



Board oversight of special investigations and SEC trends

On March 9, 2016, members of the South chapter of the West Audit Committee Network (WACN) met in Santa Monica, CA. In one session, members were joined by Bjorn Malmlund, EY Partner and West region Fraud and Investigative Dispute Services leader, and David Schindler, a Partner at Latham & Watkins, for a discussion about the board's role in special investigations. In another session, members discussed Securities and Exchange Commission (SEC) trends with EY Partners Glenn Burr and Jeff Slate. For a full list of meeting participants, please see page 4.

Board oversight of special investigations

Government enforcement inquiries and allegations of financial irregularities or senior executive misconduct often trigger investigations by independent board directors. Whether the audit committee or a special board committee leads the investigation, members emphasized the importance of seeking the right outside experts to assist in such an investigation. In most serious cases, the board seeks lawyers and forensic accountants who are independent from the company. One member said, *“The choice of outside counsel is incredibly important. You need to find someone who is independent but also has the board’s confidence and has credibility with stakeholders, including the SEC or Justice Department.”*¹ Members said that having the right counsel is especially important at the end of an investigation, when the whole board, not just those on the investigating committee, may have to act upon that lawyer’s advice.

Members discussed some of the challenges associated with scoping a major investigation. One member said, *“This is a real challenge. Expenses and benefits need to be balanced. We need counsel to weigh in with other experts to come up with a game plan.”* Mr. Schindler emphasized establishing a scope that accounts for the unpredictable nature of investigations: *“It is important to take a measured, step-by-step approach. The runaway investigations tend to be the ones where you make a plan in advance and just follow it blindly. You need to think in terms of ‘if A then B; if not A, then let’s reassess.’”* This approach requires the board and its advisers to be in regular communication throughout the investigation. One member explained, *“It is important to meet with the outside resources on a regular basis to make sure we are on the right track. There are judgment calls that are made every day. It is not good to let the lawyers and accountants make those decisions alone.”*

Members were also interested in the relationship between an audit committee and its external auditors during an investigation. Mr. Malmlund said, *“There is a lot of value in providing a heads-up call to your auditor at the beginning of your investigation to let them know what you are doing. We don’t want to interfere with the investigation; we just like periodic updates to understand what work is being performed. This helps to preserve the relationship of trust between the board, auditors, and management team.”* He added that the audit firm will conduct its own shadow investigation and that regular touchpoints ensure that all parties are focused on the right issue. Mr. Schindler added, *“My thesis about the appropriate scope of an*

¹ This document 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.



investigation is validated when we receive sign-off from the risk management team at the external audit firm. They can't be surprised."

A critical decision that boards face in many investigations is whether to self-report their findings to the government. Mr. Schindler said, *"My advice is that you need a robust discussion about this topic with the full board and, in some cases, management. In most cases, boards conclude that it is in their best interest to disclose."* Mr. Malmlund added, *"It is difficult to calculate the value of self-reporting, because the government does not announce when it declines to bring a case or whether the size of a penalty would have been different had a company self-reported."* Members said that it is especially important to obtain good advice from outside experts on this topic. One explained, *"Self-reporting is very context dependent. You need someone who knows exactly how the government agency at issue will react."*

Members also grappled with the decision about when to conclude an investigation, particularly one where there are no findings of wrongdoing. One said, *"It is really tough to turn off an investigation. I don't know of any way to protect the company other than to get to a point where everyone is comfortable with the conclusion."* Mr. Schindler said, *"Knowing when to stop has a lot to do with making sure that stakeholders like the audit firm and the government are comfortable with what we have done. That means thinking like them and also speaking with them to get comfort."*

SEC trends

In their discussion with Mr. Slate and Mr. Burr, members discussed the SEC's near-term priorities. Mr. Slate explained that this is likely Mary Jo White's final year serving as SEC chair: *"While commissioners, including the Chair, serve five-year terms, it is the custom for the Chair and senior division leaders to change when there is a change in the White House."* He added, *"The SEC is constrained because there are only three [rather than five] sitting Commissioners today. Chair White has signaled that she has no desire for a short-handed Commission to address weighty issues."* On March 15, the Senate Banking Committee questioned President Obama's nominees for the two vacancies, Democrat Lisa Fairfax and Republican Hester Peirce, but their path to confirmation is uncertain.²

One priority that members discussed was enforcement, particularly in the area of financial fraud. Mr. Slate said that the SEC is paying closer attention to gatekeepers, including external auditors and board members: *"If there are red flags present that aren't adequately addressed, the SEC is likely to take a closer look at these groups."* In addition, the SEC is using data analytics to identify potential violations. One member asked, *"If the analytics raise a question, will the SEC have the Division of Corporation Finance ask for a response or will it go right to the Division of Enforcement?"* Mr. Slate said the Enforcement Division staff generally handles these matters directly.

Members also discussed the SEC's current project to encourage improved corporate disclosures. Mr. Slate said, *"The goal of this project is not just simplification and reduction. The SEC wants to make disclosures more effective by shifting from a rules-based system to a principles-based one."* Mr. Burr added that corporate disclosure reform is likely to receive continued attention from the SEC, even following a change

² Dave Michaels, ["SEC Nominees Face Sharp Questioning at Confirmation Hearing,"](#) *Wall Street Journal*, March 15, 2016.



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in leadership, due to the staff's engagement on this issue. Members wondered whether this project would cause changes in the disclosure of non-GAAP measures. One asked, *"In some industries, GAAP financials are not very meaningful for investors. We don't want to have to leave it to the analysts to make these calculations on their own."* Mr. Burr said, *"The staff continues to ask about these disclosures and really wants everyone to have the same definitions of key metrics, but they have generally been satisfied so long as there is a clear reconciliation back to the GAAP numbers."*

Another topic of interest was trends in SEC comments on corporate filings. Mr. Slate said, *"A hot topic right now is segment reporting. Do you report on the right segments? The SEC is looking to see what information is provided to a company's chief operating decision maker and whether investors are getting information about the same segments."*

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.

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Meeting participants

- Frank Biondi, Audit Committee Chair, Amgen
- Ralph Boyd, Former Audit Committee Chair, DIRECTV
- Vanessa Chang, Audit Committee Chair, Edison International
- Rich Dozer, Audit Committee Chair, Swift Transportation
- Burl East, Audit Committee Member, Excel Trust
- Jim Hunt, Audit Committee Chair, Brown & Brown
- Diana Laing, Audit Committee Chair, Macerich
- Marty Melone, Audit Committee Member, CanWel Building Materials
- Steve Page, Audit Committee Member, AeroVironment
- Dick Poladian, Audit Committee Chair, Occidental Petroleum and Public Storage
- Joe Tesoriero, Audit Committee Chair, Smart & Final Stores

EY was represented during all or part of the meeting by the following:

- Glenn Burr, Partner, Assurance Services
- David Jolley, West Markets Managing Partner
- Jenn Lee, Senior Manager, Center for Board Matters
- Bjorn Malmlund, Partner and West Fraud and Investigative Disputes Leader
- Jeff Slate, Partner, Assurance Professional Practice
- Michael Verbeck, West Deputy Assurance Managing Partner