

# Southwest Audit Committee Network

May 2018

SWACN

SUMMARY of THEMES

## Digital innovation and transformation; institutional investor preferences; workforce development in a dynamic environment

New technologies are rapidly transforming industries and the workforce—creating both challenges and opportunities for public companies and boards. At the same time, as a greater proportion of equity is held by institutional investors with empowered governance professionals, the relationship among companies, boards, and shareholders is evolving. Southwest Audit Committee Network (SWACN) members met in Denver, Colorado, on May 31<sup>st</sup> to discuss these topics.<sup>1</sup> (For a full list of meeting participants, please see page 5.)

### Thriving in a rapidly changing business environment

Members discussed how new technologies are transforming businesses and enabling innovation through operational efficiencies, a better client experience, and the creation of innovative products or services. SWACN members were joined by Woody Driggs, EY's Americas advisory digital leader, for a conversation on transformation in the new digital world and the opportunities and challenges for companies.

Public companies are being challenged by the pace of change. Mr. Driggs told members that *“trying to see more than two years down the road is very challenging in this environment. We are seeing the need for ongoing innovation followed by sprints of rapid implementation and scaling up.”* Mr. Driggs added that the old strategy of copying the lead innovator is less likely to succeed today than it was in the past: *“Companies no longer have the luxury to be a fast follower. In this day and age, if you wait too long to implement then you will be disrupted.”*

Members said that digital innovation and transformation is increasingly making its way to the boardroom. One member commented, *“One year ago, all conversations at the board level were about cyber, but now digital strategy or innovation is a regular item on our agenda.”* Members discussed the challenges of overseeing management's efforts to transform companies in an era of technological innovation. One member said, *“I struggle with determining if we are spending enough and getting sufficient results.”* Another member added, *“We have a good team that is working hard, but it would be dishonest for me to say that I have a really good feeling for where this train is ultimately going to go.”*

Several members shared effective oversight practices related to innovation and transformation. *“Our CEO had a bunch of millennials come in and present to the board. I was*

*struggling to understand the technology and I found their presentation to be helpful,”* said one member. Another said, *“We had an outside company come in and lay out industry trends. If you don’t keep up, you will go out of business.”* Mr. Driggs encouraged members to ensure that the pace of innovation continues to increase and that projects are appropriately sized. *“Directors should be stimulating the C-suite to bring about change. You should see continuous testing and learning, and the company should be applying capital in a way that will get you ahead,”* he said.

## Understanding the institutional investor landscape

Rob Zivnuska, Partner at CamberView, joined members for a discussion about the challenges they face when trying to understand and satisfy their investor constituencies.

Members were particularly interested in the objectives and constraints of the large passive funds. Mr. Zivnuska first clarified that these investors—like others—want healthy economic returns. *“They seek to achieve these returns with different tools because of how they are constrained. They cannot sell the stock when you are in the index and they cannot agitate for more direct control without facing a series of incredibly burdensome legal and reporting constraints.”*

Members were interested in how the governance professionals interact with other capital markets players. The interaction with portfolio managers will vary based on the structure of the institution and its internal and external relationships. Mr. Zivnuska said, *“BlackRock is mostly passive, but it has a sizable actively managed operation and its governance professionals can and do work with the investment professionals there. Sometimes there is discussion outside of the firm—for example, Wellington manages money for Vanguard and sometimes Vanguard will talk with Wellington team members about portfolio companies.”* Mr. Zivnuska cautioned members not to take portfolio manager complaints about governance professionals at face value: *“Keep in mind that the portfolio manager has an incentive to have a good relationship with management. To preserve their relationship, they may blame a vote against management on the governance function when they are often in complete alignment with the vote.”*

Interaction with activists was of special concern. Although passive investors side with activists less often than active investors do, the size of their holdings makes their support important in a contested situation. Mr. Zivnuska told members that activists *“will test their ideas with governance teams and offer up the name[s] of companies they are working on. When they do so, they may get a response suggesting the investor has confidence in the company and its board leadership ... or they may get a response suggesting the investor has concerns about the company and may support an activist intervention.”* While several directors were interested in ways to convince passives to support management against an activist fight, one director suggested passives might be better served by more alignment with certain activists: *“Activist investors hold boards directly accountable. That can be very healthy, and I do not know why the passives are so reluctant to do the same thing.”*

Members discussed how companies and boards can best engage investors. In times of peace, Mr. Zivnuska recommended that boards try to understand the structure and objectives of their top 20 investors. In addition, Mr. Zivnuska said companies should look beyond their top 20 for particularly vocal investors or those with a particular focus area and meet with these investors as well. Management should lead engagement efforts but *“the board should have one person who occasionally participates in friendly conversations, so they can be camera-ready if things heat up.”* In times of crisis, Mr. Zivnuska advised members to *“demonstrate that the board can be trusted and that the accountability mechanism is working. One way to do this is by setting up a special committee, led by a director who has attended investor meetings in the past.”* Activists will often say they have met with and have the support of your top investors and that may not be the case, especially if management is well ahead of them in those conversations.

Looking ahead, Mr. Zivnuska advised members to focus on culture: *“There is a significant increase in expectations among investors that the board has a high-level of insight into the culture of the company. I see a lot of pressure coming down the road and it could arrive abruptly in companies if you are not prepared,”* he said.

## Workforce disruption in a digital world

Members were joined by Skillful’s CEO Beth Cobert for a conversation about how companies can plan for workforce disruption caused by technological innovation. Ms. Cobert told members that *“given the onset of technology, jobs will be eliminated, new jobs will be created, and certain roles diminished. It’s real and it’s now and you need to start thinking about the transitioning workforce.”*

Ms. Cobert encouraged members to focus on identifying the skills they will need for the future and how they intend to secure them. *“The current model in the US is that if a person loses their job they will have an opportunity to be retrained. It’s more effective to determine what skills you will need and get ahead of it, either by creating it from the workforce you have or creating it elsewhere.”* Several members identified the need for enhanced cooperation between corporations, academia, and the public policy arena.

Members were concerned about how to keep management focused on identifying and acquiring the right skillsets, and acknowledged that gaps could occur in many areas of the organization including those affecting internal controls and financial reporting. One member said, *“I want to know how they can retrain staff in rapid technology growth and how many can honestly be retrained.”* Another member said, *“We will be displacing people and I don’t know if management has done a skills inventory. We haven’t talked about this at the board level and we need to.”* Ms. Cobert told members that *“human resources management needs to be tracking employees’ skills and be focused on demonstrating return from investments in training/skilling—otherwise change won’t happen.”* She also advised members to *“ask management tough questions and seek to understand where the skills gaps are now, where they will be in the future, and what the plans are to fill them.”*

## **About this document**

The Southwest 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

The following Southwest Audit Committee Network members attended all or part of the meeting:

- Rodney Chase, former audit chair at Andeavor
- John Cody, Gannett
- Gayla Delly, Flowserve
- Marcela Donadio, Marathon Oil
- Barbara Duganier, Buckeye Partners and MRC Global
- Don Kendall, former audit chair at SolarCity
- Teresa Madden, Peabody
- Gil Marmol, Foot Locker
- Barry Pearl, former audit chair at Magellan Midstream Partners
- Frank Risch, Pioneer Natural Resources
- Mike Stoltz, Windstream Holdings

EY was represented by the following:

- Scott Hefner, Southwest Region Markets and Accounts Managing Partner
- John King, Southwest Region Assurance Managing Partner
- David Pond, Principal and Southwest Region Business Development Leader

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<sup>i</sup> *Summary of Themes* 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.