Risk management practices, tax reform, and the macroeconomy

Boards face varying challenges in overseeing an ever-changing set of risks and evolving enterprise risk management (ERM) processes. Tax reform represents a significant change for companies to manage, presenting compliance, execution, and financial reporting risk. At the February 7, 2018, meeting of the Southeast Audit Committee Network (SEACN) in Orlando, Florida, members shared current risk management practices and discussed other factors affecting the current business environment—namely, tax reform and the macroeconomic outlook for the United States.

Tracking the evolution of ERM

ERM continues to be top of mind for boards as they strive to ensure comprehensive processes that are both detailed and strategically focused. With EY's Neil Kaufman, executive director–risk transformation, members discussed varying approaches to risk management and how risk oversight can be advanced.

A key area of discussion was around the question of who owns risk. The answer—whether a dedicated chief risk officer (CRO) or other executives—often depends on the industry and the complexity of operations. A member said, *"Geographic risk can create the need for centralized risk management leadership. It's also due to the size and complexity of the organization."* Mr. Kaufman added, *"Decentralized global organizations often develop their own assessment processes, making it difficult to get a consolidated view. Having a centralized standard that is shared with federated groups across the company makes for a more effective process."*

At most member companies, the ERM process sits with internal audit. While most agreed that internal audit can *"facilitate the process,"* most agreed with an EY expert who advised, *"Internal audit can own the process, including establishing a framework, a lexicon, and the tools to run it, but not risk management itself. Doing so puts internal audit in a strange place that raises concerns with the independence of the function."* A member noted, *"It's important to have a robust ERM assessment. Internal audit can play a leading role in facilitating those assessments."* Members also accepted Mr. Kaufman's view that *"internal audit needs to advise those first-line functions on how to assess and manage risk; however, ERM needs to sit outside their purview for proper facilitation of the process."*

With regard to reporting and oversight practices, Mr. Kaufman noted that *"companies are all over the board."* Yet there are some common areas of focus. Many firms are considering how best to realign their ERM processes and make them more efficient, and, according to Mr. Kaufman, *"there are technologies that can enable all of that."* Participants identified some practices for improving risk management and oversight:

- **Create a shared view of risk.** Participants emphasized the need to develop a common language and categorization for key risks across the organization. A risk taxonomy aids the organization in determining what risks it's willing to assume in what areas and to better coordinate mitigation and response plans. Equally, most said they regularly discuss their firms' appetite for different risks, and several suggested most risks could be quantified precisely enough to allow for a comparison of the risk profile to the firms' appetite. Mr. Kaufman said, *"Appetite can help determine whether a risk is worth it. Having a codified appetite methodology is helpful because it gives thresholds for accepting risk."*
- **Align risk management and strategy conversations.** *"A properly done ERM process ties risk into strategy, which is the role of management and the board,"* an EY expert noted. One member said, *"We are trying to move ERM to a more strategic discussion—when you talk about strategy, to put the risks into context."* Another said, *"For me, two questions are foundational: What can derail business strategy? What can destroy value?"* Mr. Kaufman noted, *"To get the attention of management, you need to answer a fundamental question: Why should we do ERM? This should show the business impact or how the program will increase revenue or decrease cost."* In addition to looking at operational and strategic considerations, some members recommended incorporating the risks associated with industry disruptors and emerging technologies.
- **Ensure risk is embedded in the culture.** The real key to effective risk management is, according to one member, being aware of *"what the culture prioritizes, rewards—when objectives collide, which wins?"* One member expressed frustration with the difficulty of measuring culture but emphasized its importance: *"Companies cannot catalogue every risk scenario, but what you can do is look at culture. As the board, how do we know what the culture is? Can you audit culture? When I look back at crises, there was often a cultural cause."*
- **Focus on response planning.** A member observed, *"In my experience, where ERM has gone off the rails, management at every level had grossly underestimated the impact of small things going awry."* Several members agreed that the ERM process will never be completely successful in helping companies effectively manage all risks. As a result, some report focusing on their response teams and response plans and integrating crisis management into their ERM discussions.

Assessing the opportunities and risks of tax reform

EY's Angie Christie, Southeast tax managing partner; Scott Shell, Southeast region international tax leader; and Adam Bean, Southeast region tax accounting leader, recommended several approaches to help boards navigate the new tax law:

- **Find the new normal in forecasting effective tax rates.** Guest experts agreed that many domestic companies will certainly benefit from the reduction in the corporate tax rate in the 2017 Tax Cuts and Jobs Act. However, they also said the complexity of interconnected tax provisions have created surprises and even unintended results. *"As companies have started developing guidance under the new tax rules and coming up with their 2018 effective tax rate, not all are getting the answer they thought they would,"* said Mr. Shell. While the corporate rate was lowered, the law broadened the tax base by removing many deductions and adding in some new taxes. Plus, the final impact is difficult to calculate—for example, certain provisions will require companies to review and support computations of offshore earnings and related foreign income taxes going back as far as 1986. Before this new law, most firms communicated that doing these particular tax calculations were *"impracticable."* The guests from EY suggested that boards will want to review (1) the firm's current tax position and tax strategy, (2) the potential financial impact to business processes, and (3) whether business model and capital structure changes may be required in response.
- **Understand the tax change implications to foreign earnings.** For companies that have deferred recognizing US tax on offshore earnings a one-time transition tax will require companies to pay US tax on those unremitted earnings, noted Mr. Shell. In return, future offshore earnings deemed generated by tangible assets can be repatriated tax-free. However, Congress was concerned about taxpayers eroding the US tax base in this new system and created rules that impose current US tax on offshore earnings deemed generated by intangible assets, subject to a foreign tax credit. The policy was to ensure that firms pay a minimum amount of US and/or foreign tax on offshore foreign earnings. These new intangible income provisions could offset some of the benefit of lower US tax rates and increase the tax burden for many companies. In fact, companies that are expecting foreign tax credits to eliminate the US tax on offshore intangible income under these new provisions may find that they cannot do so. Mr. Shell remarked, *"This feature in the tax reform legislation has been the biggest surprise in all of this."*
- **Ensure companies are planning ahead for compliance by 2019.** The complexity of changes to the corporate tax code are stretching tax departments and advisors. The SEC's Staff Accounting Bulletin No. 118 provides guidance for companies in showing how the 2017 act will change their financial accounting and allows for companies to demonstrate where accounting is complete, where estimates are being used, and where information is unknown; companies have until December 2018, to complete the measurement of the

changes. Ms. Christie said, *"You must consider whether your tax departments have the resources and expertise to address this. Companies will need to develop a comprehensive plan to address these items during the year to avoid being surprised at year end."* Members recognized the risk of being underprepared, particularly the potential of a material weakness in year-end 2018 financial statements. Mr. Bean added, *"If you wait until the end to get these complex calculations right, and you can't get the resources ahead of time to assist, the likelihood of a material weakness in internal controls is higher."* An EY expert recommended that audit committees keep tax planning as a standing agenda item for 2018 to ensure that management has a plan well in advance of the deadline and is staying on target.

Examining key factors affecting the macroeconomy

Recent market volatility, rising interest rates, geopolitical risk, and the prospect of inflation were top of mind in a discussion with Frank Nothaft, chief economist at CoreLogic. Optimistic about the economy's prospects, Dr. Nothaft and members highlighted several key economic factors contributing to the current environment:

- **Employment, rising wages, and inflation.** The unemployment rate is 4.1%, the lowest level in 17 years, observed Dr. Nothaft. While noting the strength of the macroeconomy, he said, *"A tight labor market could add to wage growth, thus increasing inflation. The concern is that inflation will rise above the 2% target, which could be a genie in a bottle, because once released, it's difficult to put back in place. Some forecast the possibility of inflation rising even higher by year end."* One member questioned the reliability of unemployment figures, asking, *"Are we considering those who left the job market during the Great Recession and never returned?"* Other members asked whether inflation would rise in 2018. Dr. Nothaft responded, "Inflation will increase because of the rising cost of labor. We may see inflation rise above 2% in the coming year."

- **Rising interest rates and new leadership at the Fed.** Dr. Nothaft emphasized that early February's market volatility was not due to Jerome Powell's confirmation as chair of the Federal Reserve. He pointed out the intellectual capability of Mr. Powell, his tenure with the Fed, and his alignment with former Chair Janet Yellen on policy matters, including continuing incremental interest rate hikes.

- **Demographic factors affecting economic growth.** Millennials are crossing significant financial thresholds, such as home buying, much later than baby boomers did, observed Dr. Nothaft. He noted several factors contributing to this consumer behavior, including delayed labor market entry and household formation due to the Great Recession, the pursuit of degrees or advanced degrees, and the burden of student loan debt, which is indicative of a larger economic problem, income inequality. *Attitudinally, millennials have similar aspirations for homeownership as baby boomers. Wealth inequality, however, affects the ability to build wealth over time. Investment wealth, including home buying, has* *been a key way of building wealth for some time,"* said Dr. Nothaft. One member suggested that rising interest rates could help solve the problem of income inequality: *"There's been a regime of cheap cash, which allowed those with the ability to borrow to invest in equities, increasing wealth inequality. Raising rates could stop the inequality gap from widening."*

- **Lingering benefits of tax reform.** The 2017 act could have a stimulating effect on economic growth to a certain point, Dr. Nothaft said. He added, *"Some economists predict the possibility of a recession beginning in 2020, which would show an offset to the stimulus caused by the tax cuts. However, most predict that the next two years will remain strong for growth, with an expected increase in gross domestic product growth of about 0.25% from tax reform."*

About this document

The Southeast 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.

Summary of Themes is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *Summary of Themes* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *Summary of Themes* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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 are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

Meeting participants

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

- Kerrii Anderson, LabCorp
- Maureen Breakiron-Evans, Cognizant
- Juan Figuereo, PVH
- Rick Mills, Commercial Metals Company
- Jason Papastavrou, United Rentals
- Terry Rappuhn, Quorum Health Corp
- Steve Raymund, Jabil Circuit
- David Walker, Chico's FAS, CommVault Systems, and CoreLogic

EY was represented by the following:

- Les Bethune, Southeast Region Managing Partner of Accounts
- Jim Estes, Southeast Region Assurance Managing Partner
- Bryan Yokley, Georgia/Alabama/Tennessee Market Segment Leader, Assurance Partner