

Southwest Audit Committee Network

March 2019

SWACN

SUMMARY of THEMES

Critical audit matters (CAMs), major transactions, and special investigations

Members of the Southwest Audit Committee Network (SWACN) gathered on February 13, 2019, for discussions on CAMs, oversight of major transactions, and special investigations. This *Summary of Themes* synthesizes those discussions.¹ *For a full list of meeting participants, please see list on page 7.*

Members also discussed the US Securities and Exchange Commission's (SEC's) request for comment regarding quarterly reporting, including the nature, content, and timing of earnings releases and quarterly reports.² We will hold similar conversations on the request for comment with other networks and share the results separately.

CAMs

Members were joined by Carlo Pippolo, EY's professional practice director for the Southwest region, for a discussion about critical audit matters (CAMs). In June 2017, the PCAOB adopted a new auditor reporting standard intended to make the auditor's report more relevant and informative for investors and other stakeholders. Audit firms are in the midst of preparing for the change by performing pilot programs for their large accelerated clients. Mr. Pippolo noted that in addition to the pilot program, the firm is preparing for CAMs by comparing notes internally and meeting periodically with other audit firms and regulators to help align their understanding of the requirements of the new standard. Mr. Pippolo observed an average of approximately two CAMs for most companies across the pilot program, though the number varies depending on the entity and industry. As audit firms continue their CAM pilot programs, members discussed a few other key observations:

- **Industry similarities.** CAMs will likely be similar within specific sectors; for example, you might see CAMs related to reserves for oil and gas companies or business combination accounting or goodwill impairment for companies that have been particularly acquisitive.
- **Outlier concerns.** Some members shared concerns that being an outlier may draw unwanted attention. One member said, *"That could create a red flag, right? If most energy companies have three but you have four, all of a sudden the fourth one is going to be getting a lot of attention."*
- **Expectations of consistency.** Members wondered whether there is an expectation from regulators that companies come up with at least one CAM every year, and whether CAMs

should have a level of consistency from year to year. Mr. Pippolo added, *“One challenge we’re facing is there are situations where even when we do find one or two, they’re specific to a transaction that happened this year. What if the company doesn’t do a transaction next year?”*

- **Audit committee response.** A member asked, *“What does the PCAOB [Public Company Accounting Oversight Board] expect from the audit committee response? The firm is obligated to present CAMs to us; what are the expectations of the audit committee in terms of its oversight in response to that?”* Mr. Pippolo highlighted that nothing in CAMs should come as a surprise to the audit committee because CAMs are supposed to relate to matters that have already been conveyed to the committee and often have already been disclosed by companies in their critical accounting policies and estimates. As such, he advised members to focus on why the CAMs were selected and shared two questions audit committees should be asking: *“First, how consistent are the CAMs with the auditing approach described in the materials? And second, is there anything in the CAM disclosure that is new and is not disclosed elsewhere? Our expectation to our firm is that this will not happen.”*

Major transactions

Following a period of decline in the wake of the financial crisis, the M&A market is back in full force. Global total deal value in the first nine months of the year eclipsed any such period since before the financial crisis, an increase of 39% over the same period in 2017.³ To discuss oversight of major transactions, members were joined by Mark Copeland, EY’s transaction advisory services managing partner for the southwest region, and Mark Wallace, executive vice president, chief financial officer, and treasurer of Uniti Group, a real estate investment trust engaged in the acquisition and construction of mission-critical communications infrastructure.

M&A strategy in the current economic environment

Several members observed the active M&A market is in part being driven by an increase in private equity spending. One member said, *“We’ve seen a huge change in our sector in terms of private equity. They’re often bidding up the price of deals.”* Such an active market can bring inherent risks, Mr. Wallace said: *“Multiples are going up, sellers of assets are demanding less and less diligence. So, if you want to win a deal you will be asked to truncate the amount of due diligence you are able to perform.”* Members emphasized that deals should adhere to an M&A strategy, and they discussed the role the board plays in setting the strategy to frame deals:

- **Boards and management establish strategy together.** Members largely agreed that strategy setting should be a collaborative process between boards and management. One member said, *“We don’t look at strategy as an event, we look at it as a process. It never*

ends. We have the annual conversation, but you also have advisors coming in all year giving information about markets and other things that may shift strategy.”

- **Divestitures are part of the strategy.** As the market continues to drive asset prices up, companies are increasingly looking to sell. *“Many companies are completing annual portfolio reviews to identify non-core assets for potential divestment in an effort to generate capital for other strategic initiatives,”* said Mr. Copeland. Several members noted that divestments are a key part of M&A strategy that should be addressed continually by the board. One member said, *“Sometimes this is an area you have to push management to look at the full portfolio and identify some areas that are not performing or that you’d like to move away from.”*

Pre-deal activities and due diligence

Once a company begins to focus in earnest on a specific target, members broadly agreed that the audit committee tends to get more involved in specific due diligence areas like the quality of financial controls, contingent liabilities, and tax issues. A member explained why involving the board in due diligence is crucial: *“As management you can get too close to it and miss something, so the board’s role is to take that step back and maybe say that it doesn’t make sense right now or it’s too expensive.”* Mr. Copeland advised boards to push management to explain a concise transaction rationale early in the due diligence process: *“A healthy dialogue surrounding the value that is expected to be created from the target transaction is critically important for the board. Management should be prepared to share and support the transaction rationale for doing this deal. Understand the transaction rationale and then set up due diligence to address each of those areas.”*

- **Getting a full view.** For the board to make a proper assessment, it is crucial to get a full and unbiased view of the proposed transaction. Mr. Wallace said, *“Over my career I have seen in many cases acquisitions being presented to boards in the most positive light possible. The board shouldn’t get all of their information from the CEO or CFO; it should hear from all the functional areas involved and assess believability, transparency, and accuracy.”*
- **Retaining talent.** An important aspect of due diligence is often keeping key talent, noted several members. *“We’re looking to acquire small startups that have developed unique capabilities. Our issue is often figuring out how to retain these entrepreneurs beyond the next three years or so,”* one member said.
- **Scrutinizing cultural fit.** Members said that the board should try to assess the culture of the target company and consider how the two cultures will fit together. A member said, *“Culture to me is one area where the board overall has to work together to make an assessment, but it’s not a science.”* As more acquisitions of small startups occur, one

member asked, *“How do you integrate these highly entrepreneurial entities without losing the value?”*

Integration, monitoring promised value, and lessons learned

Several members agreed that the audit committee takes a more prominent role after an acquisition has been made, overseeing integration and monitoring promised value.

Integration

Before a deal is made, it is important to establish an integration plan that has been reviewed and approved by the board. Mr. Copeland said, *“The earlier you start the integration planning process, the more successful you will be.”* He added that the post-deal integration plan should line up with the transaction rationale presented to the board earlier in the process.

Monitoring promised value

Members said that boards should work with management to establish key performance indicators to be tracked. A member said, *“You made your decision based on certain criteria, whatever those factors were, they need to be a very key part of the post-deal. Management should be reporting out about those key factors either quarterly or semiannually.”*

Several members said monitoring promised value is an area where the audit committee will often take a leading role. However, one member cautioned, *“You have to be careful about the audit committee taking extra responsibilities that pull them away from their actual purview. It’s a full board’s role to oversee strategy. You need to be very careful and intentional about what the audit committee’s role is.”*

Perform root cause analysis on successful and failed transactions

Despite best efforts by boards and management, getting the most out of transactions remains a challenge. A member said, *“You need to understand and track those decision-making factor areas, because if they don’t work out, you may think differently about those factors going forward or learn lessons on how to do it better next time.”*

A few members said that, in addition to monitoring promised value, their companies have performed “post-mortems,” or lookbacks on failed transactions, to get a better understanding of what went wrong or what could be done better in the future. One member said, *“We did one and it was very instructional for the management team. It really spoke to the diligence approach and the team they used and assumptions they made, really falling in love with the deal.”* Mr. Wallace noted that post-mortems can reveal major deal risks that may have been underestimated and that the company should be wary of in the future.

One member suggested that post-mortems can present an opportunity to rethink ongoing strategy for a recent acquisition: *“We did a post-mortem and it really informed the management team about readdressing why they took some of the approaches they did.”*

Taking that step back, they saw an opportunity to double down efforts and go back after those markets. Through that process, they were able to identify different revenue streams.”

Special investigations

Oversight of special investigations is an unenviable but crucial role for boards and audit committees. John Wander and Vanessa Griffith, partners from the law firm Vinson & Elkins, joined members to discuss special investigations and best practices for board oversight in this area.

Initiating an external investigation

Deciding whether an investigation should be handled externally is a critical challenge for boards. Mr. Wander said that for boards to effectively make this decision, they must assess materiality and who the investigation is ultimately intended to satisfy. Outside counsel would typically be engaged for situations that are materially significant and for investigations intended to eventually address regulatory or government bodies like the SEC or Department of Justice. Mr. Wander added, *“Seeing the chess moves and where the pieces could fall is critical. It may start out being okay to use your inside counsel, but it could end up in a place where that doesn’t work.”* Ms. Griffith added that, in investigations involving allegations of employee misconduct, the environment has shifted in recent years: *“The inputs have changed, the materiality definition has changed. Employment cases are just different. The risk calculus is different and it can very quickly become a public relations nightmare.”*

Overseeing the investigation

Members and guests described some good practices for board and audit committee oversight during an investigation:

- **Selecting independent counsel.** Mr. Wander advised members to think broadly about their professional network when searching for an outside counsel: *“Call the other directors you know, people you know that have dealt with investigations and received good independent counsel. You can also ask your external auditor—they work with a lot of law firms and can provide beneficial insight.”*
- **Keeping necessary parties informed.** Throughout an investigation, it is important to keep the full board abreast of developments. Mr. Wander recommended the practice of hosting board update calls, which allow the outside counsel to answer any questions the board may have. Keeping the external auditor abreast is often crucial, as well. Mr. Wander said that he will often meet with the auditor to show his notes and answer questions, but will avoid sharing documents due to the lack of privilege between external counsel and an independent auditor.
- **Limit scope creep.** In response to member concerns about scope creep. Ms. Griffith shared a recommendation to limit this risk: *“Ask early on what their investigation plan is.”*

Things can change and evolve, of course, but it's good to level-set. Then, if things start to go in a different direction, you can ask them to explain what happened to the original plan and what changed." A member agreed, adding, "You really need to ask those questions. Be engaged and ask why certain things are happening and whether they're critical to the investigation."

Closing an investigation

Members and guests discussed the challenges surrounding the decision to close an investigation. One such challenge is deciding whether to self-report the findings of the investigation to a regulatory, entity such as the SEC. Some members noted that their companies have protocols in place regarding self-reporting. Mr. Wander shared a degree of skepticism regarding the benefits of self-reporting, but added that cooperation with regulators and government bodies is important and *"can definitely score you some points."*

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Meeting participants

- Kathleen Cooper, Alumna
- Gayla Delly, Flowserve
- Barbara Duganier, Buckeye Partners and MRC Global
- John Gallagher, Kraton Corporation
- Cindie Jamison, Darden Restaurants
- Gil Marmol, Foot Locker
- Barry Pearl, Magellan Midstream Partners
- Peter Ragauss, Williams Companies
- Frank Risch, Pioneer Natural Resources
- Bill Schumann, McDermott
- Jack Taylor, Murphy USA
- Billie Williamson, Cushman & Wakefield

EY was represented by the following:

- Randy Cain, Vice Chair and Southwest Region Managing Partner
- Scott Hefner, Southwest Region Managing Partner of Markets and Accounts
- John King, Southwest Region Assurance Managing Partner

Endnotes

¹ *Summary of Themes* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

² "The request for comment solicits public input on how the Commission can reduce burdens on reporting companies associated with quarterly reporting while maintaining ... disclosure effectiveness and investor protections. In addition, the Commission is seeking comment on how the existing periodic reporting system, earnings releases, and earnings guidance ... may foster an overly short-term focus by managers and other market participants." US Securities and Exchange Commission, "SEC Solicits Public Comments on Earnings Releases and Quarterly Reports," press release, December 18, 2018.

³ Eric Platt, "[Global M&A Activity Hits New High](#)," *Financial Times*, September 27, 2018.