Southwest Audit Committee Network

November 2017

SWACN

SUMMARY of THEMES

Audit chairs heading into year-end with longer list of questions for management teams

As members and experts gathered in Dallas on November 30 for the Southwest Audit Committee Network's final meeting of the year, the discussions centered on accounting issues that are top of mind heading into year-end. Given current reporting complexities and the increasing likelihood of a change in tax policy before year-end (as of the writing of this summary), audit chairs are adding to their list of questions for management. Members also discussed expected trends for the upcoming proxy season, as well as lessons learned in crisis communications, with an emphasis on shareholder activism.[1] For a full list of meeting participants, please see page 6.

Audit committees staying close to implementations of standards

With the efforts required to implement complex process, policy, and disclosure changes for the new revenue recognition and lease accounting standards, members noted their audit committees are spending a large portion of their time and focus to ensure management has the details well in hand to minimize the possibility of any significant deficiencies or comment letters.

Focus turning to disclosures for revenue recognition changes

With revenue recognition implementations well under way, oversight focus is now shifting from contract reviews and policy revisions to external communications about the changes, including reporting and disclosures. Paul Beswick, partner in EY's Professional Practice Group, and members discussed the challenges audit committees will need to ensure management is addressing. First, regardless of the size of the final impact on revenue figures, internal controls and procedures need to be evaluated to ensure consistent and accurate reporting under the new standard. Management and internal audit teams should review new processes and procedures, even if the change in revenue being reported as a result of the new standard is immaterial. *"In the last six months, we have seen companies come to the realization that they do not just need to get the accounting right, but they need to make sure they have the appropriate controls in place. We do surveys internally of our teams and changes to internal controls came up as lagging behind other aspects of the implementation,"* said Mr. Beswick. The second challenge companies are struggling with is related to disclosure changes, including the thought process and analysis behind how the new financials align with those reported previously. A member noted, *"The impact of revenue recognition at my company was immaterial but the work on changes in disclosures has been mammoth."* Mr. Beswick said, *"This is an issue the board should really focus on with management. We have seen with early adopters that disclosures are one area the SEC is really asking a lot of questions around. Be sure to think holistically about the disclosures and be very thoughtful in your analysis."* Mr. Beswick also noted that if tax policy changes are enacted before year-end, it will add a layer of difficulty for companies as they attempt to account for the impact on revenues.

Members shared other concerns that may not be as well recognized – the re-prioritization of projects and fatigue for finance teams. While both are noteworthy, examples shared of innovation and digitalization projects being postponed were striking when considering the broader context of company transformations. One member said, *"At my company we realized revenue would not be a big item for us but then to find out that the documentation would be enormous, and with lease accounting coming out right on the heels of that – our teams are experiencing significant fatigue."* Mr. Beswick said his team is seeing this trend across companies and went on to note that assessing this should be part of "*a post-implementation review on the standard which will produce key lessons learned."* Members agreed and said that an independent review is called for, particularly to assess the resources and expense required to deliver these new standards.

Lease accounting changes may contain unexpected pitfalls

Following closely behind revenue recognition is the new lease accounting standard, which many members noted that their companies have not had the resources to fully dive into yet. The changes in the lease accounting and revenue recognition standards are closely connected and members expressed concern over the level of complexity, detail and diligence involved with identifying revenue and lease components in contracts or agreements. Last minute regulatory guidance or interpretations and the increased risk of an error or restatement were also concerns for members.

Mr. Beswick laid out the important steps that companies should be taking now: *"First and foremost, be sure to develop a project plan. Next, identify all your contracts – this piece needs to get done sooner rather than later. Be sure to check your supply contracts as well because we have seen some clients dig into these and find leases*." Because leases need to be accounted for slightly differently going forward, some companies have run into issues with finding systems or solutions from software vendors that will account for two groups of old and new leases. One member agreed: *"We are looking for software to help us with leases but are struggling to find a solution that will work for us."*

The new auditor's reporting model may lead to bigger changes

Coming in fiscal year 2019, auditors will need to communicate critical audit matters (CAMs) in the audit report. In its adopting release, the Public Company Accounting Oversight Board (PCAOB) stated "The documentation of critical audit matters requires that for each matter arising from the audit of the financial statements that (a) was communicated or required to be communicated to the audit committee, and (b) relates to accounts or disclosures that are material to the financial statements, the auditor documents whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination."[2] Many members were interested in what their companies can be doing now to prepare for these new disclosures. Mr. Beswick suggested, *"This will be a learning process. If your companies haven't started running pilots with your auditors, ask them to start that now."* Mr. Beswick eased members' concerns about CAMs by saying, *"Not every audit opinion needs to include a CAM but the vast majority of companies will have one. The PCAOB has indicated there can be challenges and they will be looking for the people who blatantly disregard the standard."*

As part of the new auditor's reporting standard, auditor tenure disclosure will be required for fiscal year-end 2017 audit opinions. Members questioned whether this disclosure would put pressure on the audit committee's report concerning their decision to retain an auditor. Members also shared concerns that this disclosure will cause *"policy wonks,"* including proxy advisory firms, to suggest an audit tenure standard.

Members also considered the possible implications of new text that must be added to fiscal year-end 2017 audit reports to clarify that financial statements are free of material misstatements "whether due to error or fraud." One member asked, *"Do you think this phrase will change auditing standards? I think spelling it out in an opinion could drive behavior. I would have sympathy for auditors coming to me and explaining that we need to change our procedures because auditors are taking on an increased responsibility."*

Investors and activists likely to continue momentum in 2018

Kellie Huennekens, associate director of EY's Center for Board Matters, and Robert Kimball, partner at Vinson & Elkins, and members discussed recommendations for responding to challenging scenarios that boards face related to increasingly engaged investors and activists that are likely to continue, and perhaps even gain momentum in 2018.

2018 proxy season likely to increase focus on board composition and ESG

Ms. Huennekens, Mr. Kimball, and members addressed changing investor expectations in the context of the upcoming proxy season. Both experts noted that a growing number of investors want more disclosure showing that directors are well suited not only for their immediate oversight responsibilities but also for the future needs of the company. Specifically, experts are anticipating a continued focus on board composition and refreshment in 2018. Ms. Huennekens said, *"Companies have shown a greater focus in adding new directors to boards. We are seeing more diverse candidates – younger directors, more women, and more directors with digital expertise. Investors are also focused on technology skills including from within the framework of risk management."* Mr. Kimball spoke about the New York City Comptroller's recent Boardroom Accountability 2.0 initiative and various other investor campaigns focused on driving increased board diversity and disclosures around board composition and refreshment. He said, *"Director biographies now include disclosure on relevant past* *experience and skills that support why a director belongs on the board. Some companies are moving towards an expanded matrix disclosure – this looks at all the qualities you want for the company and evaluates the group to see if they meet the desired needs."* While embracing diverse boards, having too many specialty directors and not having enough company and/or industry experience on the board were noted by several members as a risk for compromising board effectiveness.

Directors also considered the call for increased engagement between the board and directors and changes in investor activism. Mr. Kimball explained, *"The line between active and passive investors is very blurred. Investors today have different priorities than in the past."* Ms. Huennekens added, *"Investors want to engage with the board – passive investors too, not just the activists."* In terms of trends to watch during the 2018 proxy season, Ms. Huennekens and Mr. Kimball expect investors to continue their support for ESG issues, including on climate change and board diversity. Members asked if there has been a trend to appoint directors with environmental experience, similar to the trend of bringing on technology directors, to which Ms. Huennekens replied, *"Yes, … we have seen some companies moving in this direction."* Additionally, executive compensation is expected to remain under scrutiny, with high pay not correlated to performance or in other situations where there is extraordinary compensation requiring additional engagement, as will the new CEO pay ratio disclosure.

Having a plan for activists' approach is key to success

Phil Denning, a partner at ICR, noted that activist investors have recently taken on larger companies, targeting CEOs for operational issues, and looking at companies undergoing CEO transition. He highlighted the emergence of a dedicated media beat on activism, with journalists at major news outlets seeking a constant stream of content on shareholder activism and looking to activist investors for stories and ideas.

According to Mr. Denning, *"Activists in the past looked at cash hoarding, multi-business companies, and financial engineering, and are now focused on agitating purely for operational changes. This is the trend in the activist cycle."* Members agreed that directors nominated by activists these days are far more qualified than those nominated in the past. One said, *"We have two activist-appointed board members at my company and they are very experienced and just want the company to carry out its business plan. Our experience has been completely positive."*

An increase in attacks by those taking short positions in stocks was of concern to members. Mr. Denning referred to *The Capitol Forum,* an online research publication, which appears to have a relationship with short sellers. Mr. Denning reported that his firm had identified a *"high correlation between short campaigns and coverage in* The Capitol Forum*. The short thesis gets out there in* The Capitol Forum *research, and is frequently cited in short reports on* Seeking Alpha*."*

These trends make it more important than ever to engage in *"planning in peacetime,"* according to Mr. Denning. He suggested that companies should conduct tabletop exercises to test their readiness for an activist and annually review the company's strengths and weakness to identify what might provoke an activist attack, the risk disclosures made and related crisis plans for dealing with those risks, and when and under what circumstances the board should be engaged. Mr. Denning also noted the importance of communication to investors: *"There is increasing demand for access to the board, so assign a designated director to engage with shareholders."*

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
- Vanessa Chang, Edison International
- John Cody, Gannett
- Barbara Duganier, Buckeye Partners and MRC Global
- Marcela Donadio, Marathon Oil
- Paulett Eberhart, Cameron
- Bruce Hanks, CenturyLink
- Don Kendall, SolarCity
- Teresa Madden, Peabody
- Gil Marmol, Foot Locker
- Mary Pat McCarthy, Andeavor
- Barry Pearl, Magellan Midstream Partners
- Frank Risch, Pioneer Natural Resources
- Don Robillard, Helmerich & Payne
- Mike Stoltz, Windstream Holdings
- Paul Zucconi, Torchmark

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] *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.

[2] The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and related amendments to PCAOB standards, PCAOB Release No. 2017-001, June 1, 2017.