Northeast Audit Committee Network

October 2018

NEACN

SUMMARY of THEMES

Dialogues with the PCAOB and SEC, and on director liability

The Public Company Accounting Oversight Board (PCAOB) has been moving forward under new leadership, working on a fresh strategic plan for the next several years and initiating organizational changes to help it implement that plan. At the same time, directors are focused on liability issues in light of recent, highly publicized corporate scandals. On October 1, 2018, Northeast Audit Committee Network members met in New York City to discuss new developments at the PCAOB and Securities and Exchange Commission (SEC), as well as current trends in director liability.

An important inflection point for US audit regulation

EY's Bridget Neill spoke about recent developments at the PCAOB and SEC, followed by a separate, off-the-record, dialogue with PCAOB chairman William Duhnke and SEC deputy chief accountant Marc Panucci. The following notes reflect only the conversation with Ms. Neill.

Members were interested to learn how the PCAOB and SEC are driving coordination and collaboration across their organizations. Ms. Neill noted that, *"The PCAOB and SEC are well engaged and have a very healthy relationship right now."* She said that this NEACN meeting with Mr. Duhnke and Mr. Panucci is quite timely, as it coincides with the PCAOB's publication of its draft strategic plan and review of the organization, which is undergoing a *"tremendous change in leadership."* In addition to the PCAOB's new board, all prior division leaders have departed the organization and the Board is in the process of identifying successors. Ms. Neill also commended PCAOB leaders for the stakeholder engagement they conducted in conjunction with the strategic plan, including a public survey and interviews with public accounting firms, investors, and others.

Several issues dominated the conversation:

- **Improving the PCAOB's inspections and reporting processes.** Members were curious to learn if and how the PCAOB inspection process will evolve. One member said, *"In the spirit of prevention, I have heard there may be a shift in the inspection process to focus more on the audit firm's quality control processes and less on engagements?"* Ms. Neill informed members that this may be one consideration on the table for the PCAOB. Members also offered suggestions for improving the inspections and reporting processes. Many agreed with one member who said, *"There has been a disconnect between the PCAOB's definition of a deficient audit and that of the audit firms. Audit quality has really improved, but that is* *not the sense you get from reading a PCAOB report and seeing 30% failures. I would suggest some type of ratings scale to get these results more in sync."* Another member did not find past reports helpful, mainly because, *"they were very late and no longer relevant. Timeliness should be a major focus area."*

- **Keeping up with technological change in the audit profession.** Members were interested in learning what the PCAOB is doing to equip itself for the significant digital transformation of the audit profession and the new risks created by innovation. Ms. Neill shared that the PCAOB is engaged and focused on what the firms are doing and on the talent that they and the firms need to maintain audit quality and drive further improvements. Members feared the PCAOB would struggle to keep up with the rapid pace of change; one member suggested that the big audit firms should help to bring their regulator along: *"The accounting firms have more resources than their regulator and are trying to accomplish the same goals of increased efficiency and audit quality. I think a model of collaboration between the two would work well here."* One member noted concerns with this approach, stating, *"The PCAOB persona is that of an inspector, and that is not the dynamic for a collaborative model. A change in culture would be critical in order for this model to work."*

- **Developing Audit Quality Indicators (AQIs).** Ms. Neill observed how in 2015, the PCAOB published a concept release for AQIs and noted how since then several firms have experimented with their own AQIs, using them at the firm level increasingly within external audit quality reports and at the engagement level in discussions with audit committees. Supporting the development of AQIs, one member commented, *"As an audit committee chair, it would help if I could better understand what was contributing more often to the audit failures. So, when we look at AQIs, the PCAOB is in a unique position to see the work of all of the firms and can be a real contributor and catalyst to ensuring we are asking the right questions."*

- **The reporting of critical audit matters (CAMs).** CAMs disclosure requirement will come into effect during 2019 for large accelerated filers. External auditors are doing dry-runs with companies and audit committees this year, to provide an opportunity for early quality control. Some members expressed concerns about CAMs, with one saying, *"As an audit committee chair, my fear is not so much what will show up on the list of CAMs, but rather what will happen if the regulator says they expect every company to have at least four of these and then the firms will respond by saying every audit partner needs at least four on every engagement."* Others shared positive experiences with the process. *"I was skeptical when the rule came out, that it could cause issues, but there were no big surprises when we went through our dry-run. There was a reasonable timeframe for implementation and the process went well,"* one member said. Another added, *"There was some initial concern that CAMs would prohibit conversation with external auditors, but I have not found that to be the case at all."*

- **Engaging with audit committees.** Ms. Neill said that the PCAOB and SEC appear willing to engage with external stakeholders such as audit committees: *"They want to work with audit committees and to know the type of information that would be helpful to audit committee chairs in their oversight roles."* Members were enthusiastic to hear about the PCAOB's enhanced focus on engagement opportunities.

Intensified board scrutiny focuses attention on director liability

Boards are under a great deal of scrutiny in today's corporate governance environment, with a complex set of issues creating new risks for brand damage. NEACN members were joined by Rodgin Cohen, senior chairman, and Melissa Sawyer, partner, of Sullivan & Cromwell to discuss trends in director liability. *"The laws around directors' duties have been very stable for a long time now. So, while we are seeing more scrutiny surrounding the role of directors, with social media and 24-hour news cycles, we are not seeing a fundamental shift in the bases for director liability coming out of state law,"* said Ms. Sawyer. One critical change, however, is that tolerance levels for misbehavior have changed. One member said, *"Tolerance levels for behaviors that may have been accepted before are not now, and social media has helped because it has empowered a lot more people to step up and speak out on issues. It is no longer okay to brush things under the rug."*

Many areas of director liability risk were discussed, including:

- **Workplace misconduct.** Members were concerned with the number of recent cases of workplace misconduct in light of the #MeToo movement. Thoughtful public responses to such incidents can help minimize reputational damages. Mr. Cohen and Ms. Sawyer also suggested that having a succession plan, a strong HR executive in place, and active monitoring of the whistleblower hotline are ways to mitigate risk in these situations.

- **Cyber risks.** Members were interested in hearing about the right timing for disclosing a cyber breach. Mr. Cohen spoke about the tension between different advisers—including lawyers who say, *"don't rush out there and disclose a breach before you know the magnitude,"* and PR people who encourage more timely disclosure. Mr. Cohen said he thought companies should lean in the direction of the PR firms because of reputational consideration. He also encouraged members to communicate early-on with regulators in these situations.

- **Investigations.** Mr. Cohen shared some good practices for companies to consider at the outset of an investigation: *"The first concern should not be civil liability when an incident occurs that spurs an investigation. The government has a lot of power in this area, so cooperation and transparency are key. Another mistake is not looking too deeply. If you overturn rocks, slimy things crawl out. It's better for you to find them before the government does."*

- **Sustainability.** *"ESG [environmental, social, and governance] issues are becoming more prominent in part because of the shift from active to passive investing and the publicity these issues are receiving,"* said Mr. Cohen. Ms. Sawyer added that, *"Investors are seeking more disclosure around ESG issues—they want to know how companies are thinking about this. One way to satisfy this requirement is to put out a sustainability report on an annual basis. It's costly, but it's usually effective in persuading investors for the proxy season."*

As Tesla recently discovered, disaster is only one tweet away from becoming a reality. *"In the past, companies have had time to pause and process events—now it is in the media within 30 seconds. So, what can you do? Be prepared. You can never anticipate exactly what will happen with perfection, but you can plan and have a base to work off of,"* said Mr. Cohen. Members shared their experiences with scenario planning and disaster recovery efforts at their companies. One said, *"We discuss this regularly on our board. Things happen in a flash and you must know the communication hotline, who in the executive committee to speak to, and who to direct questions to. Preparation is the best way to be in a position to react."*

Mr. Cohen said that, while management is primarily responsible for identifying key risks, the board's oversight role is an important one. He offered some advice to directors: *"Culture and tone at the top are critical for risk mitigation. It's important for management and the board to have an open line of communication."* He said board members should make it clear to management that they want to know of any emerging risks. Ms. Sawyer stressed the importance of succession planning in case the appropriate response to an event is to terminate an individual: *"With situations unfolding quickly, some companies are quick to terminate senior-level individuals accused of misconduct. Having a succession plan in gear for such an event is very beneficial."* Mr. Cohen also suggested that the board look more closely at the whistleblower hotline, taking care to review its structure and the summary of the claims made, paying special attention to the number of claims.

Finally, Mr. Cohen discussed directors and officers liability (D&O) insurance and one member shared their practice of minimizing risk: *"I like to have a lawyer who specializes in D&O insurance come in and review our policy every two to three years. It's a complicated policy, so I think it's important to have the experts weigh in."*

Meeting participants

The following Northeast Audit Committee Network members attended all or part of the meeting:

- Virginia Addicott, CDW
- Bill Creekmuir, Party City
- Steve Elliott, PPL Corporation
- Pat Gross, Waste Management
- Brian Hudson, Erie Indemnity
- Christie Kelly, Park Hotels & Resorts Inc.
- Lew Kramer, L3 Technologies Inc.
- Gracia Martore, WestRock
- Craig Owens, The J.C. Penney Company Inc. & Dean Foods Company
- Marianne Parrs, Stanley Black and Decker
- Bert Scott, Becton, Dickinson and Company
- Raymond Svider, Altice
- Ron Waters, Fortune Brands Home and Security Inc.
- Greg Weaver, Verizon
- Tim Yates, CommScope Inc.

The following Northeast Audit Committee alumni members attended:

- Toni Conti, Alumnus
- Doug Maine, Alumnus

EY was represented by the following:

- Herb Engert, New York Office Managing Partner
- Tim Tracy, Northeast Region Assurance Managing Partner