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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

3 Considerations For Audit Committees In 2015

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James B. Carlson

Audit committees are facing increased demands from many quarters heading into 2015, which expand their responsibilities, expose them to greater regulatory scrutiny and potential liabilities, and provide the basis for proxy and shareholder activists to oppose the re-election of audit committee members to the board of directors of the company.

Regulatory focus on audit committees is likely to increase in 2015, as the U.S. Securities and Exchange Commission is expected to issue a concept release in early 2015 that will propose changes in audit committee disclosures in public company proxy statements. Those additional disclosures may cover reporting on audit committee oversight of annual and quarterly company reports as well as assessments of the effectiveness of the audit committee. Explaining the background of these proposed changes in 2014, SEC Chairwoman Mary Jo White stated, "You can't overstate the importance of the audit committee functioning at the highest possible level." Expanded SEC-mandated disclosure by and about audit committees could, of course, effectively expand the scope and scrutiny of their responsibilities.

This article focuses on tax, whistleblower and revenue recognition issues that should be considered by audit committees of public companies in 2015.[1] Companies that may not initially consider "public company"-type corporate governance requirements, including U.S. private companies considering an initial public offering or a "junk bond" financing, or foreign private issuers considering accessing the U.S. capital markets, also need to be mindful of these considerations for audit committees.

Tax Risks in Financial Reporting

In 2015, audit committees should be vigilant about understanding the tax strategies and judgments that are reflected in the tax rates and contingencies presented in company financial statements. Tax risks will likely increase due to three factors: (1) corporate tax strategies are considered newsworthy; (2) companies are focused on structuring their operations for tax efficiency; and (3) governments across the globe are chasing tax revenues.

Increasing Tax Risks. Corporate tax planning is often front-page news. For instance, over the last few years, corporate inversions garnered significant public attention as many U.S.- headquartered companies considered or undertook strategic combinations resulting in the relocation of their headquarters to a lower tax jurisdiction. In late 2014, public scrutiny, even if misplaced, led to calls for legislative and Internal Revenue Service action. This culminated with the IRS and U.S. Treasury Department issuing a notice in September 2014 announcing their focus on curtailing certain tax benefits associated with inversions. Future tax guidance may also address various "earnings stripping" transactions where U.S. companies increase their intercompany debt levels, which has the effect of increasing deductions for U.S. tax purposes.

Tax authorities across the globe, including in many industrialized locations, are focused on corporate tax revenue and corporate tax planning. These tax authorities have a particular focus on perceptions that multinational companies are shifting taxable earnings from high-tax jurisdictions to low- or no-tax jurisdictions through transfer pricing, intercompany funding and other arrangements.

In September 2014, the Organization for Economic Cooperation and Development released its Action Plan on Base Erosion and Profit Shifting (BEPS). BEPS, among other things, focuses on the allocation of profits to lower-tax jurisdictions and the deduction of expenses in jurisdictions with higher rates.

Prior Practice, Prior Understandings, May Not Stand. From an enforcement perspective, the IRS has increased its examination and scrutiny in areas of typical corporate tax planning. The IRS has placed an increased emphasis on intercompany transactions — intercompany debt, transfer pricing, employee compensation — at all tax jurisdiction levels. Matters where tax risks were once considered routine are now facing a heightened degree of focus and inquiry from taxing authorities, which are now more likely to share information collected during an examination with other tax authorities.

Moreover, as two cases currently pending in the U.S. Tax Court demonstrate, the IRS can back out of certain types of agreements that taxpayers used to consider as resolving the tax matters they addressed. European tax authorities, too, are back-tracking on prior tax understandings with multinationals. Audit committees need to understand the extent and nature of any such agreements that supposedly resolve future or current tax disputes.

Tax Accounting Issues Could Lead to Financial Restatements. Income tax issues are a major reason for financial statement restatements. The audit committee is responsible for overseeing the preparation and audit of the company's financial statements, so the committee members should carefully scrutinize significant income tax issues with management and the auditors in order to avoid restatements risk.

This is obviously complicated by the fact that tax law involves a complex and ever-changing set of rules, regulations, court cases, exemptions, exceptions, limits, etc. Additionally, income tax accounting standards require the use of estimates and judgment of many subjective factors, such as forecasts of future profitability and expectations of future investments and cash needs, which themselves are subject to further judgments.

Furthermore, these standards apply to the company's operations worldwide, which involve interpreting and applying the tax laws, regulations and court cases of numerous jurisdictions. This complexity and judgmental uncertainty, however, does not provide any real or sympathetic defense to financial restatement risk, emphasizing the importance of audit committees closely monitoring evolving tax risks.

Tax Risk Questions for Audit Committees. As they consider overall tax risks confronting the company, as well as the tax positions and contingencies reflected in their financial statements, audit committees should evaluate/analyze/assess these growing tax risks from several perspectives:

- What checks and balances are in place to assess the impact of any given transaction or structure on the company's overall tax risks?

- What are the cross-border tax challenges the company could face in internal transfer pricing for assets, royalties and services, and how has the company substantiated its tax positions? Should the company further substantiate its positions in the event tax authorities initiate audits or reviews of the company's positions?

- What tax challenges might the company face with evolving "earnings stripping" and intercompany debt structures, and how has the company substantiated its tax positions? What analysis is the company doing currently to monitor the changing tax risks?

- What challenges might the company face with growing requirements for disclosure of income allocation among jurisdictions? How is the company coordinating the global nature of tax authority examinations?

- What scrutiny might the company face in relation to any business conducted in low-tax jurisdictions?

- What tax strategies are being challenged within the company's industry, and how might they apply to the company?

- How might rapidly changing tax legislation and enforcement in the United States, Europe, Latin America and Asia impact the company? What current or upcoming developments could significantly affect the company's effective tax rate?

- What are the company's most significant risks related to tax positions, and what internal controls are in place to address those risks?

- What agreements has the company reached with various tax authorities that supposedly resolve certain tax disputes? Are those agreements binding? Has any tax authority attempted to reopen matters related to these agreements?

More Whistleblowers

Rising Whistleblower Awards. In 2011, the SEC created its whistleblower program under the Dodd-Frank Wall Street Reform and Consumer Protection Act. That program rewards high-quality original tips to the SEC that result in an SEC enforcement action with sanctions exceeding $1 million. Awards can range from 10 percent to 30 percent of the money collected in a case. In 2014, whistleblower complaints and rewards accelerated.

The SEC's Office of the Whistleblower's 2014 Annual Report to Congress states that whistleblower awards were issued to nine individuals in fiscal 2014, up from four in 2013. One of the 2014 awards was for $30 million, the largest at the time of the award and the fourth award to someone in a foreign country.

The Office of the Whistleblower also reported an increasing number of tips: 3,620 tips in 2014, compared to 3,238 in 2013, and 3,001 in 2012. The most common complaints reported by whistleblowers included corporate disclosures and financials (16.9 percent), offering fraud (16 percent) and manipulation (15.5 percent). In the 2014 annual report, the Office of the Whistleblower, after commending the largest award, warned that "we hope that awards like this one will incentivize company and industry insiders, or others who may have knowledge of possible federal securities law violations, both in the U.S. and abroad, to come forward and report their information promptly to the SEC."

Audit Committee Oversight of Whistleblower Issues. Audit committees are responsible under the Sarbanes-Oxley Act of 2002 for establishing procedures for the receipt, retention and investigation of complaints regarding the company's accounting, internal accounting controls or auditing matters, as well as for the confidential, anonymous submission by company employees of concerns regarding questionable accounting or auditing matters.

Often, a company establishes a hotline for these purposes. Company whistleblowers should be able to access this company hotline, in addition to the separate whistleblower programs of the SEC and other government agencies. Audit committees are generally responsible for oversight of company whistleblower concerns by virtue of their general fiduciary duties of oversight, as well as Sarbanes-Oxley Act, New York Stock Exchange and the Nasdaq Stock Market requirements or mandates that audit committees oversee compliance, risk management and internal controls over financial reporting of the company. Whistleblower complaints may expose shortcomings in all of these oversight areas.

Audit committees should request periodic reports of all whistleblower complaints received, including the substance of the compliant and how the allegations were addressed. Anecdotally, in 2014, audit committees appeared to be experiencing some compliance fatigue, including with whistleblower oversight. Perhaps sensing this fatigue, the 2014 annual report cautioned that "two other whistleblower awards made this year drive home another important message — that companies not only need to have internal reporting mechanisms in place, but they must act upon credible allegations of potential wrongdoing when voiced by their employees." The 2014 annual report also emphasized that whistleblower complaints and responsibilities can arise from the non-U.S. entities of U.S. companies.

Third-Party Administrators? In an effort to curb fraud, some companies have retained third-party administrators to operate their whistleblower hotlines and investigate the complaints or allegations of fraud. From a compliance perspective, the ability to ensure employee anonymity is one of the most important perceived benefits of such hotlines and third-party administrators. However, the oversight responsibilities of audit committees for whistleblower programs do not compel the utilization of third-party administrators.

Whistleblower Questions for Audit Committees. With growing SEC enthusiasm for whistleblowers and their awards (and some audit committee compliance fatigue), as we move along in 2015, it is an appropriate time to review the basics of company whistleblower monitoring:

- Has the company received whistleblower complaints in the past year (or relevant reporting period)? If so, has the company provided the audit committee with information about the whistleblower complaints and how they were addressed?

- Are company employees, including those outside the United States, adequately informed as to how they can report whistleblower concerns? How do these concerns filter through internal audit, internal and financial controls, and compliance functions and to the audit committee for oversight?

- When the company engages in acquisition or joint venture activity abroad, are acquired businesses integrated into the company whistleblower procedures? (Whistleblower programs must be available to non-U.S. employees, and the increasing SEC reliance on offshore whistleblower tips highlights the importance of these programs being available to employees outside the United States.)

- Would the company and the audit committee benefit, considering the costs, from utilizing a third-party administrator for whistleblower complaints?

- If received, do whistleblower allegations indicate a deficiency in internal control over financial reporting, which could be relevant to the company's financial statement presentation and the audit committee's assessment of internal control over financial reporting?

- Do the whistleblower procedures in place ensure the confidentiality of the whistleblower?

- If received, do whistleblower allegations have potential legal implications for the company?

Revenue Recognition Changes

New global standards on revenue recognition, issued jointly by the Financial Accounting Standards Board and the International Accounting Standards Board, comprehensively overhaul existing revenue recognition rules for companies.[2] In general, the new standards are more principles-based than the existing U.S. generally accepted accounting principles and will require U.S. companies to make more estimates and subjective judgments as to when revenues should be recognized under contracts for goods and services. For many companies, adapting to these revenue recognition rules will be one of the most comprehensive changes in accounting practices implemented in many years.

These new revenue recognition rules are currently scheduled to take effect for reporting periods beginning after Dec. 15, 2016, for U.S. public companies (with retrospective adoption requiring three years of comparative financial statements) and for reporting periods beginning on or after Jan. 1, 2017, for companies that use International Financial Reporting Standards (with two years of financial statements for retrospective adoption).

2015 Focus. Subject to possible delays in implementation, in 2017, public companies reporting three years of historical, comparative financials will need to assess the impact of these 2015 revenue recognition changes. Tracking and assessing contracts associated with revenue will have a significant impact across the company, including systems, data and accounting processes, internal financial controls, and business contracting terms and processes in order to assess and document proper recognition of contract revenues.

Revenue Recognition Questions for Audit Committees. In assessing the impact of these pending revenue recognition changes, audit committees should begin to assess their impact on the company and the company's readiness to change its revenue recognition process and reporting:

- What will be the impact on the company of the proposed revenue recognition rules? Is the company evaluating contracts and revenue streams that will be subject to revenue recognition changes? Will any basic changes in company contracting practices be necessary to document in light of the changing revenue recognition standards?

- Does the company have an implementation plan for the revenue recognition rules? Does the company have sufficient information to satisfy the new disclosure requirements or must new systems, processes and controls be implanted to gather such information and ensure its accuracy?

- What is the company's chosen transition method for revenue recognition and how will that affect its implementation plans?

—By James B. Carlson, David S. Bakst, Jason S. Bazar, John P. Berkery, Edward S. Best, Michael L. Hermsen and Brian W. Kittle, Mayer Brown LLP

James Carlson, David Bakst, Jason Bazar and Brian Kittle are partners in Mayer Brown's New York office.

John Berkery is a partner in the firm's New York and London offices.

Edward Best and Michael Hermsen are partners in Chicago.

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[1] In a 2014 legal update, we addressed auditor independence, cybersecurity and FCPA/bribery risks: “Three Things US Audit Committee Members Should Consider Now,” available at http://www.mayerbrown.com/Three-Things-US-Audit- Committee-Members-Should-Consider-Now-09-11-2014/.

[2] FASB ASU 2014-09, Revenue from Contracts with Customers and IFRS 15 Revenue from Contracts with Customers.
