Central Audit Committee Network

July 2019

CACN

SUMMARY of THEMES

Technology implementation risk, critical audit matters, and the workforce of the future

Central Audit Committee Network (CACN) members met in Chicago on June 12, 2019, to discuss board oversight of technology implementation risk, critical audit matters (CAMs), restatement and material weakness trends, and the workforce of the future. This Summary of Themes synthesizes those discussions.

Opportunity and risk in IT transformation

Jared Bushek, assistant vice president and chief information officer of Madison Gas and Electric (MGE), and Anthony Carmello, partner in EY's advisory services practice, joined members to discuss the opportunities and risks of major IT transformations. The opportunities are profound: MGE's IT transformation, said Mr. Bushek, will empower the company *"to attract and retain employees; offer competitive services and products and transform our engagement with the customer; and develop means to take out cost and create efficiencies."* The risks are equally great, as one member reflected on large-scale IT transformations more broadly: *"Some of these projects are almost 'bet the company.' it's scary when you think about what could go wrong … it could set you back years,"*.

Aspects of effective IT implementation

Members and guests explored effective approaches to achieving business objectives while managing risks in complex technology-transformation projects.

Business strategy should guide technology investment

Members and guests emphasized that business goals should drive technology investment, not the other way around. *"Even though you're implementing a lot of technology, it's not about IT. It's about the business items you're seeking to deliver. Technology should enable new products, services, or business processes,"* Mr. Bushek said.

Disciplined planning and controls deliver results

Members noted that IT projects often fail to meet budgets or timelines, and original plans often reflect *"great aspirations"* that do not materialize. Mr. Bushek said that the keys to MGE's ability to bring its project in on time and on budget were, and continue to be, specifying requirements for success, adopting clear guiding principles, and exercising the discipline to stick to them. One example was requiring CEO approval for software customizations. This *"potentially saved millions in cost overruns,"* he said. Mr. Carmello observed that "*the leadership team has shown the discipline to focus on must-haves vs. nice-to-haves."* Mr. Bushek added that an executive steering committee consisting of the CFO, CEO, the controller, the EY project co-sponsor and Mr. Bushek helped guide the project to success.

Organizational readiness matters as much as the technology

The *"rigor of the IT project,"* is certainly important, Mr. Carmello said, but he stressed that the central question is *"are we really ready to operate in these new systems? It doesn't matter how good the design and build is; if your organization isn't ready to execute and operate that technology, you won't achieve ROI, long-term efficiencies, or the transformation [itself]."* Mr. Bushek noted that getting people issues right was at least as challenging as managing technology for MGE: *"We fared well in departments where we had change agents. Where departments were not ready to change, we experienced problems,"* including increased rates of turnover. Assessment of various parts of the organization's readiness to adapt to change helped to determine the sequencing and staging of MGE's project.

Members and guests emphasized key aspects of organizational readiness:

- **Communication and buy-in**. Mr. Carmello stressed the need to explain the rationale behind changes to those who will *"operate the system and processes. Have they bought into the purpose, goals, and business needs of the project? You have to spend time communicating 'why' to employees, [and] how their lives will be changed."* Mr. Bushek described a concerted effort to do just that at MGE, including holding an *"Olympic ceremony"* to kick off the project.
- **Training.** Members commented that insufficient training is often at the heart of failed technology-transformation initiatives. The success of MGE's transformation depended on rigorous training, both before and after the implementation of the new system. Mr. Carmello said, *"For employees that continue after the transformation, there is a lot of training and communication around ramping up in the new world with new products and services."*

A culture of candor is essential

Every project has problems, but Mr. Bushek reminded members that *"the whole thing depends on whether you can assess and be candid. Bad news is not a bad thing. Our CEO doesn't mind bad news, it's 'let's go solve the problem.'"* Mr. Carmello agreed: *"I've seen too many times where on Tuesday it's green, and Wednesday it's red. Teams need to be empowered to tell the realistic truth. Better to be red early than late."* He emphasized the role of company leadership in setting expectations of candor: *"You need to set culture around realistic expectations in project management. A lot of that is tone at the top."*

Third-party relationships bring added risks

Companies are increasingly relying on third parties to address strategic infrastructure needs, and some of them are becoming more like business partners than vendors. As companies seek to gain comfort with these providers, Mr. Carmello said that many have adopted a strategy of enacting technology transformation in smaller segments, such as moving to the cloud over time. *"We're not saying 'no'; we're saying; 'not yet.' But we're building in a way that buys us the option to move there,"* he explained.

One member underscored the potential for risk even in established third-party relationships. That member's company set up a new distribution system, using a third party to do IT and robotics. The third party was acquired*, "and things went from green to red almost overnight,"* he said. *"We're not sure if it's ever going to work. They had been our partner for years, and maybe we didn't put enough internal controls into the contract because of the previous relationship."*

IT project lifecycles should extend beyond launch date

Mr. Carmello emphasized that *"the true end"* of transformation projects is *"not the go-live date; it's when we've realized the business processes and customer relationships we set out to achieve. That could be months or years down the road."* Members agreed, with one emphasizing the importance of measuring savings from transformation projects *"well past the go-live date,"* given the fact that *"the whole plan was built on what the savings would be."*

The methodology should fit the business

Mr. Carmello noted that, while agile methodologies, in which organizations *"do sprints and fail fast,"* are gaining traction, they are not the right approach for all projects. One member worried that agile methodologies could lead to poorly tested software. This can work in the world of smartphone apps, where developers can react quickly to customer feedback and swiftly fix a malfunctioning product. But it can be disastrous for a mission-critical system. *"Some things don't work on the principle of the minimum viable product. Some things just have to be right. We have to know what kind of a product we have,"* the member said.

The board's oversight role

Members discussed the boards' efforts to mitigate IT risk and lessons drawn from reviews of tech implementations. They discussed board challenges and how best to organize oversight.

- **Ensuring the robustness of IT risk management.** Members warned against letting risk management become perfunctory: *"If you say, 'We've got a risk map and we're done,' that kills it. Risk oversight has to be a tool embedded in the business."* One advised, "*ask a bunch of questions and 'what ifs.' Then people will sometimes dive deeper. But listen closely. Things that sounded minute sometimes weren't so small."* A third member emphasized the importance of using lookbacks to ask what might have been missed by the existing risk management process.

- **Aligning risk tolerances with business realities.** Boards can help management prioritize risk tolerances, since most organizations cannot afford to apply the same process to each different type of initiative. The board, Mr. Carmello said, must *"customize"* how it applies the risk management process based on *"tiering"* of acceptable risk: "*You have to know the things that are critical, the things that can't go wrong."* He said the board must ask itself *"Where can we accept zero degree of failure, vs. the next tier where we can accept some risk?"*

- **Organizing for technology oversight.** While members said the full board generally has responsibility for approving major technology investments, oversight often falls to the audit committee. One member said, however, that *"IT is a standing agenda item at the full board; it's no longer just an audit committee matter."* Several others agreed. One noted that companies now often subject IT projects to the *"same level of scrutiny as capital projects."* Other members spoke of a variety of arrangements, including *ad hoc* and special IT subcommittees of the board and the audit committee, that are formed to oversee specific initiatives. Some companies are adding technology committees, although this practice is not common among CACN members' companies.

- **Ensuring adequate expertise on the board.** One member said it's important to understand whether board members have the knowledge to oversee IT projects: *"Does the board have the expertise to really do the job? Or do you add someone to the board with IT experience? I used to say 'no' until I met IT people who have excellent business backgrounds. They become, in effect, a subcommittee."* Another said it made sense *"from a functional standpoint"* to bring on *"a director who's a sitting CIO."* But another member, arguing that *"within five years, they are out of date,"* suggested relying on outside consultants instead.

- **Working with internal and external auditors.** Members agreed that it is essential to have a strong relationship with internal audit and that it should be *"fully integrated, right there at the table."* Mr. Carmello stressed that the internal audit team "*has to have the right capabilities, especially on these more innovative programs and projects."* He advised investing heavily *"in risk and control integration—financial and operational,"* and consulting internal audit *"early and often."* The external auditor is another resource for insight into the risk and control environment for major IT initiatives.

CAMs: lessons from dry runs

Steve Sheckell, central region assurance managing partner for EY, joined members to discuss critical accounting matters (CAMs), a part of the new auditor reporting standard issued by the Public Company Accounting Oversight Board (PCAOB) in 2017. The goal is to "provide audit-specific information that is meaningful to investors and other financial statement users about matters that required especially challenging, subjective, or complex auditor judgment" and are material to the financial statements.[1] Mr. Sheckell said that the new standard is intended to *"challenge the traditional pass/fail of the audit and offer greater insight to investors"* by revealing more of the *"intent of the auditors in the process."*

The discussion highlighted the choice and numbers of CAMs, as well as questions about how they might evolve:

- **Identifying CAMs.** Mr. Sheckell observed that the PCAOB's guidance on choosing CAMs was intentionally broad, to promote greater dialogue among the *"company, auditors, and the audit committee."* Some factors to consider in identifying CAMs, he said, include items with high inherent risks (such as industry-related matters or fraud risk); items that require the use of a specialist outside the core audit team; judgments and critical estimates; unusual or complex transactions; and matters about which there is a lack of evidence available to the auditor (e.g. the difficulty of obtaining good evidence to support contingencies). The most common CAMs so far have been in the areas of income taxes, contingencies, goodwill, and revenue contracts.
- **Numbers of CAMs.** Mr. Sheckell reported that auditors have identified an average of two CAMs for US companies. The largest global companies may have more due to the complexity of their operations. He noted that the standard states that companies are expected to have at least one CAM.[2]
- **Concerns about new disclosures and the future of CAMs.** A few members expressed concern about what would happen after the June 30, 2019, deadline for large accelerated filers. *"So many of these things were in footnotes, but now it's a screaming headline,"* one said. *"We haven't gone to war yet,"* said another. Members wondered what would happen if *"five of your competitors mentioned 'x' and you didn't'?"* In response, Mr. Sheckell encouraged communication among companies, acknowledging, however, that it's *"harder when … companies are widely dispersed."* Several members voiced concern about how the PCAOB might handle a missed CAM. One member predicted, *"If something terrible goes wrong at a company and the company has not identified it as a CAM, then there will be litigation."*

  On the other hand, a member who was initially apprehensive about CAMs said that in the event, *"they reflected how we felt about those issues and how the auditors should feel about them."* Mr. Sheckell agreed, and noted that *"once people see what's written, they feel better about CAMs."* He also advised patience with the reporting practice: *"We've been doing SOX for 15 years, and it's still evolving. This is just year one for CAMs."*

Restatements and material weakness trends

Material weakness are *"running about 5%,"* which is broadly consistent with last year, said Mr. Sheckell. The most common areas noted are income taxes and revenue recognition, with reclassifications, contingencies, and goodwill impairment the next most frequent. Members and Mr. Sheckell discussed ways to mitigate risks of control deficiencies or weaknesses:

- **Pay attention to major changes in personnel, processes, and systems**. Changes in personnel and major changes in the business can often be an early warning sign for a potential control weakness, especially in *"understaffed or resource-constrained* areas,*"* Mr. Sheckell said. He cited the example of a company that sells a division that *"isn't ready to go as a stand-alone entity and runs into problems."*
- **Prioritize tax expertise**. *"It's hard to find people who know both taxes and planning. Companies that have the right person in charge [of taxes] don't get into trouble,"* said Mr. Sheckell. The impending retirement of a company's tax expert is an early warning sign and an example of how personnel issues can translate into bigger problems.
- **Emphasize contract controls.** Concern derives primarily from how revenue is reported and *"the controls companies have over contracts,"* Mr. Sheckell said. He explained that the PCAOB is scrutinizing the effectiveness of controls and *"what we do to test contracts."* Mr. Sheckell emphasized the importance of correcting issues up front: *"We see companies that don't correct errors they know about. Not correcting what you know gives you less room to deal with new things you find."*

The workforce of the future

Members were joined by Randy Beck, central region managing partner in EY's People Advisory Services (PAS), and Dick Caldera, EY senior advisor, for a discussion on the trends shaping the workforce of the future. Several key themes emerged from the conversation:

- **Generational changes.** There are now five generations in the workforce. Mr. Beck noted that, according to some estimates, millennials, already the largest cohort, will comprise 75% of the workforce by 2025. Millennials bring different goals, sensibilities, and motivations to their work, including a desire to align their personal sense of purpose with the organizational mission and to have a positive social impact. As a result, firms need to be clear on their purpose and how their activities flow from it. Millennials also emphasize creativity, flexibility, and opportunities for development.

  Members and guests noted that the social contract of long-term mutual loyalty, once implicit in employment, has disappeared: *"This generation see themselves more as free agents,"* said Mr. Caldera. At the same time, organizations, one member pointed out, no longer provide the security of a job for life or a pension in retirement.

  While generational shifts are not new, the sheer volume of Baby Boomers retiring means that a larger-than-usual proportion of the workforce is turning over. And Boomers take with them valuable skills and experience that firms in some industries will struggle to replace.

- **New patterns of influence.** In a time when hierarchies are getting flatter and roles are more fluid, organizations need to work harder to engage their employees, and employee engagement is a crucial aspect of firm performance. Mr. Beck suggested that boards can deploy social network analysis to determine which employees exercise real influence, whatever their place in the organizational chart. Boards, he said, should ask, *"'Where are the social influencers in the organization?' You can ask every employee, 'Who are the three or four people you trust to give you information?'"* Technology, members noted, is enabling the board to get an immediate sense of employee engagement. One member said, *"We do quick pulse surveys, and the board sees that; it's a normal reporting item. You have the ability today to get real-time feedback."*

- **New leadership qualities.** While members and guests acknowledged continuity between essential leadership qualities past, present, and future, Mr. Beck and Mr. Caldera noted a few critical leadership traits that are taking on a greater prominence. These include empathy, the ability to build and deploy social networks, and the abilities to embrace disruption and inspire—not just motivate—others.

Meeting participants

- Howard Carver, Assurant
- Pat Condon, Entergy
- Rick Fox, Univar
- Dick Gabrys, TriMas
- Marla Gottschalk, Big Lots
- Mike Hanley, BorgWarner
- John Holland, Cooper Tire
- Laurette Koellner, Celestica and Papa John’s International
- Al Smith, Simon Property Group
- Ingrid Stafford, Wintrust Financial
- Pam Strobel, Illinois Tool Works
- Steve Strobel, Newell Brands
- Phoebe Wood, Invesco

EY was represented by the following:

- Rich Bonahoom, Partner, Business Development Leader, Central Region
- Steve Sheckell, Central Region Assurance Managing Partner, EY

Endnotes

[1] Public Company Accounting Oversight Board, *Implementation of Critical Audit Matters: A Deeper Dive on the Determination of CAMs*.

[2] "The requirements of the new standard note that it is expected that in most audits, the auditor would determine at least one matter involved especially challenging, subjective or complex auditor judgment." PCAOB AS 3101.12 quoted in Center for Audit Quality, "Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements," July 2018.