Southwest Audit Committee Network

December 2019

SUMMARY of THEMES

Audit committee effectiveness, year-end considerations, and corporate disclosures and investor preferences

On December 5, 2019, members of the Southwest Audit Committee Network (SWACN) met in Houston for discussions on audit committee effectiveness, year-end considerations, and corporate disclosures and investor preferences. This *Summary of Themes* provides a brief overview of the meeting.[1] *For a full list of meeting participants, please see page 6.*

Audit committee effectiveness

Members discussed good practices for enhancing the effectiveness of the audit committee, with three key themes emerging:

- **Motivating committee members.** SWACN members stressed that successful audit committees often exhibit high levels of engagement by all audit committee members. A member said, *"A strong audit committee is one that is very engaged. It cannot become a committee of one and I often see it become just that. As chair, you need to be engaging the team and you need members that want to be engaged."* It is the audit committee chair's responsibility to set expectations with fellow committee members and promote engagement. Some members suggested this included ensuring that committee members review all materials prior to formal meetings so that everyone is prepared to contribute. A few SWACN members also recommended that chairs reach out directly to others on the committee to share feedback, sending a message that their input during meetings is valued. One stated, *"I think everyone likes to hear that what they shared in the meeting was helpful. It encourages them to share more in the future and indicates that this is a particular area where you're counting on them to engage more."*

  Another part of ensuring an effective and engaged group is getting the right mix of skillsets onto the committee. As one member put it, *"You need a good foundation and core, and that starts by looking at the committee members themselves: the talents, skills, and experiences they bring to the table."* Committee composition has become increasingly important as the list of oversight responsibilities for audit committees continues to grow to include more emerging risk areas. To that end, some members highlighted the value of working closely with the nominating and governance committee to take fresh looks at the audit committee's needs and ensure alignment.

- **Soliciting feedback from the external auditor.** Several members noted that the external auditor is well-positioned to provide feedback into the performance of audit committees as they offer a unique perspective and the ability to compare practices. Yet, getting this type of insight from the external auditor can be awkward. A member said, *"The external auditor brings so much value to the audit committee and the committee appreciates that, but they need to have the courage and strength to communicate honest feedback."* EY's Scott Hefner said, *"I totally agree. The external auditor's responsibility is to provide information about the business, and that includes insights that are both good and bad."* A member explained that establishing a trusting relationship with the external auditor can enable this sort of candid exchange: *"This is why it's vital to have an effective and trusting relationship, especially with the lead partner. I've found you can get really useful feedback if you have the right relationship."* The EY experts in the room suggested that it would be useful for audit committee chairs to explicitly ask their auditors for this type of feedback, noting that it is not always a common practice.
- **Driving efficiency.** Members shared strategies for ensuring that audit committee meetings run as efficiently as possible. Many described working with management to streamline materials and presentations. While executive summaries are becoming a common feature in board reports, several members described unique features their committees are using in this regard. One member explained that the company's chief financial officer provides a memo on the front of the audit committee materials highlighting the most important issues. Another member said the company's external auditor color codes materials to indicate changes made since the previous meeting. Though effective audit committees have carefully planned agendas and attempt to allot the necessary time for all discussion topics, meetings may still run longer than expected. Several members stressed the importance of taking the time that is needed in order to cover audit committee matters thoroughly. As one member explained, *"I had a predecessor that was so focused on not going over time that it inhibited communication. Efficiency is important, but having useful conversations that arrive at conclusions is more important."* Another member added, *"If you get pushback regarding meetings running long, as chair it's your job to say that if something needs to be discussed, we're going to discuss it and we're not going to cut the meeting short, period."*

Year-end considerations

As the 2019 calendar year draws to a close, members were joined by EY's Joe McGrath and Herb Listen for a discussion on critical year-end considerations for audit committees. Below are some key areas audit committees should pay attention to:

- **Critical audit matters (CAMs).** With CAMs reporting now live, members and guests discussed items for audit committees to keep in mind at year-end. Mr. Listen stressed that no CAM should be a surprise: *"Remember, we can't say anything in the CAM that the* *company hasn't disclosed in financial statements. That means part of your role as the audit committee is to look at the CAMs and ask, 'Do these make sense based on the communications we've had?'"*

Mr. Listen also recommended that audit committees also have discussions with management to ensure they are comfortable with how CAMs are being described. As early filers have reported CAMs, some trends are beginning to emerge. Mr. McGrath said, *"I think there will be a lot of commonality around what CAMs are identified in a given industry. Also, companies with similar size and complexity can trigger commonality. What we've seen so far in early adopters is fairly consistent themes sector by sector."* Yet, he added, this does not mean CAMs are becoming boilerplate: *"Of course, the actual drafting of the CAM documents will be unique by necessity."*

The EY experts noted that the SEC's chief accountant has indicated an interest in CAMs, and therefore the potential exists for the SEC to issue related comment letters. Mr. McGrath recommended that members ask their auditor what the plan would be if the company got a comment letter from the SEC on CAMs. *"That's a good question to bring to your lead audit partner: If you do get a comment letter, how are you going to proceed?"* he noted. Though most members indicated that CAMs are not a major concern, they did share unease about issues arising right at year-end. Mr. McGrath noted that these potential issues should be identified and monitored: *"The external auditor should have an inventory of things likely to be CAMs, potential CAMs, and potential trigger points that aren't on those first two lists."*

- **Cybersecurity disclosures.** As reliance on technology continues to expand, cybersecurity has become an increasingly vital aspect of a company's risk profile, with regulators pushing for more disclosures in this area. Mr. McGrath said that auditors may benefit from improved insights into a company's cybersecurity, particularly with regard to how events affect financial reporting: *"The auditor's role has been obtaining an understanding of business and operational risk in an organization and how it translates to the financial statements … the auditor does have a unique vantage into the potential for risk around cyber. Certainly, to the extent that an event occurs within a company, whether a cyber event or penetration, there is the potential for that to have financial statement implications."* It is critical for audit committees to ensure that the proper controls are in place to prevent or mitigate future cyber events and that there is a process to report a breach. Mr. McGrath said, *"Regulators are expecting companies to have a process in place for evaluating and assessing matters and figuring out the disclosures. They're very cautious and mindful to make sure there is less lag between the event and impact on financial statements and disclosures around that."* Members and guests also highlighted the importance of establishing a materiality threshold to disclose an event and having a process in place to determine if any insider trading occurs following an incursion.

- **Transactions.** Given the current state of capital markets, companies are creating complex structured transactions that may introduce accounting and internal control challenges. Mr. McGrath said, *"When you look at when deals close, it does seem it often happens late in the calendar year and it can impact risk assessment, audit response, financial reporting, etc."* The guests shared that in this environment, audit committees need to be involved early in the process to understand how the company and external auditor may view any accounting complexity a transaction may introduce. Mr. Listen said the audit committee can help ensure that everyone is on the same page: *"If there's a good chance a deal could get done, it's important to make sure management has focused on talking with the external auditor up front, getting aligned on accounting issues and what evidence is needed with regard to the internal control opinion … That's an area where the support of the audit committee can be really helpful, and the earlier in the process, the better."*

Corporate disclosures and investor preferences

Members exchanged views on the recent trends in corporate disclosures and investor engagement with Tanya Levy-Odom, a director within the BlackRock Investment Stewardship (BIS) team in the Americas. A few key points are below:

- **Disclosures.** Ms. Levy-Odom said disclosures should be an opportunity for companies to stand out in a positive way: *"Good disclosures show me something distinctive about your company, something that conveys the culture of your company and its identity. That's so very helpful."* Several members asked about the growing practice of disclosures related to environmental, social, and governance (ESG) issues. One said, *"With ESG, I think most boards don't struggle with the "E" or the "G"; it's the "S" that is very hard to get a hold on. It's difficult to figure out appropriate metrics and how to handle disclosures."* Ms. Levy-Odom shared, *"Human capital management is the best anchor, I think. Who is in your building? How is management developing those people and ensuring they're treated fairly? How are you investing for the future?"* This is an area where many companies could improve disclosures, she added: *"I really need to understand if the company grasps the relevant issues and is focused on making improvements … Most of the time, the work has already been done and the information has been shared elsewhere. It's just about getting it together."* Members also asked about potential "red flags" BIS might see in audit reports, and Ms. Levy-Odom cited indications of any material weaknesses in internal controls and turnover in the CFO role as issues where the team is likely to dig deeper.

- **Engagement.** The BIS team engages with companies via direct communication and the proxy voting process. As BIS's website touts more than 17,000 votes cast and 2,000 engagements annually, members inquired how the team determines engagement priorities. Ms. Levy-Odom noted that the group utilizes inputs from a variety of sources, including a prioritization tool that measures indicators such as the percentage of assets under management that a relationship represents, as well as proxy statements and shareholder proposals. Once direct engagement occurs, Ms. Levy-Odom noted that the team's preference is often to meet with the lead director. However, she added, this can vary: *"It's topic by topic and case by case, but for a particular topic, whoever can speak to that best is the person I want on the phone. I don't want to just get the party line from the investor relations person."* She stressed that engagement is focused around key priorities for the BIS team and is not intended to be prescriptive. *"We like to have a conversation. It's not a cut-and-dry approach—we look at the context,"* she said.

With regard to proxy voting the BIS team develops its own voting policies taking into account a number of internal and external inputs including proxy advisor research. Ms. Levy-Odom shared that most votes are straightforward, and that BIS supports management close to 95% of the time. When asked what issues could result in voting against a proxy, Ms. Levy-Odom provided some examples: *"Material issues over a number of years that are not being corrected, that would be a concern … Also challenges related to internal processes that keep repeating. Environmental, social, and governance (ESG) issues where the company committed to doing something and didn't follow up."*

The BIS team acts as a centralized resource for portfolio managers, working to preserve and enhance the value of client assets by engaging with companies, encouraging practices that support sustainable financial performance long-term, and providing insight on ESG issues relevant to all investment strategies.[2] The team votes at more than 15,000 shareholder meetings and on more than 130,000 proposals on an annual basis. Ms. Levy-Odom explained that, although BIS works with other parts of BlackRock, including portfolio managers of active funds, it has its own set of objectives and is focused on long-term investment horizons. Members noted that it may be beneficial to ask other audit committee members and fellow directors if they understand the priorities and voting policies of the company's major investors.

Meeting participants

- Mark Baldwin, KBR, Inc.
- Vanessa Chang, Transocean
- Marcela Donadio, Marathon Oil
- Barbara Duganier, MRC Global
- Rodney Eads, NOW, Inc.
- Paulett Eberhart, LPL Financial
- Tom Glanville, Itron, Inc.
- Sue Gove, Tailored Brands
- Steve Johnson, Globe Life Inc.
- Don Kendall, SolarCity
- Teresa Madden, Peabody
- Gil Marmol, Foot Locker
- Royce Mitchell, Pioneer Natural Resources
- Barry Pearl, Magellan Midstream Partners
- Peter Ragauss, Williams Companies
- Don Robillard, Helmerich & Payne
- Bill Schumann, McDermott
- Mike Stoltz, Windstream Holdings
- Valerie Williams, DTE Energy Company

- EY was represented by the following:
  - Robyn Bew, Director, Markets, West Region Leader – Center for Board Matters
  - Scott Hefner, Global Client Service Partner
  - Frank Mahoney, Vice Chair and Regional Managing Partner – US West
  - Bill Strait, Houston Office Managing Partner

Discussion questions for audit committees

Audit committee effectiveness

- ? What opportunities exist to encourage active engagement of all members of the committee?
- ? Are the format and content of audit committee reports from management and the external auditor staying fit-for-purpose given the committee's priorities?
- ? How might the committee use the annual evaluation process or other avenues to identify areas for continuous improvement?

Year-end considerations

- ? What is your external auditor seeing in terms of trends and developments with CAMs in our industry sector? What impact will new auditor reporting requirements have on audit committee disclosures?
- ? Have we discussed the potential impact various types of cyber incidents could have on the financial statement audit of ICFR?
- ? At what point in the transaction cycle does the audit committee discuss accounting, financial reporting and internal control implications, particularly with complex transactions? When does the management team involve the external audit firm?

Corporate disclosures and investor preferences[1]

- ? Does the company's proxy statement effectively communicate the board's role in oversight of strategy and long-term value creation?
- ? How do disclosures regarding director qualifications and board composition highlight the expertise, experiences and backgrounds of audit committee members?
- ? What additional voluntary disclosures might be useful to shareholders related to the audit committee's time spent on certain activities, such as cybersecurity, business continuity, mergers and acquisitions, and financial statement reporting developments?

[1] See EY Center for Board Matters, *What audit committees are telling shareholders in 2019*.

Endnotes

1 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.

2 "Investment Stewardship," BlackRock, accessed November 20, 2019.