West Audit Committee Network

March 2018

WACN

SUMMARY of THEMES

Tax reform and information security governance

Company leaders are digesting the widespread implications of the first comprehensive tax reform in over 30 years. In addition, boards are expanding their engagement with information security professionals to ensure that this critical area is receiving satisfactory oversight. In February meetings in Palo Alto and Santa Monica, members of the West Audit Committee Network (WACN) met to discuss these issues.

Directors discuss the implications of US tax reform for corporations

The new tax law comes with two important changes designed to make the US corporate tax code more competitive in the global marketplace. Joe Hogan, EY's West region tax managing partner, explained that on the corporate side there are two major implications: (1) a rate reduction from 35% to 21%, and (2) a shift from a global system to a modified territorial one. He explained that under the new system, *"future profits are taxed only in the jurisdiction where they are earned, subject to the expanded anti-deferral provisions such as global intangible low-taxed income (GILTI)."* There is also a transition tax on historic deferred foreign earnings, payable over eight years. *"Profits that were previously considered trapped will now be deemed repatriated, with a rate of 8% for illiquid investments and 15.5% for cash and cash equivalents."* Mr. Hogan said.

Mr. Hogan and members discussed three key provisions in the new territorial system:

- **Base erosion and anti-abuse tax (BEAT).** The BEAT is a minimum tax that limits deductions for payments to foreign subsidiaries where those payments result in a US tax liability below 10% of the company's modified taxable income. Mr. Hogan cautioned, *"Some companies have significant operations in India that are compensated by the US parent. You can change global contracts to account for this, but it takes time and can be complicated."*
- **Global intangible low-taxed income (GILTI).** *"GILTI is a 10.5% minimum effective tax rate on foreign earnings. This raises questions about intellectual property held in tax-haven countries like Bermuda and Barbados that have an effective tax rate below 10.5%. There are companies planning to move their intellectual property onshore into certain lower tax European countries due to this provision,"* Mr. Hogan said.
- **Foreign-derived intangible income.** This provision provides an incentive for certain income from export of goods and services, which will now be taxed at a preferential 13.125% rate.

The new law required immediate changes to US companies' financial statements. The most critical changes relate to disclosure of the transition tax owed on foreign earnings and deferred tax assets or liabilities. One member mentioned, *"Our company did the initial computations, which was a ton of work, and then I got the dreaded call that we made a mistake. It was a minor hiccup, but it made us rethink the process to include reviews from people outside of the tax chain."* Mr. Hogan added, *"The SEC has come out with Staff Accounting Bulletin [SAB] 118, which allows companies to disclose that the numbers used in the financial statements are estimates. They will have a year to true this up. Of the disclosures we have analyzed, 92% of companies are taking advantage of SAB 118."*

Mr. Hogan also mentioned a change that eliminates the exemption for performance-based compensation from the $1 million deductibility limit on pay to certain covered employees. The law also expanded the scope of those who are covered by this limit to include chief financial officers. Members said that they are monitoring how these changes play out, but did not expect any radical changes to pay plans in response.

How are companies responding to the tax change? Mr. Hogan noted that of the 545 corporate disclosures his team has analyzed, more than three-quarters have issued bonuses to employees or raised the minimum wage at their companies. Some members categorized these decisions as public-relations efforts, not major strategic shifts.

Members also discussed whether the new tax law would lead to different capital-allocation choices. Most members said it was too early to know for sure, but they were considering a range of options. One said, *"We have mostly been channeling dollars into already identified strategic objectives like e-commerce updates."* Others mentioned using additional cash to pay down debt. But one member said that the windfall might not be as large as many expect: *"It seems to me that the amount of taxable income coming back to the US is not necessarily the amount of cash. Nothing gives me a bead on how much tax is actually being repatriated. Yes, there is $3 trillion parked offshore, but companies must invest that somewhere. It's already invested somewhere else."*

Information security leaders share perspectives on their evolving role

Audit committee chairs consider oversight of information security among their most important responsibilities. It is therefore increasingly important for directors to have regular communication with their chief information security officers (CISOs) or other designated leaders. Members were joined by Alex Stamos, chief security officer for Facebook, and Bob Worrall, chief information officer for Juniper Networks, in a session in Palo Alto, and by Jonathan Chow, CISO for Live Nation, in a session in Santa Monica, to discuss the evolving role of information security professionals and ways that audit committees work with them.

In recent years, CISOs have become more prominent members of management teams. Some companies are moving the CISO out of the information technology (IT) organization and providing a direct reporting relationship with a more senior executive. Members and guests

agreed that the CISO's place on the organizational chart is less important than having the ear of senior management and the board. Mr. Stamos espoused the value of a CISO who is part of the small group that is involved in all major decisions at the company.

Members said that their CISOs are spending more time with the audit committee, but with mixed results. Some expressed frustration that the CISO's presentations seemed sterile or did not cover the issue in a board-appropriate way. One member said that interim meetings outside the boardroom could help: *"The audit committee chair assigned me to be the board liaison that meets with the CISO every quarter. I review the results of all red-team exercises and do a report out to the audit committee and the full board. It's useful to have some continuity on the issues and all the learning that goes along with that."*

Mr. Chow asked, *"Does data drive confidence in your CISO? Or is it just confidence in your relationship with them? What convinces you that you are in good shape?"* Members expressed the importance of a trusting relationship, since CISOs are in a better position to evaluate the data than boards. One key to a strong relationship is the ability to break technical jargon down to layman's terms. A good CISO is also able to candidly share his or her concerns with the board. Mr. Stamos said, *"If your CISO is telling you everything is great, you should fire them. You should be hearing 'I am so terrified every day!'"*

Members also rely on external sources to validate their perspectives on the information security team. One said, *"We had an external adviser come in and evaluate the CISO and their team. It helped cement our trust in them and helped the board sleep better at night."* Mr. Worrall agreed with this approach, adding, *"Don't blindly trust your CISO. An independent assessment can help the audit committee get a sense that we are hitting our benchmarks."*

Information security professionals with both technical skills and business acumen are in high demand. One member said, *"It seems like there is a feeding frenzy for talented information security professionals. How do you attract and retain good people?"* The guests suggested that challenging the CISO and his or her team with meaningful work is a key element to retention. (Compensation on par with other senior executives helps too.)

One way to enhance the CISO's portfolio is to include responsibility for not only IT security but also product security. Mr. Worrall added that integrating security at the design stage and having members of the CISO's team embedded in the business helps to build more secure products too.

The massive shift to cloud computing is also changing the CISO's role. Mr. Stamos said, *"Anything standard is pushed out of our data centers and to the cloud. Our IT team maintains oversight, but the cloud service providers are better at securing standard services."* Mr. Worrall added, *"I agree with leveraging the cloud, but keep in mind that if a security incident does occur, you will still share the responsibility with your provider. You can't sign your way out of that."* Mr. Chow cautioned, however, that relying too heavily on cloud providers could be

prohibitively expensive. He said that the CISO and IT team should cooperate to decide how to utilize cloud-based resources.

Mr. Stamos noted an increased focus for CISOs on breach response: *"My role has gone from 90% prevention, 10% response to 50-50. This shift underlines the importance of having a crisis-response plan in place."* One member added, *"You can put locks on all the doors, but the bad guys will just come through the window. We spend a lot of time preparing for crisis response on my boards."* The guests discussed the importance of penetration testing and tabletop exercises to test response capabilities and identify areas for improvement.

Some members were concerned that their board discussions still focused on prevention and detection and planned to ask more questions about breach response. Mr. Stamos added that continuity in the CISO role during a breach response helps: *"There will be a security incident—let this be your expectation. When there is, let your CISO see it through. Wait to make any permanent employment decisions until the situation is resolved. You don't want to lose the person that has insider knowledge of all of your systems in a time of crisis."*

About this document

The West 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

WACN-North meeting

- Skip Battle, Expedia and Workday, Inc.
- Bev Briscoe, Goldcorp
- Joe Bronson, Jacobs Engineering and Maxim Integrated Products
- Judy Bruner, Varian Medical Systems
- Alan Earhart, NetApp
- Earl Fry, Hawaiian Holdings
- Mohan Gyani, Blackhawk Network Holdings
- Paul Haack, Esterline Technologies
- Bala Iyer, Power Integrations
- Lou Lavigne, Depomed, Novocure, and Zynga
- Steve Orlando, Molina Healthcare *(South member)*
- Betsy Rafael, Autodesk and Shutterfly
- Chuck Robel, GoDaddy and Model N
- Malia Wasson, Columbia Sportswear

WACN-South meeting

- Frank Biondi, ViaSat
- Rich Dozer, Knight-Swift Transportation Holdings, Inc
- Burl East, Communidad Realty
- David Engelman, PrivateBancorp
- Leslie Heisz, Edwards Lifesciences
- Ed Lamb, Real Industry
- Roger Molvar, PacWest Bancorp *(North member)*
- Steve Page, AeroVironment
- Dick Poladian, Occidental Petroleum and Public Storage
- Peter Taylor, Edison International

EY was represented by the following:

- Lee Dutra, San Francisco Office Managing Partner, West Region
- Kay Matthews, Vice Chair and West Region Managing Partner
- Todd Moody, West Region Managing Partner of Markets and Accounts
- Mike Verbeck, West Region Assurance Managing Partner