Surveying the Regulatory Landscape

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The pace and extent of regulation are a top concern for directors, as investors and regulators have been pushing for greater transparency. NACD, in partnership with the audit consulting firm BDO USA, hosted a roundtable discussion in New York City that focused on how public company directors are addressing these issues and the future of disclosure requirements. Facilitating the discussion were Jay D. Hanson, board member of the Public Company Accounting Oversight Board (PCAOB); Lowell Robinson, director of EVINE Live, Smithsonian Libraries, and the Metropolitan Opera Guild; Amy Rojik, partner at the Center for Corporate Governance and Financial Reporting, BDO USA; and Leslie Seidman, former chair of the Financial Accounting Standards Board (FASB), current executive director of the Pace University Center for Excellence in Financial Reporting, and director and audit committee chair of Moody's Corp. and the Financial Industry Regulatory Authority (FINRA).

The first part of the discussion focused on the board's role in setting cybersecurity strategy and monitoring practices. Some attendees suggested that the subject was too broad to be wholly delegated to a single committee, while others saw oversight responsibility as being within the natural purview of the audit committee and posited that more gets done because there are fewer people primarily responsible for oversight. But all attendees agreed that the full board not only needs to have a grasp on the subject, but also needs to stay up to date on this area of risk because it constantly changes.

"If you choose to house this function within a committee, that committee really needs to have full access to the director of information technology [IT], outside consultants, whatever they need to become comfortable with this issue," said Maria Karalis, BDO USA audit managing partner. "Cybersecurity is not just a monetary risk, it's a reputational risk."

When a company does get hacked, directors face a potential onslaught of regulatory actions from both state and federal agencies. Here, Robinson mentioned the forthcoming attestation standard of the American Institute of Certified Public Accounting (AICPA) designed to evaluate the effectiveness of a company's cyber-risk management practices. "AICPA standards already require that auditors understand how IT is used and its impact on financial statements and how it impacts IT controls," he said. "In assessing the risk of misstatements, auditors are already required to demonstrate their understanding of the company's IT systems and controls. The question becomes: 'Should auditors go the extra step and attest to the organization's cyber risk oversight effectiveness?'"

"From the auditor's perspective, we're looking at it as performing a service where we can attest to management's description of their cybersecurity risk framework and the suitability of the design and operating effectiveness of related controls," Rojik said. "The first step is to get management to a point where they can describe the criteria, controls, and activities they are performing. What better people to do it than the people who are already looking at it and understand such controls and activities?"

This is a prime concern considering that stress-testing processes may need to be communicated to shareholders. While there are steps that the board can take to manage risk, no set of cyber-risk management standards is dynamic enough to provide assurance—and there is no single standard by which boards can assess their own processes. Some directors noted that they enlist the services of white hat hackers to stress test their systems; others suggested hiring a different firm each year to evaluate the company's systems.

The second area of discussion explored the use of non-GAAP measures to communicate various dimensions of company performance to shareholders. Directors and auditors noted the degree to which they are used can draw unwanted attention from federal regulators.

"When I was at FASB, we challenged ourselves to think about whether the use of non-GAAP measures meant there was something wrong with the accounting standard," Seidman said. "Now that I am on a couple of boards, I can see the need to communicate information in more than one way so that people can understand the company's core performance. Companies get in trouble when they put more emphasis on the non-GAAP than the GAAP and when they selectively use non-GAAP reporting to make the numbers look better." In addition to referring to the Securities and Exchange Commission's (SEC's) updated guidance, Seidman identified three areas board members need to consider when using non-GAAP measures:

1. Know whether management is up to date on current regulations and comment letters that other companies have received on the use of non-GAAP measures.
2. Understand the internal policies and processes for deciding which non-GAAP measures are being used, and why.
3. Consider whether the company is being consistent in its approach to both positive and negative adjustments, and whether the company seems to be an outlier compared with peer companies.



Leslie Seidman (left), Amy Rojik, and Jay Hanson

"We've had a number of questions about the auditor's role," Hanson said. "A couple years ago we put out a proposal on what the auditor does relative to information outside of the financial statements but included in a filing. The non-GAAP measures were presented in earnings releases, and investors' calls were not part of that proposal, but questions are being discussed about that the auditor's role should be. Another topic that gets rolled into the non-GAAP bucket is key performance indicators. There are a number of ways to slice and dice information, none of them totally right, none of them totally wrong."

In the third segment of the roundtable, Hanson discussed a PCAOB project that takes its cues from European governance models. The project, which has been through several iterations of proposals and may be finalized by the end of the year, is intended to make auditor reports more informative and move beyond the rote three-paragraph statement that, according to Hanson, generally doesn't change from one financial statement to the next.

"The controversial part of the proposed standard is that the auditors would include some commentary on critical audit matters—the things that were the most difficult or challenging matters that the auditor dealt with and communicated to the audit committee," Hanson said. "I hear from some management members and advocates that if investors want more disclosures, that the SEC or FASB should determine what those disclosures are. On the other hand, we hear from investors and activists that they want to hear more from the auditor, who is in a prime position to offer valuable information and insight that will add to the total mix of information available to investors." But even Hanson admitted that academic studies on the European models have yet to conclusively demonstrate that these disclosures add measurable value.

One attendee remarked that the bigger issue is that there are no market forces at play to counterbalance the government's growing list of regulations, making it easy to lose sight of the major issues. "There are so many nitty-gritty issues you can get into," Robinson added. "As an audit committee chair, you want to get into what the major strategic issues are for the audit committee, otherwise you lose the strategic value of the audit committee."

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