Northeast Audit Committee Network

December 2019

NEACN

SUMMARY of THEMES

Audit committee effectiveness, IT transformation, and navigating uncertainty

On November 20, 2019, members of the Northeast Audit Committee Network (NEACN) met in New York City for discussions on audit committee effectiveness, oversight of IT transformation, and navigating in turbulent times. This *Summary of Themes* provides a brief overview of the meeting.[1] *For a full list of meeting participants, please see the list on page 5.*

Members share effective audit committee practices

As members exchanged views on effective audit committee practices, three areas dominated the conversation:

- **Building relationships with management.** Many members stressed the importance of a strong, transparent relationship with management. One said, *"I define success by assessing the openness of the management team, not only at the top senior levels but also the next levels down. We hold a breakfast with different members of management following the audit committee meetings and use it as an open dialogue to hear their concerns and also to develop relationships deeper in the organization."* Another member added, *"The transparency of the management team is very valuable. I have seen 'gotcha' audit committees where management does not want to raise issues. Open dialogue and willingness to bring up ideas are so important."* A third member said that a transparent relationship with the external auditor can be beneficial to understanding management's responses: *"Not everyone gets this benefit, but I have a team that lives at the company. They are my eyes and ears on the reactions of management several layers deeper in the organization to what we do in the audit committee."*
- **Preparing efficient materials and presentations.** Members shared approaches to streamlining the materials that management provides to the audit committee. There was a general consensus that decks have gotten too long and a concern about the time dedicated to putting them together. One member said, *"I wonder about the effort management is putting into these decks assuming this is something of value to the board when we actually gloss over it. It can't be of any value to them either, so why are they doing it?"* One member suggested a page limit: *"I don't review the decks in advance, but I do set a 20-page limit with management and require a 1- to 2-page executive summary. I ask management to assume we read the materials and that our questions will be guided by that background."* Other members said that they always review the materials in advance on pre-

meeting calls but that instead of setting page limits, they have excess information placed in appendices. One said, *"I'm not reviewing to edit or correct information because we have already established guidelines of only a few pages on what you want to summarize and then any supporting material in the appendix. The pre-calls are to understand the issues we will be talking about and the questions that will come up so I can better guide the conversation in the meeting."*

- **Setting effective agendas.** Some members' audit committees meet five times per year while others meet three times per quarter, depending on whether board meetings are scheduled at a time when the committee can review earnings releases and SEC filings. With a laundry list of required agenda items, members emphasized the importance of fully utilizing their time together. One discussed a process for incorporating "flex time" into agendas: *"We have four or five in-person meetings a year and we have four earnings release calls, which takes that out of the in-person meeting time. We meet for about three hours per meeting and half of that time is spent on charter-required items. We also have one educational topic at each meeting, something on business performance by region or maybe succession planning—different topics each time—and then spend the rest of the time in executive session discussing pertinent matters."* Another member ran into challenges when trying to add in topics beyond what was covered in the charter: *"I got into trouble with other committees because we were talking strategy and they said, 'hey that's not your domain' so I said, 'okay, take it back!' We have enough to cover as it is."*

Technology transformation requires business support

New technology systems and applications can make a big difference for a firm's competitiveness, yet companies often underestimate the challenges that come with large-scale implementation. Two chief information officers (CIOs)—Robin Dargue of WPP and Steve Randich of FINRA—helped members think about how to improve oversight.

- **The build vs. buy debate is evolving.** Members and guests discussed the pros and cons of building versus buying new technology platforms. One member said, *"With build packages you would become obsolete very quickly. In-house staff can't keep up with the upgrades and tech in the same way—it's the other company's lifeblood."* However, guests suggested building for highly strategic projects that can differentiate a firm from its competitors. Mr. Randich added that the best approach for building major IT projects is agile development: *"Agile is iterative and the short feedback cycle keeps the process on track. Projects fail when the new system is not intuitive because you run into challenges weaning people off of the old system."* The rise of cloud-based software adds a new dimension to decision making. While moving to the cloud offers many potential benefits, Mr. Dargue advised it should not be viewed as a silver bullet: *"Many IT teams do not know how to operate properly in the cloud. Poor cloud practices run the risk of bypassing traditional IT controls. This has left many organizations now facing the challenge of increased risk, not reduced* *risk, from these new cloud environments."* Mr. Randich summed up the debate with this analogy: *"Think of IT as Legos. World class IT is building systems out of Legos. They aren't building the actual Legos or buying completely assembled Lego toys—it's the gray area in between, which will become the dominant path."*

- **Projects need to be resourced and managed appropriately.** Technology transformations are most effective when they are driven by clear business needs. Mr. Dargue noted, *"Most projects that fail do so because there is no business sponsor, not because there isn't enough money. There are very few 'pure' IT projects—they are all business projects and require a business leader to own the project benefits."* This approach often calls for a dedicated team of IT and business resources. Mr. Randich said, *"The most successful projects have operations people assigned to the project full time."* Convincing top talent to leave their business roles to join potentially risky IT projects can be a real challenge. Mr. Dargue advised: *"Good practice is for HR to perform career mapping to find the best talent for the project and plan a path for them at the project's end."*
- **Good governance can minimize the risk of failed implementation.** Members said that technology projects are most likely to succeed when there is strong governance at both the management and board levels. One member stressed the importance of expending extra effort to train those lowest in the ranks: *"I have seen projects fail when certain functions at the lowest level of the chain don't understand the changes to their processes."* Mr. Randich discussed the importance of finding the right CIO for your organization: *"You must match the skills of your CIO to the needs of your business. If you buy a lot of third-party products, you want a CIO who can build partnerships. If you do a lot of building, you need IT talent and innovators. Make sure it maps."* Mr. Dargue concluded, *"Be sure your CIO sees technology as a lever to pull for the business, not IT as an end in its own right. The ideal is a CIO with a business aptitude to complement their technical knowledge."*

Navigating in turbulent times

EY's Tim Tracy and Tapestry's Michael Mahoney co-facilitated a discussion on management preparations for a downturn and board oversight in turbulent times. The conversation focused on several dimensions:

- **The current economic environment.** Mr. Mahoney laid out some of the factors contributing to today's uncertain environment, including: a temporary inversion of the yield curve, public debt at historic highs, trade wars with China and Europe, impeachment proceedings, Brexit, looming US elections, and massive technological change. Despite these headwinds, some fundamentals suggest reasons to remain optimistic: corporate profits are strong, companies have cash on hand, private equity firms are sitting on capital, and unemployment and inflation are low. Members debated whether we are on the verge of a downturn. A member said, *"We were relatively optimistic a year ago and now we are more cautious because of the uncertainty. We have concerns about taxes depending on the election, volatility of the* *trade deal, etc. No one is suggesting a recession in 2020 but it's unclear what's in store beyond."* Mr. Tracy added, *"One of the things our Chairman has been talking about and many CEOs of clients agree is that if everyone keeps talking about a recession it could happen. We see many industries' leaders continuing to signal strong confidence though."*

- **Management preparations for a downturn.** Members discussed what they are seeing management teams do in preparation for a downturn. One member strongly suggested paying down debt, *"If you haven't refinanced debt by now you are crazy. We are in the best borrowing environment ever—it can't get much better than this."* Another member discussed selling off underperforming assets now, before the fire sales begin: *"We recently took on a large number of acquisitions, so the board has asked management to look at the whole portfolio and see if there are pieces that we acquired that may not make sense. We can monetize those assets now and create a pipeline of M&A to acquire opportunistically in the future."* Mr. Tracy encouraged members to focus on supply chain alternatives: *"If there is a slowdown, you do not want to compromise the fundamentals of the business. Understand your supply chain, how you procure, and what your options are for getting out of China. It's not as easy as you may think given the infrastructure in China compared to surrounding countries."* Members also discussed the importance of keeping costs down as much as possible but maintaining investments in areas critical to the long-term viability of the business, such as technology and talent.

- **Board oversight in turbulent times.** Preparedness is an important step for boards to navigate today's environment and many members suggested scenario planning can be helpful. One said, *"Given the uncertainty and rapid changes in technology, we have been doing a lot of scenario planning. No one can predict the future but it's best to prepare."* Mr. Tracy agreed with this approach but warned members of its difficulty: *"We recently had clients hire outside consultants to scenario plan alternative supply chains. They came up with a lot of different data points but no real answer. Given the amount of uncertainty, it's difficult to do."* Members also stressed the importance of an open line of communication with the management team as issues continue to evolve. One said, *"My most valuable information comes from talking to people 1:1 over lunch. It's a relaxed environment to ask tough questions."* Another agreed and added, *"Also talk to different layers of the organization: one to two levels down from the senior executives. Talking to their direct reports helps ensure you don't miss something—and you need that trust and open dialogue now more than ever."*

Meeting participants

- Virginia Addicott, CDW
- Bert Alfonso, Eastman Chemical Company
- David Brown, EMCOR
- Brian Ford, Clearway Energy
- Art Garcia, ABM Industries
- Pat Gross, Waste Management
- Mary Guilfoile, Interpublic Group
- Gracia Martore, WestRock
- Craig Owens, The J.C. Penney Company & Dean Foods
- JoAnn Reed, Waters Corporation, American Tower, and Mallinckrodt plc
- Judy Schmeling, Constellation Brands

EY was represented by:

- Tim Tracy, U.S. East Assurance Managing Partner, EY

Endnotes

[1] *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 made before and during meetings are not attributed to individuals or corporations. Guests, however, have given permission for their remarks to be attributed. Comments by guests and network members are shown in italics.