Audit committee oversight of non-GAAP financial measures

As company leaders and boards are digesting the widespread implications of the first comprehensive tax reform in over 30 years, audit committees are also considering the challenges posed by reporting financial results that fall outside of generally accepted accounting principles (GAAP). At the same time, the recent wave of high-profile harassment complaints against senior executives has resulted in new interest in board oversight of workplace conduct. The Southwest Audit Committee Network (SWACN) members met in Dallas on March 8 to discuss these topics.[1] For a full list of meeting participants, please see page 6.

Assessing the opportunities and risks of tax reform

The complexity of the changes to the corporate tax code challenges tax departments and advisors. Kent Gerety, EY's Southwest Region Technology, Media and Telecommunication Business Tax Practice Partner, and Wesley Poole, EY's US Oil and Gas Tax Partner, recommended several approaches to help boards navigate the new tax law:

- **Be aware of the changes in deductions and the potential impact to capital structure and other operating activities**. While most domestic companies will generally benefit from the reduction in the corporate tax rate, deductions eliminated to reduce the cost of tax reform may also significantly affect them. One important example is the limitation of deductible interest expense, which *"has already begun to cause companies to evaluate the mix and location of their equity v. debt financing in preparation for further restrictive limits to business interest expense deductions that take effect after 2021,"* Mr. Gerety said. Although a number of deductions have been limited or eliminated, one member focused on the positive: *"My sense is that if you were a pure domestic player your tax rate will effectively be lower, even if you are losing deductions."*

- **Monitor potential changes to state and local taxes.** At the state level, conformity with the federal corporate tax base expansion will likely result in increased corporate tax collections, but the magnitude of that impact for each state will depend on how it chooses to conform to the new Internal Revenue Code (IRC), the composition of its economy, and the way in which specific provisions contained within the TCJA are implemented at the federal level. It is ultimately unclear what impact the new federal tax changes will have on state and local governments and whether additional changes will occur at the state and local levels. Mr. Gerety noted that changes at the state level could be far reaching: *"What we know today* *will be subject to the whims of state legislatures."* One member commented, *"State legislatures will face extreme pressure. This could start bidding wars for companies to relocate."* According to a recent EY study, the nationwide overall increase in state corporate income tax bases is estimated to be 12% over the 10-year period from 2018 through 2027, with significant variations between the states. The average expansion in the state corporate tax base is estimated to be 8% from 2018 through 2022, which increases to 13.5% for the period 2022 through 2027.[2]

- **Model potential foreign tax scenarios.** The new tax law represents a shift from a global system to a modified territorial system. Mr. Gerety noted that international companies need to consider their overseas earnings, intangibles, and the business purpose behind their current company and asset structure: *"If your primary reason for locating business functions or intangibles overseas was because of the lower taxes, that should probably be revisited."* Mr. Poole added, *"The ability to have fluid cash movement is a huge benefit. You now have the ability to structure and move cash more freely around (after 2018) because deferred earnings overseas will no longer be currently taxed upon repatriation."* For many complex multinational corporations, the net effect of these tax changes is not yet clear, in part because foreign jurisdictions are unlikely to sit by while assets come to the United States. Mr. Gerety counseled, *"Companies should be aggressively modeling different scenarios to determine potential tax impact[s] and related changes. This may be a massive effort. One of my clients recently tripled their department budget for international tax services to allow for adequate modeling of potential outcomes. Other companies likely need to invest more in their tax groups to navigate this new environment."*

- **Tax Reform is more than just about "tax."** It is clear that tax reform will impact how companies execute against their strategies. There are impacts to consider in many areas including supply chain, capital structure, executive compensation, organizational structure, and many others. Entities should consider holistic planning scenarios for the future and stay up to speed on the numerous interpretations necessary to implement to the new law.

Evaluating non-GAAP disclosures

There is substantial pressure on companies to disclose key operating and non-GAAP financial measures, members said, placing pressure on audit committees to ensure that such disclosures are useful, compliant, and accurate. Non-GAAP measures can help provide a more complete picture of performance for investors and other stakeholders, but members recognized the risk of providing inaccurate or misleading information. *"There's a lot of pressure on companies to meet market expectations. Sometimes you see a new non-GAAP adjustment when you might otherwise miss consensus earnings,"* one member said. *"That pressure is real and as an audit committee, we have to resist it. A new adjustment that saves us a penny and hits our earnings target just is not right and is not worth it,"* added another member.

Determining which measures and adjustments are appropriate can be challenging. One member summarized, *"[Any deviations] need to pass the Wall Street Journal test. I always ask myself how [the measure] would stand up to public scrutiny."* Consistency, comparability, and transparency are key, members said. Internal policies that clearly delineate what types of measures and adjustments are appropriate can be helpful. One member described the benefits of having an internal policy that clarifies the guidelines: *"My company developed a framework which they use any time they want to make an adjustment. It serves as a basis for our discussion."* EY's John King said, *"Investing the time in creating clear policies can be very helpful in reducing the level of uncertainty and [the] number of judgments that need to be applied."*

Sometimes the focus is not consensus earnings but executive earnings, as when compensation metrics are tied to non-GAAP numbers. *"Creating a process where the audit and compensation committees work together to oversee these measures seems like a good idea,"* one member said.

Members were particularly interested in how they can work with their external audit teams in overseeing non-GAAP numbers. There is no standard against which non-GAAP numbers can be audited, but members expect that their audit teams can help them identify when certain disclosures deserve greater scrutiny. EY's Scott Hefner said, *"You need to tell your service provider if it's important to you that they review the non-GAAP measures. The external auditor may not have a formal opinion but can certainly have a discussion on what they have seen."*

Overseeing sexual harassment

Recent sexual harassment allegations in the entertainment industry and at several major companies have shined a spotlight on oversight practices. Jennifer Trulock, chair of Baker Botts' Labor and Employment Practice, joined members for a discussion on sexual harassment, workplace culture, and the board.

Ms. Trulock emphasized that the board should understand the training offered, ensure internal controls are in place, and conduct a policy review including the company's harassment policy, code of conduct, and business ethics. That said, she emphasized, *"just having an updated code of conduct is not enough."* Sometimes the board needs to be involved directly, such as when the C-Suite is implicated in a complaint. Beyond the C-Suite, understanding what types of complaints and issues will be brought to the board—and when—is important, Ms. Trulock said. *"Ask your management teams to talk you through the process when a complaint comes in and how it is handled. It's critical to know that the HR team is up to the task."*

One member said, *"I'm uneasy with the advice that we need to go and look for trouble if we don't see it."* Ms. Trulock said, *"The guiding principle is to be reasonably proactive."* That includes asking management about complaints and looking into unusual numbers. *"That is true in both directions,"* Ms. Trulock pointed out. It's obvious to look at any business or geography that has a high percentage of complaints, *"but also look when the numbers are suspiciously low."*

About this document

The Southwest 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.

Meeting participants

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

- Mark Baldwin, TETRA Technologies and KBR
- Kathy Cooper, Williams Companies
- Gayla Delly, Flowserve
- Marcela Donadio, Marathon Oil
- Barbara Duganier, Buckeye Partners and MRC Global
- Paulett Eberhart, Cameron
- Mercedes Johnson, Micron Technology
- Gil Marmol, Foot Locker
- Barry Pearl, Magellan Midstream Partners
- Frank Risch, Pioneer Natural Resources
- Mike Stoltz, Windstream Holdings
- Jack Taylor, Murphy USA
- Billie Williamson, Energy Future Holdings

EY was represented by the following:

- Randy Cain, Vice Chair and Southwest Region Managing Partner
- Scott Hefner, Southwest Region Markets and Accounts Managing Partner
- John King, Assurance Managing Partner, Southwest Region
- David Pond, Principal and Southwest Region Business Development Leader

Endnotes

[1] This document 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.

[2] EY, *The impact of federal tax reform on state corporate income taxes* (New York: Ernst and Young LLP, 2018),16.