could suffer’ doesn’t tell them anything, really.”

The Advisory Council discussed two current projects aimed at analyzing and “rationalizing” disclosures that may help:

- FASB is conducting an analysis of existing disclosure requirements to develop a “disclosure framework” for issuers to consider.
- KPMG and the Financial Executives International (FEI) Research Foundation recently published Disclosure Overload and Complexity: Hidden in Plain Sight – a study of “disclosure expansion over the last six years” with recommendations to address disclosure overload.

**PCAOB proposals to enhance auditor independence and skepticism**

The PCAOB has a number of initiatives underway that have potentially significant implications for auditing and audit committee oversight, including possible changes to the auditor’s traditional “pass/fail” reporting model and mandatory audit firm rotation – both of which
generated a robust dialogue. Specifically, participants discussed the scope and usefulness of information conveyed in the typical audit committee report, as well as the pass/fail auditor’s report.

To enhance audit transparency and narrow the “expectations gap” about what an audit does and does not achieve, and about the activities of the audit committee, there was general agreement that a more robust audit committee report – describing in more detail what the audit committee does – would be beneficial. However, the scope of an expanded audit committee report may be limited to what corporate counsel is comfortable saying in the proxy.

- **Action item:** NACD will develop guidelines for an expanded audit committee report, which can be used as a framework to be considered and customized by audit committees.

Participants also commented on the alternatives to the current auditor’s reporting model that are explored in the PCAOB proposal:

- An “auditor’s discussion and analysis” (AD&A)
- Emphasis paragraphs
- Auditor assurance on information outside of the financial statement (e.g., MD&A, non-GAAP information, earnings releases)
- Clarification and additional information about the auditor’s standard report.

Audit chairs expressed several concerns about a separate auditor’s AD&A, including the issue of dueling disclosures and the potential for confusion that could arise in reporting on nuanced decisions in the financials – areas not easily explained in just a few paragraphs. Participants discussed the merits of alternatives to improving transparency, including using an emphasis-of-matter approach or clarifying language in existing disclosures.

The discussion also extended to a broader issue: while Sarbanes-Oxley generally improved the quality of audits, many outside of the boardroom still do not fully understand what the audit does and does not do. To this end, the auditor’s standard report might be further developed to provide more fact-based information about the audit and procedures performed.

The concept of mandatory audit firm rotation – another alternative under consideration by the PCAOB to enhance auditor independence and skepticism – generated a largely negative response from the director community. While participants generally agreed that gaining a better understanding of the costs of audit firm rotation is an important part of the dialogue, the current PCAOB proposal does not take into account the challenges and concerns related to getting new auditors up-to-speed about the business and implementation of mandatory rotations – particularly for global organizations.

Roundtable participants discussed the methods available to audit committees to help advance regulators’ overarching goal of improving audit transparency, and audit committee chairs were encouraged to share their views and comments with the PCAOB in writing (even if the formal comment period has closed), and in person (scheduling meetings with PCAOB representatives).

- **Action item:** NACD will identify/facilitate opportunities for audit committee chairs to meet with the PCAOB and exchange views on a more regular and proactive basis.
Attendees also expressed desire for more communication and transparency about the PCAOB inspection process and the significance of inspection findings. As the PCAOB is precluded by law from sharing certain inspection results with the audit committee, various Advisory Council delegates – including auditors and audit chairs – emphasized the importance of audit committees having robust discussions with the auditor about the results of a PCAOB inspection.

**IT risk and emerging technologies**

Noting the 2011 KPMG Audit Committee Institute survey finding that “IT risk and emerging technologies” is the top issue that audit committee members want to devote more time to over the next 12 months, attendees discussed the significant – and accelerating challenge – of effectively overseeing IT risk and governance.

Boards (often with the audit committee taking the lead) are delving deeper into the risks posed by IT and emerging technologies that are transforming the business landscape, from cloud and social media to mobile devices and data analytics. “Defensive” IT risks, such as data security and privacy, compliance, business continuity, and the integrity of financial reporting systems are in the forefront; but boards are also increasingly concerned about strategic IT risks – i.e., risks posed by the failure to leverage technology to innovate and build competitive advantage.

The challenge of instant communications – and the need for companies to be communications-ready – was highlighted, as was the difficulty of assigning oversight responsibilities for new and emerging areas of IT risk. For example, social media has created a new set of cross-departmental risks, involving marketing, HR, IT, legal, and investor relations. As a leading practice, companies are putting “governance frameworks” into place – for IT, data, and social media – to help manage and oversee IT and data, both as a risk and an opportunity.

In the same KPMG survey, audit committee members identified the CIO as the person in management they most want to hear from more frequently; and most respondents said their company’s strategic planning process did not effectively address the impact of technology innovation and change on the company. To help visualize the scope of the IT risk-oversight challenge, audit committees may choose to review a sample IT Risk Committee charter. (Similarly, reviewing recent guidance from the SEC’s Division of Corporation Finance on cybersecurity disclosures may help provide a fuller picture of the implications of IT risk.)

Summing up the IT discussion, one audit chair said, “Any board that’s not focused on this is missing the boat.” And most agreed on the need for some level of IT expertise on the board – both by virtue of new directors, but also through increased knowledge and awareness among current directors.

- **Action item:** NACD will develop an online, board-level educational resource to help directors better understand – and stay apprised of – IT risks and emerging technologies.

**Exercising skepticism and encouraging constructive debate**

How can audit committees and boards establish the right climate of constructive dissent in the boardroom and ensure that directors are appropriately challenging the information they receive from management and others? Following a recap of key findings in the recent study, *Bridging*
Board Gaps, the Advisory Council turned to this issue of board skepticism: Is it a widespread problem? And what are the keys to exercising healthy skepticism?

While some participants expressed surprise that constructive skepticism would be an issue on any board, as it is a substantial part of the director’s role, other participants emphasized the need to stay vigilant and maintain a culture that challenges management appropriately. Particularly important is the need for directors to hear viewpoints from those below the C-level, as they often bring a different perspective than what is heard in the boardroom.

Regarding auditor independence and skepticism, participants noted the difficulty of challenging the auditors. Using executive sessions effectively and meeting with the auditor informally, outside of regular meetings can be invaluable solutions. While informal meetings can provide additional nuance, in formal meetings the auditor should provide views and perspective, not simply “We did the audit, and it complies with accounting standards.”

Asymmetric information risk

Management, naturally, has far more information than directors do about the company’s performance, operations, risks, and strategy – and that presents a challenge for directors in terms of being able to probe and challenge and hear dissenting views.

Recognizing that information prepared and presented by management can dominate the boardroom agenda and dialogue, attendees discussed the ongoing challenge of “asymmetric information risk,” as well as clues or indicators of when this risk is too high. While clearly a full board issue, audit committees – given their inclination to view information through a “risk lens” – may be in the best position to monitor this issue.

The group discussed what actions would be meaningful countermeasures to asymmetric information risk, with much of the dialogue focusing on the importance of bringing third-party information and “dissenting views” to the board. Options discussed included:

- Enlisting the viewpoints from not just outsiders, but also those who are critics of the company
- Appropriately questioning and testing the views of the company’s leader—the CEO
- Listening to investors, on why they invested – or did not invest – in the company
- Gaining the perspective of a sell-side analyst – what they like and don’t like about the company
- Gathering comprehensive benchmarking data on industry trends, competitor trends, etc., to better understand whether the company’s own practices, risks, and strategy are appropriate. The external auditor may also be a source of independent information on industry trends and benchmarking.

Concluding Observations – and Continuing the Dialogue

The Audit Committee Chair Advisory Council provides an important opportunity for dialogue around critical challenges facing corporations and their investors as well as some of the approaches boards, regulators, standard setters, and auditors are taking to help ensure financial reporting integrity, effective governance, and long-term corporate performance. From a

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2 Bridging Board Gaps: Report of the Study Group on Corporate Boards, 2011, Columbia Business School, the Weinberg Center for Corporate Governance, University of Delaware
practical, “how-to” perspective, sharing evolving practices is a clear benefit of the session; as one attendee noted, “I always leave with three or four good ideas to bring back to my audit committee.”

The 2011 meeting raised awareness of timely and emerging issues shaping audit committee and board oversight, as well as expectations of investors and regulators – from IT risk and PCAOB proposals that could fundamentally change audit reports and the role of the audit committee, to compensation clawbacks, conflict mineral disclosures, and “disclosure overload.”

One participant observed that “perhaps one of the most valuable outcomes of this year’s meeting was recognizing the importance of ongoing conversations among audit chairs and key stakeholders – particularly the PCAOB.”

NACD believes that the frank, open dialogue facilitated by this Advisory Council is vital to advancing the common goal of all boards, investors, and regulators: a sustainable, profitable, and thriving Corporate America. We invite all Fortune 250 audit committee chairs and other interested stakeholders to join us in this dialogue.

**NACD Action Items**

As referenced in this paper, NACD identified three action items stemming from the dialogue to help advance audit committee practices and address common objectives of Advisory Council representatives:

- Identify/facilitate opportunities for audit committee chairs to meet with the PCAOB and exchange views on a more regular and proactive basis
- Draft a model/template for an “expanded audit committee report”
- Develop a board-level educational resource to help directors better understand – and stay apprised of– IT risks and emerging technologies
Recommended Readings

PCAOB Initiatives

PCAOB Docket 037: Concept Release on Auditor Independence and Audit Firm Rotation

NACD Comment Letter on Possible Changes to Auditor’s Reporting Model
http://www.nacdonline.org/Resources/Article.cfm?ItemNumber=4006

PCAOB to Consider Proposing Amendments to Improve Transparency through Disclosure of Engagement Partner and Certain Other Participants in Audits
http://pcaobus.org/News/Releases/Pages/10062011_OpenBoardMeeting.aspx

IT Risk

Don’t Forget the Offensive Side of IT Risk
http://www.directorship.com/don%e2%80%99t-forget-the-%e2%80%98offensive%e2%80%99-side-of-it-risk/

Taming Information Technology Risk: A New Framework for Boards of Directors
http://www.nacdonline.org/Resources/Article.cfm?ItemNumber=3332

SEC Corporate Finance Guidance: Topic No. 2 Cybersecurity, October 13, 2011

Social Media: Time for a Governance Framework
http://www.directorship.com/social-media-time-for-a-governance-framework/

Governance Trends and Practices

Bridging Board Gaps: Report of the Study Group on Corporate Boards

KPMG’s 2011 Audit Committee Member Survey – Highlights

2010 Annual Audit Committee Chair Advisory Council – December 19 Washington DC
http://www.nacdonline.org/Resources/Article.cfm?ItemNumber=3207

What to Ask Your Company’s Auditors – Robert Pozen, HBR Blog

Disclosure Overload and Complexity: Hidden in Plain Sight
### National Audit Committee Chair Advisory Council Delegates

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<tr>
<th>Name</th>
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<tr>
<td>Charles Adair</td>
<td>Tech Data Corp.</td>
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<td>Daniel Akerson</td>
<td>American Express Company</td>
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<td>Thomas Corcoran</td>
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<td>Brenda Gaines</td>
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<td>Daryl Henze</td>
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<td>Denise O'Leary</td>
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<td>Carol Tome</td>
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<td>Hatim Tyabji</td>
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<td>Sandy Warner</td>
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