Northeast Audit Committee Network

March 2019

SUMMARY of THEMES

Critical audit matters, board oversight of risk, and geopolitical uncertainty

Audit chairs are engaged with external auditors to prepare for reporting on critical audit matters (CAMs), which will be a required component in auditor's reports for large accelerated filers whose fiscal year ends on or after June 30, 2019.[1] At the same time, directors continue to focus on their enterprise risk management (ERM) programs and emerging risks, including risks created by the current geopolitical climate. Members of the Northeast Audit Committee Network (NEACN) discussed these topics on March 4 in Washington.[2] *For a full list of meeting participants, please see the list on page 6.*

Members also discussed the US Securities and Exchange Commission's request for comment regarding quarterly reporting, including the nature, content, and timing of earnings releases and quarterly reports.[3] Tapestry will hold similar conversations on the request for comment with other networks and share the results separately.

Critical audit matters

Danita Ostling, EY's professional practice director for the Northeast region, and Val Bauduin, Marriott's controller and chief accounting officer, joined members for a discussion about CAMs. In June 2017, the Public Company Accounting Oversight Board (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 preparing for the change by performing dry runs for their large accelerated clients. Some members noted differences in the level of detail provided by the different audit firms, but Ms. Ostling said these discrepancies are likely to be resolved: *"The firms have met together, through the Center for Audit Quality, with the PCAOB so that we are all hearing the same guidance and feedback at the same time."* Ms. Ostling observed an average of approximately two to three CAMs for most companies during dry runs, though the number varies depending on the entity and industry.

Members and guests discussed some key recommendations:

- **Expect no surprises.** Mr. Bauduin told members, *"The audit plan presented to you by your auditors is your road map for your CAMs. The population of topics is coming from information that the audit committee should already know about; so there should be no* *surprises."* Ms. Ostling added, *"You won't find a CAM that the company has not already identified as a critical accounting policy or accounting estimate."*

- **Anticipate some convergence.** Members wondered whether there is an expectation for CAMs to have a level of consistency from year to year. Ms. Ostling replied that depending on a given company's business model and industry, there may be CAMs that continually recur. However, Ms. Ostling remarked, *"While we may see a coalescence by industry, we will never see absolute commonality. Different risk factors of different businesses will always have different outcomes."*
- **Challenge management.** The audit committee is crucial to setting the tone at the top to signal the appropriate message to management. Mr. Bauduin advised members, *"Management will look to the audit committee for cues on the importance of CAMs. If you delegate this as an auditor issue, management will not take it as seriously as when you assign the responsibility to them. Be sure to continue to challenge management and ask them questions to gauge how prepared they are for CAMs disclosure by the auditors."*
- **Consider investor implications.** Mr. Bauduin shared some helpful takeaways from his dry-run process with members: *"One important step during CAM dry runs is to consider the investor response. We worked with our investor relations team to determine any equity, debt, or other investor concerns. I would encourage members' companies to pick a few areas that you know will be CAMs and think through how the information will impact investors' views of the business."*

Board oversight of risk

Joined by Lynne Coviello, the northeast region risk leader at EY, and Cristina O'Naghten, chief risk officer for Laureate Education, members explored ways to improve the board's oversight of risk. While ERM is relatively mature in members' organizations, questions remain about how to enhance and improve board oversight.

Ms. O'Naghten told members that Laureate recently did a complete overhaul of its strategy and ERM process. *"We had been reactive to risks and are on the path to putting a more proactive ERM process in place,"* she said, highlighting new practices her team was employing, such as interviewing over 100 individuals across Laureate, including board members, management, and more junior employees, to aid in the risk identification process. The discussion with members identified practices, described below, that could lead to more robust ERM programs.

Assess risk exposures and mitigation

One member asked, *"How can you get comfortable with management's mitigation plans?"* Ms. O'Naghten responded, *"I would ask internal audit to evaluate the integrity of management key performance indicator data to ensure accuracy. Additionally, if there are high risks that* *management thinks are well controlled, I can ask internal audit to validate or disprove management's assertions."* A member said, *"We take all risks from the heat map and compare that with the internal audit scope and plan, as well as the audit committee agenda, to be sure all risks are being covered."* Members also said they use external audit as a resource and way for the audit committee to gain insights about the company's risks and the external risk environment.

Clearly define risk owners

Members discussed the importance of not only management but also the board owning certain risks. One member discussed a management-level risk committee at their organization. Another said that their company will be appointing a chief risk officer (CRO): *"Risks overlap and we think it's important to have someone oversee all risk, including audit activities, to get better insights into our challenges."*

Ms. Coviello suggested that having a CRO is a good practice for companies: *"Your CRO sits in your second line of defense. Having one individual that brings together and coordinates the reporting regarding risk management in the organization is a trend we are seeing more and more of."* Another member discussed delegation at the board level: *"At my company, the full board is responsible for oversight of risks, but the audit committee reviews the ERM process to ensure it is interlinked with the strategy of the business and the audit plan."*

As members consider issues ranging from major transactions, joint ventures, new business models and technology transformation, the tight connection between strategy and risk becomes clear. A member noted that their company recently created a strategy and risk committee: *"This committee was recently formed after going through a transformative acquisition. It has taken risks off the audit committee's plate so there is more time to focus on other tasks."*

Keep track of low-probability, high-impact risks

Ms. Coviello told members she was *"seeing a lot of companies focus on"* low-probability, high-impact risks, noting, *"We refer to them as 'known black swans.'"* One member said, *"I've seen audit committees be presented with only the top 10 risks in some cases and the whole universe of risks in others. What I have found consistently is that when something blows up, it's usually number 30 on my list."* One member shared how their board keeps track of these risks: *"We do controlled, soft monitoring. It's something we assign to the business group to monitor the things we think are risky, and it's included in their goals for the year."*

Understand risk tolerance

Members discussed how a board develops its risk appetite—a commonly used concept for understanding and quantifying financial risk. One member said, *"We look at what is happening in the industry. On cyber, for example, you never feel like you can do enough, but we find reassurance by looking at industry practices and what other companies are doing."* Another member shared their process: *"We try to tap into the experience of where surprises have come up in the past. Every presentation from management states the risks and the mitigation, and we hear from experts about it. Then you have to get comfortable with it—is it a real risk you want to take, and how bad could the impact be?"*

Develop a risk culture

Establishing a culture of risk awareness and systematically engaging the entire organization—from the board and senior executives through the front line—is a critical concern in risk management. *"Setting the tone at the top is crucial to ensure that people at the business level are involved in risk mitigation and taking risk ownership,"* said one member. Ms. O'Naghten described a road show during which she will visit risk leaders across the markets that Laureate operates in: *"We want people throughout the business to be aware of our enterprise risks as well as proactively engage in thinking and informing me of emerging risks. The goal of the road show is to increase dialogue around risks and make it a conscious part of the decision-making process."*

Prepare for a crisis

Another critical aspect of strong ERM is when an organization is equipped to respond to wild-card risks, whose severity or frequency cannot be anticipated. Ms. O'Naghten and members discussed how their companies link risk management with crisis management. Several members recommended including board members in scenario planning and/or tabletop exercises and assessing the readiness of the company's external environment and advisors.

One member discussed a recent tabletop exercise: *"We took an abbreviated version of a real crisis and worked through the process of when to notify people. As a board, we were all over the place. Management does these exercises with more frequency and they did pretty well, but there were a number of gaps in response at the board level that we will need to address."* Another member advised, *"A great communication plan can prevent a problem from becoming a crisis. It might not be a huge issue to begin with, but if you don't handle it properly, it definitely becomes one."*

Opportunities and risks created by geopolitical uncertainty

EY's Mary Cline, senior policy adviser in the Office of the Chairman, and Scott Sarazen, deputy leader of the Geostrategic Business Group, joined members for a discussion on geopolitics.

Key geopolitical concerns and the impacts on business

Ms. Cline described the volatile geopolitical environment as *"a game of whack-a-mole—just when you think you understand the threat on the horizon, another one pops up."* Members were particularly interested in the impacts of the US-China relationship on global trade. Ms. Cline said, *"Regardless of any trade deal, the current tensions in the US-China relationship reflect a structural change, not a blip on the radar. We thought that the rise of China's market* *economy would lead to a gradual opening and a greater harmonization of business norms, but now there is less confidence in that."* She added, *"China is running a marathon—something the US can't easily do when it's just sprinting to the next election."*

Members also asked Ms. Cline about the state of Brexit. She said, *"Experts think we are looking at a 70% chance of a delay, since there is no strategy and no solution on the table that would make the UK or the EU better off."* Any delay, however, would have to be short lived. Ms. Cline explained, *"If the vote is delayed to May/June, the UK would have to participate in the EU elections, which would be quite awkward."*

Members discussed shifting their supply chains from China to other low-cost countries and developing scenario plans in the case of a hard Brexit. One said, *"We are definitely paying closer attention to these issues because we have distribution and supply chains in China. Though we have no sense of reducing our footprint yet, we are looking at our options in the rest of the world."* Another added, *"If you have exposure to Brexit and you don't yet have a plan in place, you might as well file for Chapter 11 right now."*

Ms. Cline said that this increasing complexity is creating a new global business environment: *"Globalization is not over; it's just different."* She noted that the pace of change will continue forward, but the United States will not be playing as strong a role as it has in the past. Mr. Sarazen said the expectations of companies in society are really changing: *"As the Western world pulls back from globalization, your businesses are becoming the leaders. Think about how this affects your employees, suppliers, and investors. They care about these issues."* He added that in this role, businesses need to be nimble and think strategically about how they manage geopolitical risk.

Advice for businesses in this uncertain time

Mr. Sarazen stressed that members should not let their companies get *"too complacent."* He added, *"All businesses need a geostrategy. It's important for audit chairs to understand the impact of their company's footprint in this world and ask management to present that to you on a regular cadence. Have strategies in place to react to black-swan events and be sure to know the risks in the markets you have a presence in, as well as in the neighboring countries."*

Some members said that they incorporate geopolitical risks into a dynamic ERM process, a practice that Mr. Sarazen agreed was a good idea. One member described how their board tries to stay informed of geostrategic threats: *"We include a conversation about risks in key areas in our tactical execution board meeting. To educate ourselves, we bring in the business heads from key markets and also outside consultants and have a discussion about it."*

Meeting participants

The following NEACN members attended all or part of the meeting:

- Virginia Addicott, CDW
- Bert Alfonso, Eastman Chemical Company
- Carl Berquist, Beacon Roofing Supply
- Art Garcia, ABM Industries
- Christie Kelly, Park Hotels & Resorts
- Simon Lorne, Teledyne Technologies
- Gracia Martore, WestRock
- Judy Schmeling, Constellation Brands
- Bert Scott, Becton, Dickinson and Company
- Bill Shaw, The Carlyle Group
- Tim Yates, CommScope

EY was represented by the following:

- Rich Jeanneret, Americas Vice Chair
- Tim Tracy, Northeast Region Assurance Managing Partner
- Kevin Virostek, Greater Washington Managing Partner

Endnotes

[1] Ken Tysiac, "Tips For Understanding Critical Audit Matters," *Journal of Accountancy*, July 24, 2018.

[2] *Summary of Themes* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations. Guests, however, have given permission for their remarks to be attributed. Comments by guests and network members are shown in italics.

[3] "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," news release, December 18, 2018.