NATIONAL DIRECTORS INSTITUTE | NDI Executive Exchange

Audit Committees

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FOLEY

FOLEY & LARDNER LLP

Panelists

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Non-GAAP Financial Measures

- On May 17, 2016 the SEC issued Compliance and Disclosure Interpretations regarding the use of non-GAAP financial measures.
- The CD&I's focus on SEC Regulation G and Item 10(e) of Regulation S-K.
- The SEC expressed concern regarding a perceived over-emphasis on non-GAAP financial information, with particular focus on "equal or greater prominence" requirements.

Non-GAAP Financial Measures

- Item 10(e)(1)(i)(A) of Regulation S-K requires that when an issuer presents a non-GAAP measure, it must present the most directly comparable GAAP measure with equal or greater prominence.
- The CD&I's make it clear that the following disclosures of non-GAAP measures are more prominent and therefore noncompliant:
  - omitting comparable GAAP measures from an earnings release headline or caption that includes non-GAAP measures;
  - a non-GAAP measure that precedes the most directly comparable GAAP measure (including in an earnings release headline or caption);
  - presenting a non-GAAP measure using a style of presentation (e.g., bold, larger font) that emphasizes the non-GAAP measure over the comparable GAAP measure;
  - describing a non-GAAP measure as, for example, "record performance" or "exceptional" without at least an equally prominent descriptive characterization of the comparable GAAP measure;
  - presenting a full income statement of non-GAAP measures or presenting a full non-GAAP income statement when reconciling non-GAAP measures to the most directly comparable GAAP measures;
  - providing tabular disclosure of non-GAAP financial measures without preceding it with an equally prominent tabular disclosure of the comparable GAAP measures or including the comparable GAAP measures in the same table;
  - excluding a quantitative reconciliation with respect to a forward-looking non-GAAP measure in reliance on the "unreasonable efforts" exception in Item 10(e)(1)(i)(B) without disclosing that fact and identifying the information that is unavailable and its probable significance in a location of equal or greater prominence; and
  - providing discussion and analysis of a non-GAAP measure without a similar discussion and analysis of the comparable GAAP measure in a location with equal or greater prominence.

Non-GAAP Financial Measures

- The SEC Division of Corporate Finance has been sending comment letters on these points to approximately 80 or more known companies during 2014-2016.
- During September the SEC Division of Enforcement sent out many broadly worded requests seeking information from as far back as 2012, including both earnings releases and SEC filings.
- On September 8 the SEC instituted an enforcement action against a REIT for manipulating a measure called "adjusted funds from operations" which it was also reporting on a per share basis.

Audit Committee “Overboarding”

- There is no absolute limit on the number of audit committees on which a person can serve.
- However, the New York Stock Exchange (the “NYSE”) discourages directors from serving on more three audit committees.
- Furthermore, the NYSE requires that if an audit committee member simultaneously serves on the audit committees of more than three public companies, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the company’s audit committee.
- Additionally, the company must disclose such determination either on or through the company’s website or in its annual proxy statement or annual report on Form 10-K, as applicable.
  - If this disclosure is made on or through the company’s website, the company must disclose that fact in its annual proxy statement or annual report, as applicable, and provide the website address.
- NASDAQ does not have a comparable rule.
- Due to this disclosure requirement, the practical challenges and risks to a board member serving on audit committees of multiple companies, as well as the risks to the companies themselves, many public companies require that their audit committee members not serve on more than three public company audit committees.

Directors' and C-Level Executives' View of Cybersecurity

- More than 90% of corporate executives say they cannot read a cybersecurity report and are not prepared to handle a major cybersecurity attack.
- 98% of the most vulnerable have little confidence in their company's ability to monitor devices/users on their systems.
- 40% said they don't feel responsible for the repercussions of hacking and not personally responsible for cybersecurity or for protecting customer data.
- It's the IT department's problem.
  - Source: Center for Strategic and International Studies survey that polled 1,530 non-executive directors and C-level executives from US, UK, Germany, Japan, and Nordic countries.

Directors' and C-Level Executives' Cybersecurity Assessment

- What are the greatest cyber security threats and risks to the Company's highest-value intangible assets, and the most sensitive Company and customer information?
- What is the Company's volume of cyber security incidents on a weekly or monthly basis?
- What would the worst-case cyber incident cost the Company in terms of lost business, system downtime, reputational damage?
- What is the Company's specific cyber security breach response and crisis management plan, and how will it respond to customers, clients, vendors, the media, regulators, law enforcement, and shareholders, traditional and social media, NGOs, bloggers? Have the plans been practiced in mock situations?

Directors' and C-Level Executives Cybersecurity Assessment

- What cyber security training does the Company include in its compliance program?
- What due diligence does the Company perform with respect to its third-party service providers?
- What cyber security due diligence is done as part of any acquisition?
- Has the Company performed a cyber security IT audit of the Company's systems, services and products to analyze potential vulnerabilities that could be exploited by hackers?
- What infrastructure enhancements have been adopted to show affirmative action to protect the Company's IP, intangible assets, sensitive data and customer data and personal information?

Common Components of Effective Security Policy Programs

- Be aware of Federal and State requirements; tailor privacy policies as applicable.
- Designate people responsible for security in the organization.
- Conduct security training for employees.
- Take reasonable steps to ensure vendors/service providers protect data.
- Consider minimizing data collection.
- De-identify where possible.
- Conduct a privacy or security risk assessment initially and periodically thereafter.
- Consider encryption, particularly for storage and transmission of sensitive information such as health data.

Personal Relationships Between Management and Auditors

- On September 19, 2016, the SEC announced its first enforcement actions against auditors that violated the independence rules by developing close personal relationships, both platonic and romantic, with their audit clients.
- The auditors were employed by Ernst & Young LLP ("E&Y"), which paid $9.3 million to settle the charges.
- The Platonic Relationship
  - A former E&Y partner developed an inappropriate relationship with the then chief financial officer of audit client after being asked by the firm to improve relationships with the troubled account.
    - E&Y had policies relating to independence, including directives on travel and gifts. Those policies were repeatedly violated, and the partner incurred entertainment expenses of over $100,000 for activities involving the CFO. The majority of the expenses were billed as audit expenses.
    - The partner was ordered to pay a $45,000 penalty and is barred from appearing or practicing before the SEC.
    - E&Y paid disgorgement of $3,562,400 of audit fees, together with prejudgment interest of $212,600 and a civil money penalty of $1.2 million.
    - E&Y also revamped its policies and procedures with respect to client entertainment and expenses.

Personal Relationships Between Management and Auditors

- The Romantic Relationship
  - A former E&Y partner was involved in a romantic relationship with an audit client's chief accounting officer, while she performed audit and review services.
    - The coordinating partner was aware of the romantic relationship but did not raise concerns with the firm's independence group.
  - The relationship was uncovered after a whistleblower complaint, and E&Y had to withdraw its audit reports on the financial statements along with the reports on the effectiveness of internal control over financial reporting.
  - The partner cannot appear or practice before the SEC for three years, and the CAO cannot appear or practice before the SEC for one year. They were ordered to pay $25,000 each.
  - E&Y was ordered to pay disgorgement of $3,168,500 of audit fees, prejudgment interest of $198,151, and a civil money penalty of $1 million.
  - As a result, E&Y improved its independence policies and procedures regarding personal relationships and the impact of those relationships on E&Y's independence.

PCAOB Re-Proposal on the Auditor's Report

- On May 11, 2016, the PCAOB re-proposed for public comment an auditor reporting standard that would enhance the auditor's report.
- Intended to make the report more relevant and informative to investors and financial statement users.
- The re-proposal revises the initial proposal issued in August 2013.
- In particular, it modifies the definition of what would be included as "critical audit matters" ("CAM").

PCAOB Re-Proposal on the Auditor's Report

- The auditor would be required to communicate CAM arising from the audit of the current period's financial statements.
  - CAM are any matters arising from the audit of the financial statements communicated, or required to be communicated, to the audit committee and that (i) relate to accounts or disclosures that are material to the financial statements and (ii)involved especially challenging, subjective, or complex auditor judgment.
- The auditor's report would (i) identify the CAM; (ii) describe the principal considerations that led the auditor to determine the matter is a CAM; (iii) describe the matter was addressed in the audit; and (iv) refer to the relevant financial statements and disclosures.

PCAOB Re-Proposal on the Auditor's Report

- The re-proposed standard modifies the 2013 proposal in the following ways:
  - It limits the source of potential CAM to matters communicated, or required to be communicated, to the audit committee;
  - It adds a materiality component to the definition of CAM as it relates to accounts or disclosures;
  - It narrows the definition to only those matters that involved especially challenging, subjective, or complex auditor judgment;
  - It narrows the related documentation requirement to be consistent with the definition of a CAM; and
  - It expands the communication requirement so the auditor describes how the CAM was addressed in the audit.

PCAOB Form AP

- On December 15, 2015, the PCAOB adopted new rules and amendments requiring disclosure of the name of the engagement partner and information about other accounting firms that took part in the audit.
- The information is filed by the auditor on the PCAOB form, Auditor Reporting of Certain Audit Participants ("Form AP").
- The filing requirements are the following:
  - The name of the engagement partner;
  - The names, locations, and extent of participation of other accounting firms that took part in the group audit, if their work constituted 5% percent or more of the total group audit hours; and
  - The number and aggregate extent of participation of all other accounting firms that took part in the group audit whose individual participation was less than 5 percent of the total group audit hours.
- Auditors must begin filing Form AP for public company audit reports issued on or after:
  - January 31, 2017, for engagement partner names.
  - June 30, 2017, for other audit firms that participated in the audit.

Enforcement Trends

- With its Financial Reporting and Audit Group of dedicated lawyers and accountants and a data analytics system comparing 100+ corporate financial statement metrics to generate leads, the SEC is driving change more than ever before.

Audit Committees Critical to Keep the SEC From Knocking

- Audit committees should be aware of enforcement trends and internally flagging issues before the SEC comes knocking, particularly given recent actions against noncompliant audit committee chairs and other gatekeepers.

SEC Enforcement Priorities

- What are the SEC's current financial reporting and disclosure enforcement priorities?
  - Revenue recognition
  - Valuation and impairment issues
  - Earnings management
  - Missing and insufficient disclosure on perks and related parties
  - Internal accounting controls
  - Clawbacks of bonuses and incentive-based compensation when restatements occur due to misconduct

Defensive Priorities

- What top three priorities should audit committees be tackling now?
  - Proactively address ASC 606, the new revenue recognition standard that will significantly impact every enterprise's reporting, disclosure and internal controls procedures.
  - Increase focus on related party transactions and overall risk assessment, particularly as the PCAOB ramps up oversight in these areas.
  - Fine tune enterprise process to strongly incentivize whistleblowers to report to the committee, as 18% of SEC tips relate to corporate financial and disclosure matters.

SEC Disclosure Effectiveness Project

Project timeline

December 2013
Public Company Disclosure
(Staff Report)

September 2015
Effectiveness of Financial Disclosures about Entities Other than the Registrant
(Request for Comment)

April 2016
Business and Financial Disclosure Required by Regulation S-K
(Concept Release)

July 2016
Disclosure Update and Simplification
(Proposed Rule)

https://www.sec.gov/spotlight/disclosure-effectiveness.shtml

SEC Concept Release

Business and Financial Disclosure Required by Regulation S-K

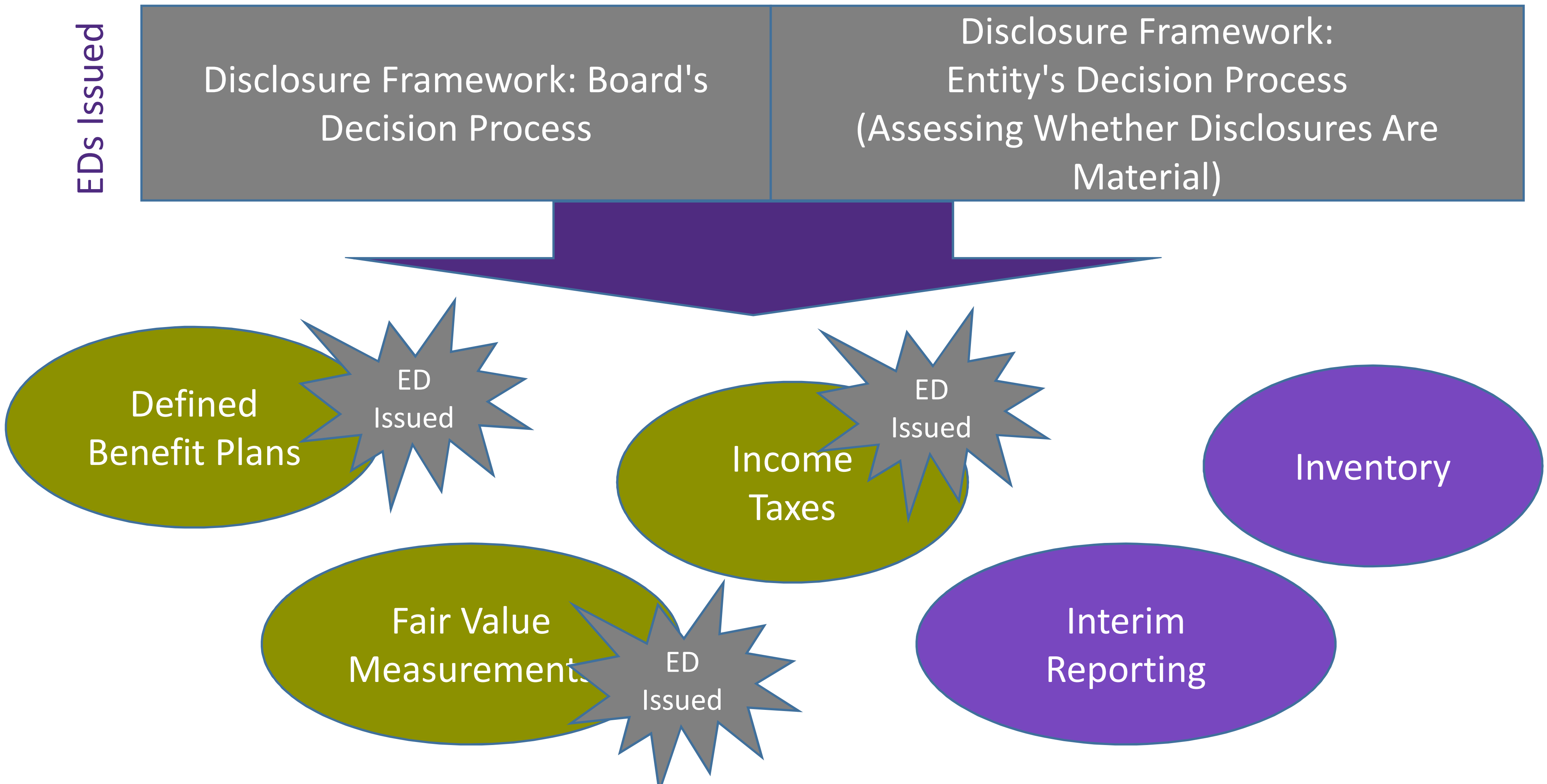
- Disclosure framework
- Business and financial disclosures
- Presentation and delivery of information
- Other matters

SEC Proposed Rule
Disclosure Update and Simplification

Purpose: To eliminate redundant, overlapping, outdated, superseded disclosure requirements	Should the SEC modify or eliminate disclosure requirements that overlap with US GAAP?
Mainly applicable to domestic issuers and foreign private issuers	Should the SEC disclosure requirements to refer incremental the FASB for potential incorporation into US GAAP?

FASB Disclosure Effectiveness Project

Work to date



FASB Disclosure Effectiveness Project

Work to date

Improve effectiveness of disclosures

Add certain disclosures

Modify certain disclosures

Remove certain disclosures

Revenue Implementation

Transition Resource Group (TRG)

- Formed by the FASB and IASB to address stakeholder questions raised
- Identifies areas where the new guidance may be unclear or could lead to diversity in practice
- Provides a forum for stakeholders to learn about the guidance
- While non-authoritative, SEC advises entities to follow the TRG

www.fasb.org > Standards > Revenue Recognition Transition Resource Group

Revenue
Implementation challenges

Selecting a transition approach	Communicating the impact of adoption with appropriate stakeholders	Determining system needs / how to meet disclosure requirements	Resource constraints / budget challenges
Updating accounting policies, internal controls and documentation	Educating staff cross-functionally	Getting comfortable with the increased need for judgment	Devil is in the details

- Variable consideration and the constraint
- Accounting for customer options
- Determining if the "over time" criteria are met

Leases

Lessee Implementation challenges

Selecting a transition approach	Communicating the impact of adoption with appropriate stakeholders	Determining system needs / how to meet disclosure requirements	Resource constraints / budget challenges
Updating accounting policies, internal controls and documentation	Educating staff cross-functionally	Getting comfortable with the increased need for judgment	Devil is in the details

- Identifying a lease
- Determining lease and non lease components

THE NEW REVENUE RECOGNITION STANDARD

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THE NEW REVENUE RECOGNITION STANDARD

- Overview
- Complexity drivers
- Challenge ahead

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THE NEW REVENUE RECOGNITION STANDARD
BACKGROUND

- Joint project between FASB and IASB to issue a single converged principle-based revenue recognition standard

- Effective for public entities for annual reporting periods beginning after December 15, 2017. Early adoption is permitted to original effective date of annual periods beginning after December 15, 2016.

- Transition Resource Group formed to discuss implementation issues

- Amended in 2016 to clarify certain aspects of the guidance including identifying performance obligations and implementation guidance on licensing and principal versus agent evaluations

- Supersedes virtually all revenue recognition guidance in US GAAP and IFRS, including prescriptive guidance and industry-specific practices

- Utilizes more principles and requires more estimates and greater judgment

- Requires evaluation of the policies, processes, systems and controls by which revenue is recognized and disclosed

- Security and Exchange Commission (SEC) is yet to announce on-going relevancy of SAB 104

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THE NEW REVENUE RECOGNITION STANDARD
OVERVIEW - TRANSITION OPTIONS

	2016	2017	2018
Full Retrospective	Current GAAP		New GAAP
	New GAAP (restated)		New GAAP

Cumulative Effect

Effective date 1/1/18

	2016	2017	2018
Modified Retrospective	Current GAAP		Disclose impact on each line item
			New GAAP

Non public entities have one additional year to adoption – effective date is January 1, 2019 for calendar year non public entities

THE NEW REVENUE RECOGNITION STANDARD

OVERVIEW - FIVE-STEP MODEL

Core principle – Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity ***expects to be entitled*** in exchange for those goods or services

- Identify the contract(s) with a customer
- Identify the performance obligations
- Determine the transaction price
- Allocate the transaction price to the performance obligations
- Recognize revenue when or as an entity satisfies performance obligations

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THE NEW REVENUE RECOGNITION STANDARD
COMPLEXITY DRIVERS - ACCOUNTING

Contracts

- Specific criteria to identify existence of contract
- New guidance on contract modifications
- Requirement to identify explicit and implicit terms
- Collectibility assessment
- Contract combinations

Performance Obligations

- Identification of all explicit and implicit promises
- Determination of separation of promises
- Assessment of future purchase options
- Assessment of warranty features
- Principal versus agent considerations

Transaction Price

- Fixed + Variable component
- Identification and estimation of variable consideration
- Payments made to customers
- Non cash consideration
- Impact of modifications on transaction price

Allocation

- Estimation of stand-alone selling price
- Specific guidance on allocation of variable consideration and discounts

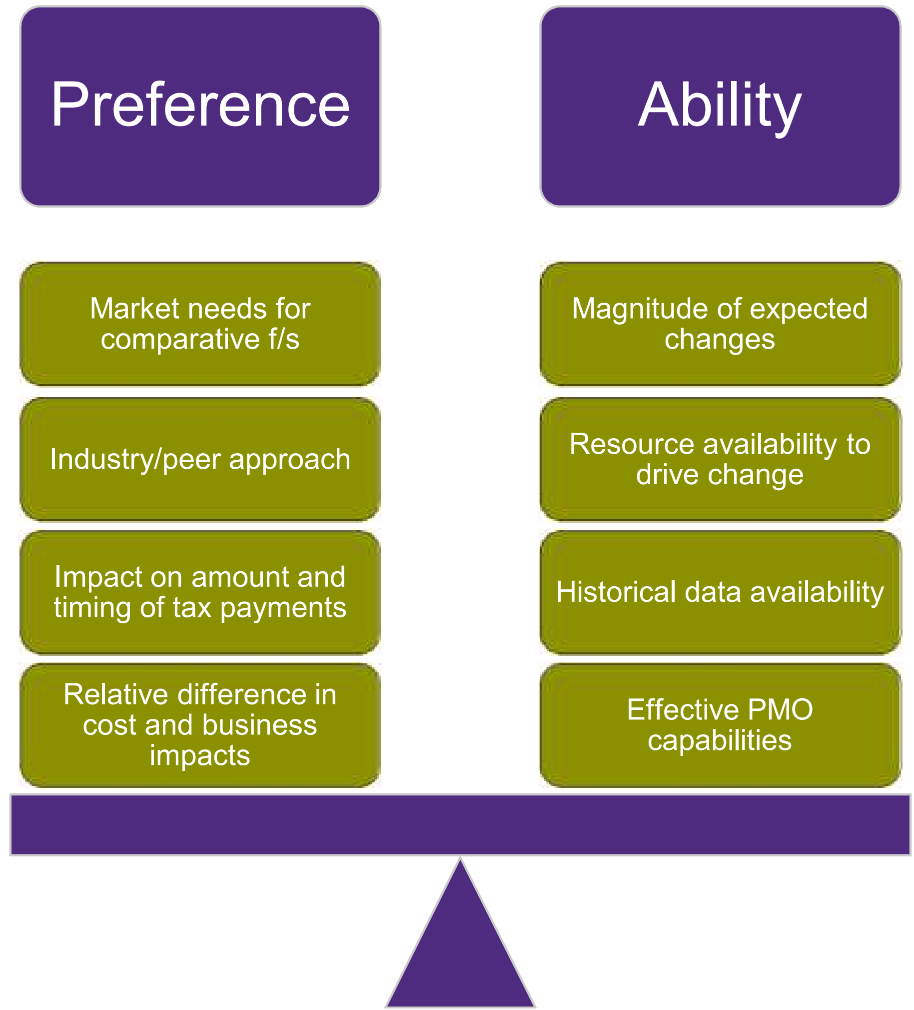
Pattern of Recognition

- Transfer of control point in time or overtime
- Assessment of measuring progress over time
- Repurchase provisions
- Nature of licenses
- Impact of customer acceptance

Disclosures

- Significantly increased disclosure requirements including presentation of both quantitative and qualitative information at a more disaggregated level

THE NEW REVENUE RECOGNITION STANDARD
COMPLEXITY DRIVERS – TRANSITION METHOD



THE NEW REVENUE RECOGNITION STANDARD

COMPLEXITY DRIVERS - IMPLEMENTATION

- Diverse lines of businesses
- Local/Global operations
- Centralized/Decentralized operating model
- Number of IT/ERP systems
- Level of statutory requirements
- Experience with significant change management
- Standard/Nonstandard contracting practices
- Level of required accounting change

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THE NEW REVENUE RECOGNITION STANDARD

CHALLENGE AHEAD - MORE THAN AN ACCOUNTING CHANGE

Requires evaluation of the policies, processes, systems and controls throughout entire organization – EVERYONE IS IMPACTED!

THE NEW REVENUE RECOGNITION STANDARD
CHALLENGE AHEAD - PATH FORWARD

Interdependency of phases

Project planning
- Training and education
- Cross organizational governance structure
- Project management office set up
- Timeline creation including specific milestones
- Internal and external stakeholder communication plan development
- Understanding inventor/analyst expectations
- Involvement with and benchmarking to peer group

Accounting impact assessment
- Transition method selection
- Accounting gap analysis
- Revenue stream scoping
- Contract sampling and review
- Policy whitepaper development
- Disclosure requirements assessment
- Quantification of impact
- Assessment of changes to any financial covenants

Solution development
- Selection of manual versus system solution
- Identification of required management information
- Identification of business requirements to affect accounting change including process changes to capture additional data points
- Data conversation including data integrity testing
- Evaluation of risks related to completeness and accuracy of data
- Development of processes and controls
- Changes to contracting practices and renegotiations with customers
- Testing and parallel running of solution including testing of new processes and controls
- Go-live planning

Operationalize and sustain
- Post go-live support
- Continuing process review and improvement plan
- Continuous optimization of solution

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THE NEW REVENUE RECOGNITION STANDARD
CHALLENGE AHEAD - HOW CAN GT HELP?

PLANNING	**Initial Planning**	• Assist or perform materiality of impact assessments of significant revenue streams • Identify key implementation issues for each materially impacted revenue stream/geography/division/subsidiary • Evaluate transition options • Work with management to develop action plans and timetables
	Detailed planning and implementation oversight	• Leverage the overall initial assessment and implementation timetables to develop very detailed action steps • Through a Grant Thornton PMO, oversee and report on implementation progress • Adjust plans as needed based on frequent consultation with management and pursue completion of the plans.
ASSESSMENTS	**Assess IT systems, design implementation plans, and execute on plans**	• May involve modification of existing systems, as well as adoption of new systems and reporting interfaces
	Assess tax implications	• Assess tax provision and return filing implications due to changes to revenue recognition and whether corresponding changes in method of accounting are necessary
	Assess compensation and benefits implications	• Redesign, train and implement new comp and benefits arrangements
	Assess implications for sales	• Assess for sales agents, representatives, and vendors • Work with legal resources to redesign, train and implement new arrangements
	Assess debt covenant implications	• Work with management on negotiation of new arrangements, work-arounds and other accommodations

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THE NEW REVENUE RECOGNITION STANDARD
CHALLENGE AHEAD - HOW CAN GT HELP?

DEVELOP NEW PROCESSES	**Develop new processes** **Update or implement applicable financial reporting systems**	• Develop processes and controls • Create process and control documentation • Update or implement applicable financial reporting systems • Train personnel • Document new controls with linkage to new COSO Framework
	Draft accounting policy manuals **Assist with any necessary tax filings**	• Draft policy manuals, policy disclosures, and interim disclosures about implementation status and expected impact • Prepare any necessary Forms 3115 to request a change in accounting method from the IRS
RESOURCE SUPPORT	**Technical Accounting Resource support** **Financial Systems Experts** **Loan Staff Professionals**	• For aspects of the project managed internally by company personnel, Grant Thornton to provide technical specialists to support internal teams • Grant Thornton can provide all levels of accounting and other professionals to assist in aspects of implementation that may require resources to supplement company personnel

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THE NEW LEASE STANDARD

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THE NEW LEASE STANDARD

- Overview
- Industry specific considerations
- Complexity drivers
- Challenge ahead

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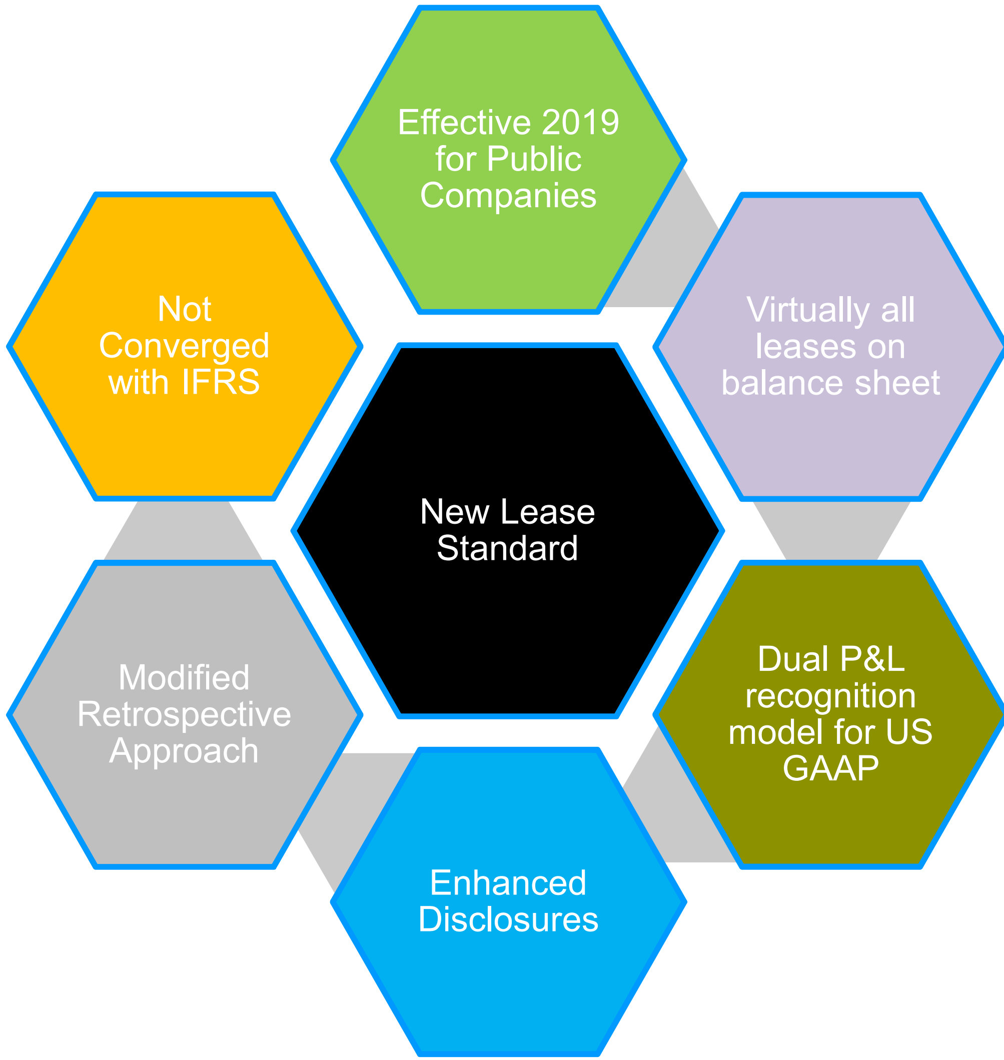
THE NEW LEASE STANDARD
OVERVIEW - BACKGROUND

- Effective for public entities for annual reporting periods beginning after December 15, 2018. Early adoption is permitted
- As issued, FASB standard is not fully converged with IFRS 16 issued by International Accounting Standards Board (IASB)
- Requires lessees to put most leases on their balance sheets but recognize expenses on their income statements in a manner similar to today's accounting. The guidance also eliminates today's real estate-specific provisions for all entities
- For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases
- All entities classify leases to determine how to recognize lease-related revenue and expense. Classification continues to affect what lessors record on the balance sheet
- Entities may be required to develop new processes and controls or adjust existing processes and controls to identify and account for leases
- Practical expedient (as part of a package of transition related expedients) allow entities to make policy choice to apply existing lease identification and classification conclusions, however asset and liabilities must still be booked on balance sheet

THE NEW LEASE STANDARD
OVERVIEW - HIGHLIGHTS (LESSEE)



Requires separation of lease and non-lease components unless practical expedient is selected

THE NEW LEASE STANDARD

OVERVIEW - STEPS IN RECOGNITION OF A LEASE

Definition– contract is or contains a lease if it conveys the right to control the use of identified property, plant or equipment (an identified asset) for a period of time in exchange for consideration

Bright lines are no longer retained in the requirements to assess finance lease but can be used

Identifying a lease

- **An identified asset**
- Explicitly or implicitly specified
- Supplier has no practical ability to substitute or would not economically benefit from substitution
- **The right to control use of the asset**
- Decision-making authority over the use of asset
- The ability to obtain substantially all economic benefit from the use of the asset

Lease classification

- **Finance lease**
- Transfer of ownership
- Option to purchase is reasonably certain
- Lease term is a "major part" of the economic life
- Present value of lease payments is "substantially all" of the fair value
- Specialized nature
- **Operating lease if not finance lease**

Recognition & measurement

- **Operating lease**
  - Right to use asset and lease liability on B/S
  - Lease expense on I/S
- **Finance lease**
  - Right to use asset and lease liability on B/S
  - Interest expense and amortization expense on I/S

Ongoing requirements

- Reassessment upon modification
- Asset impairment for right-to-use asset

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INDUSTRY SPECIFIC CONSIDERATIONS: Retail

THE NEW LEASE STANDARD
COMPLEXITY DRIVERS

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CHALLENGE AHEAD - PATH FORWARD

Project planning

- Training and education
- Cross organizational governance structure
  Project management office set up
- Timeline creation including specific milestones
  Internal and external stakeholder communication plan development

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Accounting impact assessment

- Inventory of lease contracts
- Accounting assessment of identified lease contracts
- Disclosure requirements assessment
- Quantification of impact
  Assessment of changes to any financial covenants

→

Solution development

- Selection of manual versus system solution

→

Operationalize and sustain

- Post go-live support
  Continuing process review and improvement plan
  Continuous optimization of solution

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