Central Audit Committee Network

April 2018

CACN

SUMMARY of THEMES

Enterprise risk management, tax reform, and the macroeconomy

At the March 21, 2018, meeting of the Central Audit Committee Network (Central ACN) in Chicago, members and guests shared approaches to enterprise risk management (ERM) and discussed two factors affecting the current business environment: tax reform and the US macroeconomic outlook.

Growing more mature risk management processes

Boards strive to ensure that risk management is robust, comprehensive, and strategically focused. Joined by Dan Cullen, a senior risk advisory partner at EY, and Jennifer Van Aken, assistant treasurer, corporate finance, and ERM leader for GATX, members discussed ways to improve the maturity of a firm's risk management program.

Mr. Cullen told members, *"There are widely varying applications of ERM concepts. Some are very basic—they identify the top 10 risks to share with the board. Some are moving toward a 'protect and grow' mentality—ERM processes are there to protect assets but also allow you to take on risks that enable you to grow."* Members suggested that the general level of ERM maturity needs improvement, with one saying, *"We have a long way to go … It is early days, but my boards are having heated discussions about why we are at early days."*

While preventing or mitigating risks is central to ERM, members emphasized the need to move beyond simply identifying and reducing risks to building ERM processes that foster strategic opportunities. One commented, *"The better the brakes, the faster the car. If you have better ERM, you can afford to take bigger risks than the competition. How do you get that?"*

A critical concern: establishing a culture of risk awareness and systematically engaging the entire organization—from the board and senior executives through the front line—in risk management. One member said, *"One thing that always disturbs me is that while at the higher end of the organizational chart they are sensitized to risk, if you move down the chart, people say, 'It's not my job, we have internal audit,' etcetera. It doesn't seem to be a culture."*

The discussion identified practices that could lead to more robust ERM programs:

- **Support from top-level management.** Ms. Van Aken emphasized that for the growth of GATX's risk management processes, *"it has been huge to have the support of the CEO, which contributes to the credibility of the program."* She also pointed to the benefits of having the audit committee's support of the ERM program and including the CEO and the

CEO's direct reports on a management risk committee. Mr. Cullen agreed: *"Effective programs have senior-level reporting responsibilities, making sure everyone cares about it. It cascades through the organization. The question is, does it become the fabric of how we do what we do, or is it just an exercise?"*

- **Clear lines of ownership throughout the organization.** One member's firm assigns risk ownership to group presidents, which helps communicate *"the concept that the enterprise and all the business units are focused on what can go wrong and what we can do about it."* Ms. Van Aken said it is also important to assign executives within the business lines to own particular risks in order to *"get the response and responsibility [for risk] down into the various levels of the organization and give them a sense they have a part to play."* The business owners of risks periodically present to audit committee or to the full board, which is, according to Ms. Van Aken, *"a tremendous motivator"* for business owners to take their risk management responsibilities seriously.
- **New risk assessment tools.** Members noted various ways to move beyond heat maps to more robust reporting tools. Multiple members expressed the value of dynamic reports that describe changes in risk probabilities, risks that have been added or dropped, and the reasons for those changes. Interviews and surveys can identify additional risk information. Ms. Van Aken reported that GATX annually *"does risk assessment interviews and surveys to find top risks identified through the organization."* They then examine the *"top risks identified through that process compared with the heat map identified by top management. Where there are differences, we ask why. Does it warrant more discussion?"* Members expressed a desire for better benchmarking against industry peers. One said their board asked, *"How do we compare with peers? It's in every one of our meetings."* The member acknowledged that it can be *"hard to come by some of that data."*
- **Developing the resilience and agility to respond to unpredictable events.** Another critical aspect of strong ERM is an organization equipped to respond to wildcard risks, whose severity or frequency cannot be anticipated. One member said that for those types of risks, the question becomes, *"How resilient is the company? How agile are we at identifying, responding, mitigating, and controlling these risks?"* The member added, *"We try to imagine what the scenario could be and say, 'We didn't plan for that, so we'll figure out how to respond.'"*

Tackling the challenges of implementing tax reform

Headline elements of the 2017 tax reform legislation seem to provide a straightforward benefit to US corporations. However, implementing those changes entails significant complexity, and the interconnectivity of various provisions may generate unintended consequences if not carefully modeled and considered. Members were joined by Marna Ricker, EY's central region tax managing partner, and recently announced as America's Vice Chair of Tax – Elect, who pointed out, *"The devil is in the details."* Complexities include the following:

- **The one-time transition tax on foreign deferred earnings.** Ms. Ricker noted that the transition tax associated with the move to a territorial system has been the immediate and largest source of implementation effort stemming from the reform bill. Determining the tax requires calculating historical deferred foreign earnings and tax payments. Ms. Ricker said, *"Certain provisions of the new law requires companies to keep track of new data. Those data sources and controls over such sources will be important. Specific to the transition tax, depending on the historical relevance of earnings and profits to the financial statements, not every company kept records and made appropriate adjustments at the level of detail required, and therefore, these calculations may require significant additional work."*
- **Complications in the move to a territorial system.** While shifting to a territorial system means that, in general, future foreign earnings will not be subject to US taxation, the reform bill introduced new provisions that impose current US tax on offshore earnings, most notably the Global Intangible Low Taxed Income ("GILTI") provisions. The new provisions were designed to ensure that corporations pay a minimum amount of tax on offshore foreign earnings. According to Ms. Ricker, the application of these provisions seems to have generated the greatest unintended consequences thus far and they are therefore most likely to be subject to technical corrections.
- **Lack of regulatory guidance.** Regulations and technical corrections have been slow to emerge because regulators lack clarity on the intentions of the legislation and because of capacity constraints in the IRS. Ms. Ricker advised audit chairs to ensure companies have a baseline calculation in place and a path and plan to monitor forthcoming guidance to allow for sufficient time to reflect such guidance in their financial statements. She expects state and local tax policy to evolve over the next year or so.
- **Impact on valuations and transactions.** The tax reforms fundamentally change the economics of deal making by complicating the tax effects on transactions. One participant noted that the reform is *"widening the bid-ask spread because sellers are using the 21% rate as permanent, but buyers are saying, 'I'm not so sure.' The change makes companies look more valuable, which is making it harder for deals to get done."*

The new legislation will force organizations to build in new competencies and capacities. As one member put it, tax organizations *"need to start thinking small where they have been thinking big. They haven't had to worry about blocking and tackling for a while. We've had a stable environment for a long time. Now, to say it's unstable would be an understatement."* Ms. Ricker summed up the challenge: *"We have thousands of experts spending full time digesting and applying these new rules, and we have as many questions as answers as guidance unfolds."*

She told members, *"Boards should use a materiality threshold in looking at these new provisions. Ask which of these provisions are really impacting your company – and prioritize*

those provisions in the expanded workload for both financial reporting purposes and for the broader business implications in both the functions and the global business units." One member reminded the group, *"Most control material weaknesses arise on the tax side."*

Assessing the macroeconomic environment

Over dinner, Robert Aliber, professor emeritus of international economics and finance at the University of Chicago Booth School of Business, led members in a discussion of the macroeconomic climate. He began by noting that the US economy shifted from being the largest creditor nation in the world in 1980 to the largest debtor today. The United States has seen four dollar-asset cycles since 1980. Such cycles begin with an expansive phase, when foreign investment dollars flow in, driving up the price of the dollar and leading to rising real estate and securities prices. Each peak is followed by a contractive phase, when these inflows slow, leading to a price decline in both the dollar and US stocks.

The price of the US dollar peaked in December 2016, suggesting that a transition from the expansive to the contractive phase is now underway and that the US equities market is heading for a downturn. Mr. Aliber suggested that the economy is facing a *"perfect storm: Inflation is creeping up. The deficit is going up due to the fiscal policy, leading to an increase in the interest rate. There is the unwinding of QE2 [the Federal Reserve's second round of quantitative easing]. Investor demand for US dollar–denominated securities will dry up, and rising interest rates will tank the market."*

He asserted that the trade deficit, which went from nothing in 1980 to $800 billion today, has been driven by other countries buying US securities to hold down the value of their currencies while the United States has not intervened in the same way. Some members argued that the primary driver has been the relative productivity of the United States and its international competitors. Whatever the cause, Mr. Aliber said that the trade deficit had contributed 3 million of the 8 million manufacturing jobs lost by the US economy since 1980. Members also pointed to job losses due to robotics and artificial intelligence.

About this document

The Central Audit Committee Network is a select group of audit committee chairs from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

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Meeting participants

- Anne Arvia, GATX
- Pat Condon, Entergy
- Dick Gabrys, TriMas
- Rick Navarre, Civeo
- Neil Novich, Beacon Roofing Supply
- Ingrid Stafford, Wintrust Financial
- Steve Strobel, Newell Brands
- Phoebe Wood, Invesco
- Donna Zarcone, Cigna

EY was represented by the following:

- Julie Boland, Vice Chair and Central Region Managing Partner - Elect
- Rich Bonahoom, Partner, Business Development Leader, Central Region