Audit Committee Agendas 2016: Emerging Issues and Best Practices

January 14, 2016

Moderator: **Dennis Chookaszian – Former Chairman and CEO, CNA Insurance Co.**

Panelists: **Ana Dutra – CEO, The Executives' Club of Chicago**

Dave Landsittel – Former Chair, COSO

Bill Tomazin – National Audit Market Development Leader, KPMG

Chookaszian thanked Bill and KPMG for hosting the extended NACD Chicago Audit Program and introduced an ambitious list of topics for the afternoon's program. Each issue was discussed in varying degrees of detail and scope by the panel and members in attendance including the following:

(1) Implementation of New Revenue Recognition Accounting Standard

Tomazin noted that 2016 is the first year of the three-year cycle that will end in 2018 to report revenue items under the new standards. Companies are facing a number of challenges, including long-standing industry norms, long-term contracts, contracts with diverse terms, and the need for internal system changes. Companies must also evaluate the impact of implementation on tax strategies and covenant compliance. Tomazin believes that most companies have not yet decided whether to use full retrospective or cumulative adoption. His recommendation to Audit Committee members is that they understand both the adoption process and the required areas of change.

(2) FASB-related topics of interest to Audit Committees (AC) (including disclosure effectiveness)

Chookaszian discussed the need to study disclosure effectiveness, noting that the voluminous amount of information currently presented often includes unnecessary and immaterial discussions that deter the effectiveness of the disclosures. New rules being proposed by FASB focus on changes to the definition of materiality and the disclosure framework for footnotes. SEC proposals focus on changes to the MDA. Investors are not happy with the proposed changes, and this issue should be an agenda item for boards. Directors should know who at their companies monitor proposed rule changes, and AC members, in particular, should know whether the company's treatment is consistent with peers. Members of the audience noted that peer comparisons are the largest factor in what might be considered excessive and unnecessary disclosure.

(3) Methods of assessing effectiveness of Audit Committees

The Panel noted that more scrutiny and required assessments followed the financial industry meltdown in 2008. Objective assessments of ACs should include the logistics of how the AC functions, including meetings, member qualifications, and resources; the relationship between the AC and the rest of the board; and clarity between the roles and responsibilities of the AC and the Risk Committee. More subjective assessment items should include how the AC communicates with shareholders, and relationships among members and with internal and external audit functions.

(4) Impact of recent PCAOB audits, which have increased documentation standards

Tomazin noted that the PCAOB and the SEC are working well together currently. He believes management should be interested in improving documentation, although Chookaszian noted the increase in costs, mostly centering on the internal audit function. Dutra added that ACs must ensure that internal and external audit groups are not duplicating efforts.

(5) Current COSO developments, including internal control update

Landsittel noted COSO's focus on internal control, fraud, and risk management in the group's 2013 recommendations. There has been good market acceptance, including over 80% of public companies and many private entities as well. The recommendations have become more visible outside the United States as well, having been translated to date into seven languages. Implementation issues remaining include documentation and controls relating to changes in the business environment, like technology. ACs should be concerned with the timing of adoption, particularly as the SEC is clearly asking questions of any company that has not adopted the new standards as of FY15; investments in internal and external audit functions during the transition; and the status of any PCAOB comments and the company's responses.

(6) Future direction of convergence with IFRS

Tomazin noted that the 2008 push by then-SEC commissioner Cox to converge with IFRS has largely been reversed. The SEC is supportive of one high quality set of standards, but is looking for collaboration rather than mandatory or even voluntary compliance. The major issue is industry specific rules.

(7) Pros and cons of outsourcing internal audit functions

Dutra laid out three possibilities, noting that this difficult decision should be based on a careful cost benefit analysis on a company-by-company basis. If a company decides on full outsourcing, it should, at the least, retain a head internal auditor. Under a partial outsourcing scenario, a company can often gain the benefits of external expertise. If a company decides to keep the audit function in-house, the expertise and jobs are clearly directed to the company's needs. If companies find it difficult to outsource because of specific issues or complexities, they might want to follow a "lift and shift" strategy in which internal audit assets are placed with an external firm that can then provide experienced outsourcing. In deciding the best approach for each company, management and board members must determine whether their internal audit teams can develop the expertise needed and how cyclical/scalable their needs might be.

(8) Evaluation and management of cyber security risks

Tomazin noted that cyber security is prominent on most AC agendas, listed as a top-ten enterprise risk issue. Directors want more and better information, and some companies are asking whether they need another board committee for this specific concern. Dutra believes that cyber security should be one of the main responsibilities of the Risk Committee, with members asking management to identify the real assets within the company that need to be protected.

Other topics discussed by the panel included COSO's current project developing an update to its risk framework, the development of block chain technology on ledger processes and the impact on payment systems, the separation of Audit and Risk functions as well as the valuation of newly emerging technologies such as autonomous cars and related risks.

The session adjourned followed by a networking reception.