

## Digital transformation, audit technology, and emerging risks

Just as digital technologies create opportunities for new business models, they also create possibilities for disruption of a firm's core business. On June 13, 2018, Central Audit Committee Network (CACN) members met in Chicago to discuss board oversight of digital transformation, innovations in audit technology, and emerging risks.

### Oversight of digital transformation and disruptive innovation

Herb Schul and David Nichols of EY joined CACN members for a discussion of digital innovation and business transformation. Several themes emerged from that conversation:

- **Business model transformation and technology innovation can be mutually reinforcing.**

While new technologies are often seen as drivers of change, Mr. Nichols pointed out that most disruptive businesses do not introduce new technologies into the marketplace. Rather, they build innovative business models—such as Uber's ridesharing platform or Netflix's video streaming service—on top of existing technologies to respond to emerging social trends or address shifting customer preferences. These new business models, in turn, promote the adoption and use of technology. For example, streaming video services depend on the widespread availability of broadband internet access, while also creating new demand for the ubiquity and performance of broadband technology. Members stressed the importance of underlying infrastructure such as the interstate highway system, mobile phone technology, or the internet. One member said, *"What Amazon is doing it could not have done if we hadn't built that highway infrastructure. In energy, you now have an infrastructure capable of accepting energy from residential solar installations in ways it didn't before. With blockchain, we'll figure out use cases for it."*

Mr. Schul suggested that successful new business models would concentrate on a particular piece of the value chain and partner with others to improve a business's value proposition. The key question, he suggested, is, *"Where are you in that value chain and where do you want to drive value?"* He added that firms should acknowledge that, *"I can't do all this myself, so how do I interact with others? What part of the value chain do they have and how does it add new value?"*

- **Mastering customer relationships is critical.** Several members noted that business models that are more directly connected to the consumer experience are more likely to be either enhanced or disrupted by digital technologies. One member said, *"Digitization is on the*

*agenda of all the boards I serve, but the closer a business is to the consumer, the more prominent digitization is to the company.*” At the same time, members said that enterprises that are closest to and can master the customer relationship will be better positioned to thrive. *“The solution is always the end user and the consumer. It’s all about how to get to end users,”* said one member. CACN member companies find themselves on both sides of the disruption of customer relationships. One member described a firm’s effort to change its business model to directly connect with consumers, eliminating distributors and other intermediaries. Another described the ways their direct customer relationships have been jeopardized by competitors using digital technologies. Owning customer relationships requires firms to deeply understand and enhance the customer experience, incorporate design thinking into their processes, and, often, radically reorient organizational structures and business models around customer needs.

- **Human capital is evolving as quickly as technology.** As one member noted, “The talent agenda is equivalent to the technology agenda because job definitions are going to be changing rapidly. The human side is going to be just as transformational and just as quick.” Workers of the future will need different skills and capabilities, and will bring different experiences and expectations about work into the workplace. Mr. Schul suggested that the shift from employees to contingent workers would continue: “We think of the talent agenda now as 95% employees; in the future it’s going to be 30% employees, with 70% rotating on a 12-month basis.” This raises important implications for continuity of knowledge, capabilities, and culture in the workforce. Members also noted that bringing talent into an organization might require an acquisition. One member said, “Because we were looking at our business model differently, we did an acquisition to acquire talent. We wouldn’t have been able to do it on our own.”
- **Boards must encourage management to look for disruptive trends.** Members noted that, as custodians of the firm’s ability to create long-term value, boards must challenge management to seek out emerging trends, threats, and changes in the competitive landscape. One way to do so, participants suggested, is to examine trends in venture capital and angel investment, along with private equity and investment banking activity. Since their *“whole business is reading the tea leaves,”* as Mr. Nichols put it, these players can have valuable insights into disruptive innovations on the horizon. By bringing outside perspectives, including Silicon Valley experts and millennials, into the boardroom, a board can gain a broader view of disruptive trends, opportunities, and challenges. Members described an increased level of focus on digital strategy, including ensuring management is establishing a culture of innovation and setting the right tone at the top.
- **Speed and agility are more important than ever.** The pace of disruption means that organizations need to move rapidly to adapt. One member said, *“We always talked about speed and agility—now it’s real. Everybody is faced with this dilemma. How do you become the most agile and responsive?”*

## Audit technology innovations

Scott Zimmerman, EY's Americas assurance innovation and digital leader, presented technologies that are improving the quality of public company audits. Members saw a demonstration of EY's global audit platform, which takes data from a wide variety of sources and creates a unified and comprehensive view of the audit process. In addition, the platform connects audit teams to one another and to their clients, and enables all parties to track tasks and milestones throughout the audit cycle.

EY's Ed Kilbane and Yanyan Xu demonstrated the platform's client portal and a suite of data analytics tools that analyze audit data from the individual transaction level up to the consolidated trial balance. These tools can automate much of the traditional audit activity of identifying and verifying transaction data, allowing auditors to concentrate on anomalies and outliers.

Goals for these tools include reducing reliance on sampling, automating many of the routine aspects of an audit, and using artificial intelligence and other analytic tools to generate meaningful insights. As Mr. Zimmerman said, *"It allows auditors to ask better questions, immediately getting to the 'why' rather than focusing on the 'what.'"*

## Emerging risks

Over dinner, members discussed emerging risks that figured high on their list of concerns, including:

- **Geopolitical risks.** Several members noted the continuing rise of China as an economic and political power whose centralized leadership and long-term strategic focus are enabling the country to move rapidly in technology, infrastructure, and energy. Others pointed to the growing role of nation-states in cyberwarfare activities and raised concerns about vulnerabilities in critical systems, such as the electrical grid and the banking system. Members expressed concerns about civic unity and the seeming inability of national leadership to confront these challenges. As one member said, *"We need leadership in this country, and we are rapidly losing it."*
- **Education and future workforce needs.** Members highlighted the unsustainable economics of higher education in the United States, with rising costs, exorbitant student loan debt, and practical limits on the ability to continue raising tuition to keep pace. Several members pointed to studies suggesting that a significant number of institutions would be forced to cease operations over the next five to ten years. The challenges to US higher education raised questions about whether dramatically new models of educating and credentialing upcoming generations would emerge. In addition, demographic trends in the developed world point to an aging population and shrinking workforce that, when combined with challenges to the educational model, raise questions about filling future workforce needs.

- **Debt and future obligations.** Members discussed debt of various kinds as another concern, particularly public debt, noting that, in the United States, municipalities, states, and the federal government all face large unfunded future obligations. On this issue as well, members pointed to a failure of leadership, and some members suggested that these issues could only be solved by altering existing political structures.

### **About this document**

The Central 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.

*Summary of Themes* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *Summary of Themes* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *Summary of Themes* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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## Meeting participants

- Anne Arvia, GATX
- Pat Condon, Entergy
- Cheryl Francis, Morningstar
- Dick Gabrys, TriMas
- Marla Gottschalk, Big Lots
- Sandy Helton, Principal Financial
- John Holland, Cooper Tire
- Laurette Koellner, Papa John's and Celestica
- Mike Merriman, Nordson
- Rick Mills, Commercial Metals Company (*SEACN Member*)
- Bob Murley, Stericycle
- Sherry Smith, Deere
- Ingrid Stafford, Wintrust Financial
- Phoebe Wood, Invesco

EY was represented by the following:

- Rich Bonahoom, Partner, Business Development Leader, Central Region