Southeast Audit Committee Network

June 2018

SEACN

SUMMARY of THEMES

Dialogues on board oversight of digital transformation, audit innovations, and investor priorities

Digitalization presents both opportunities and challenges for companies as operational processes, business models, and risk environments change. On May 23, 2018, Southeast Audit Committee Network (SEACN) met in Atlanta, Georgia to discuss board oversight of technology transformation, digital audit innovations, and investor priorities in the current proxy season.

Board oversight of digital transformation

SEACN members were joined by Blake Patton, founder and managing partner at Tech Square Ventures, an Atlanta-based seed- and early-stage venture capital firm, for a conversation on innovation and business transformation. Mr. Patton and members shared several strategies for boards to consider:

- **Invest in a portfolio of innovation initiatives and define success**. A member expressed concern that *"companies can get deeply involved with investments in innovation with not a lot to show for it."* Not all innovation investments will produce easily identifiable, near-term financial returns, Mr. Patton noted. He continued, *"Companies need to diversify their investments and understand what success means for each one. To me, the biggest gap in thinking is the lack of understanding these activities as a portfolio. This is a longer-term strategy. Success may or may not be financial, or it may or may not be a new product. What it might be is helping the company to think faster and process innovation internally … Some companies invest to accelerate a broader change they would like to see happen in the industry."* While acknowledging that pressure for quarterly returns is a constraint on companies' ability to invest in innovation or to think longer-term, Mr. Patton said that helping the company define success is a role directors can play: *"Board members and management need to be good at defining success, because the startups are not. You should own what success means for the company as you make investments in innovation."*
- **Engage with startups and use innovation centers**. Partnering with startups presents companies with a strong channel for generating innovative ideas, according to Mr. Patton. In contrast to well-established, large corporations that can execute gradual change, he highlighted the agility of startup ventures: *"Big companies are good at incremental change, but not so good at transformative innovation. Smaller companies are good at transformation, but not so good at execution."* Mr. Patton suggested large companies could

benefit from the ideas being generated by startups, noting, *"There is a mutual benefit to these engagements, but corporations are able to take a risk that wouldn't otherwise be allowed within their organizations. Working with startups allows them to step outside of the box."* Members and Mr. Patton also discussed the challenges and benefits of innovation centers outside of the business. These spaces provide the company with a place to test innovative approaches with less risk and a separate budget from the business. *"Innovation labs produce good ideas, but bringing those nuggets back into the business, or making someone accountable for making it work, is a challenge,"* said Mr. Patton.

- **Encourage a culture of innovation**. Corporations often struggle with the shift from *"doing digital"* to *"being digital,"* noted Mr. Patton: *"The major impact of investing in innovation, like working with startups, is on culture."* A member agreed, *"By changing the way the company thinks, these initiatives can help find out-of-the-box solutions to big problems."* Another member said, *"A key attribute of companies that are really working on innovation is this effort to change the culture of the established business. If you don't change it, being able to bring these investments back into the organization is extraordinarily difficult. Companies are spending a lot of time exercising new muscles inside the organization to foster innovation and create that shift."* Members and Mr. Patton acknowledged the integration risk associated with bringing new ideas back into the business, regardless of whether the idea comes from a distinct innovation lab or from the business unit.
- **Educate the board on emerging technologies and associated risks**. While most directors are aware of the impact of technology, not all agree that boards are adequately prepared to oversee key decisions related to these initiatives and the associated risks. Several members noted that their boards recently added directors with technology expertise to fill that gap. Others have created separate technology committees to oversee a range of issues, from investments to cybersecurity. Another member noted an effort to educate current board members: *"Instead of bringing in a CIO or someone similar, our chairman asked three of us on the audit committee to become as knowledge as possible on cybersecurity, so we are completing training in this area to get up to speed."*

Audit innovations

Scott Zimmerman, EY's Americas assurance innovation and digital leader, presented the technologies that EY is deploying to transform many aspects of a public company audit. Members saw a demonstration of EY's global audit platform, which connects audit teams to one another and to their clients and enables clients and EY management to track the status of milestones throughout the audit cycle. Importantly, it also enables comparisons across audits by industry, geography, and other metrics.

In addition, EY's Ed Kilbane and Andrew An demonstrated the suite of audit-based data analytics tools which use advanced methods, including artificial intelligence, to analyze data from the transaction level up to the consolidated trial balance. The analytics tools can speed up identification of outliers in data—for example, spotting payroll entries where the tax paid is unusually high or low. The overall goal is to conduct audits that have the potential to examine virtually all data in a company, reducing sampling, eliminating tedious and expensive data re-entry, and using data analytics to leverage human judgment.

Investor priorities for the 2018 proxy season

Public companies have seen changes in the composition of their shareholder base, including a consolidation of capital in ETFs and mutual funds as well as an increase in scale among large institutional asset managers. Jim Woolery, partner and head of the M&A and Corporate Governance practices at King and Spalding, highlighted key elements of the current environment and shared investor priorities:

- **Environmental, social, and governance (ESG) issues remain a key focus of institutional investors.** Mr. Woolery said, *"ESG will no longer be a specialty area. It's moving from an interesting component of the proxy to a norm. Investors do not want an ESG section of the proxy statement. They want to see how ESG issues affect the company, including the strategy and risk. Investors also want to see these considerations run throughout their disclosures. They want to know it's been thought about."* Mr. Woolery noted that while investors do not expect a separate committee focused on these issues, they do want the topics to be *"an aspect of a committee's portfolio, probably the governance committee, that will oversee how the company is staying on top of the issues."* In addition, Mr. Woolery noted the stark decrease in investment activity among Millennials in comparison to previous generations. For some institutional investors, ESG efforts are a defensive move to attract higher investment rates from this demographic.

- **Investor engagement evolves.** Mr. Woolery highlighted the benefit of continual engagement with major investors, especially when things are going well. He noted, however, that while large institutional investors appreciate engagement, the sheer number of companies they invest in makes it impossible for investors to meet directly with most companies or with boards or individual directors. A member noted that one large institutional investor is interacting with directors and management through regional investor showcases.

  Mr. Woolery shared one solution adopted by some large corporations: *"Companies, like Coca-Cola, have established a new position with titles like Director of Corporate Governance, which sits outside of investor relations and typically under the General Counsel. This person provides policy expertise and functions as a channel for the company to stay up-to-date and connected to the investor community on issues like ESG, including attending investor events where most major investors' governance people gather."* Understanding the interests and concerns of these large asset managers and institutional investors is increasingly important as their influence increases and the role of the proxy advisor wanes.

- **Algorithmic trading creates short-term volatility in share prices.** Directors need to understand the underlying functionality of algorithmic trading and its influence on share price, noted Mr. Woolery. *"Machines are trading. Directors need to become aware of how this works and how it generates abnormal moves in the market and pricing. For example, if a company misses earnings the stock will go down in the first 24 hours, but will bounce back eventually. What does it mean for boards? For value? It means price matters, but it's value over the long term that you should remain focused on,"* said Mr. Woolery. The volatility increases because hedge funds are trading on the short-term downward swings in price, *"betting that they can unlock the catalyst for a rebound,"* and increasing *"event-driven"* investing.

- **High-vote stock draws increased attention.** Mr. Woolery highlighted high-vote stock as a key concern for investors. Snapchat's initial public offering in 2017 drew investor attention because its capital structure provided for public investors to receive no vote stock. As a result, after prodding by investors, several major index providers decided to exclude these types of companies from their indexes.

- **Boards and management can influence the composition of the shareholder base**. Mr. Woolery said, *"We will see boards and management playing a more active role in composing their investor base. Boards can take a more affirmative view regarding the strategic investors that can be impactful for companies."* Mr. Woolery also anticipates an increase in engagement with private pools, such as family offices, and private pension plans. Companies will have to be proactive, however, as *"Wall Street is not delivering these kinds of investors,"* according to Mr. Woolery.

About this document

The Southeast 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.

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.

Meeting participants

The following SEACN members attended all or part of the meeting:

- Eddie Adair, Rayonier Advanced Materials
- Carolyn Byrd, Regions Financial
- John Davidson, Allergan and Legg Mason
- Denise Dickins, Watsco
- Bill Easter, Delta Air Lines
- Curt Espeland, Lincoln Electric Holdings
- Juan Figuereo, PVH
- Tom Hough, Equifax
- Doug Johnson, Aflac
- Clayton Jones, Cardinal Health
- Claude Lilly, Erie Indemnity
- Jason Papastavrou, United Rentals
- David Walker, Chico's FAS, CommVault Systems and CoreLogic
- Rick Williams, Crawford

EY was represented by the following:

- Sam Johnson, Vice Chair, Southeast Region Managing Partner
- Bryan Yokley, Georgia/Alabama/Tennessee Market Segment Leader, Assurance Partner