WEST
AUDIT COMMITTEE NETWORK

Summary of Themes

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The future of technology, a dialogue with the Financial Accounting Standards Board, and internal audit transformation

Boards and audit committee members are carrying out their oversight duties in an era of widespread change. New technologies are transforming company structure and strategy, and new accounting standards changing the way companies disclose their performance. Members of the North and South chapters of the West Audit Committee Network met on September 27 and 28 for the network's seventh annual joint meeting to discuss how they plan for the future and supervise rapid transformation.[1]

Crawford Del Prete, executive vice president and chief research officer at International Data Corporation (IDC), joined members to address the challenges and opportunities of new technologies. Financial Accounting Standards Board (FASB) member Hal Schroeder met with members to discuss the FASB's current priorities and future focus areas. Members were also joined by Steve Singer, EY's Global Advisory Internal Audit leader, for a conversation about the transformation of the internal audit function. For a full list of meeting participants, please see page 5.

The evolution of information technology

"At many businesses today, digital transformation and innovation are projects. But digital transformation is changing every aspect of business. Those that will gain the most in the coming years will treat these subjects as core to their businesses," Mr. Del Prete said. *"The big legacy technology companies – those that we at IDC categorize as 'second-platform' companies – are in decline; between 2016 and 2021, we expect their compound annual growth rate to be (-6.8%). The new big tech companies built on emerging technologies (social media, mobile, cloud computing, and data analytic)s – those we view as 'third-platform' companies – are almost mirror opposites, with a positive 6.9% CAGR [compound annual growth rate] over the same period. But the biggest news is for companies in the innovation acceleration space, companies working on next-generation security, augmented and virtual reality, Internet of things, cognitive and artificial intelligence, robotics, and 3D printing. We expect those companies to see a 17.2% CAGR between 2016 and 2021."* IDC believes that the growth of these companies will disrupt many existing business models (as well as enable new businesses), in the technology sector and elsewhere.

Mr. Del Prete's provocative presentation raised a number of questions for members. Several were interested in how companies can monetize the large pools of data they collect. One member said, *"In my organizations, we struggle with the knowledge that data is a huge asset, but we don't know how to monetize it, so we end up focusing on protecting it and not sharing it."* Mr. Del Prete acknowledged that this is an issue for many companies because sharing might mean giving up competitive data, but he provided examples of companies and the public benefiting from cooperation. *"The Mayo Clinic, for example, coordinates with other facilities to gather and share data. It leads to better information and ultimately better care for patients. And the added benefit is that they can convert their brand and data pool into a revenue stream by providing it to these facilities for a fee,"* he said. Mr. Del Prete also pointed out that when companies create new

[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 are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

revenue streams based on data, then the data becomes more practical to value with tools like discounted cash flow models. Another member was interested in the potential consumer backlash if companies monetize their data: *"What happens when the consumer realizes their personal data is the asset? It's free now, but what about when they get smarter?"* Mr. Del Prete agreed that this is inevitable and will be a major challenge for organizations. However, these businesses are now operating at scale, and providing valuable services on which consumers depend. While it might be possible to create new business models that are not based on monetizing "freely collected" data, these will be difficult to scale to the same rate as services currently in place.

The FASB continues to focus on process improvement and stakeholder outreach

Mr. Schroeder provided his perspective and answered members' questions regarding the FASB's current activities, continued process improvements, and future agenda. He summarized the focus of the organization by noting, *"The one constant has been that the mission is to provide useful and relevant information to all stakeholders of the global capital markets."*

Members were interested in how the FASB analyzes the costs and benefits of proposals. Mr. Schroeder said, *"Every issue we deal with has been defined as a problem by someone, usually accounting firms or the companies themselves. If companies like the standards, we don't hear much about cost, time to implement, or systems changes. However if companies are not in favor of the standards, we get tremendous pushback and hear about the high costs."* One member asked, *"Does the FASB ever go back and look at the standards that were implemented, how the market adopted them, and if it was worth it?"* Mr. Schroeder outlined the FASB's post-implementation review process, which enables the FASB to apply lessons learned to future endeavors, and noted that it was an area of focus for the organization.

One member said, *"You talked about the fact that standards are proposed to solve a problem. I'm wondering your thoughts on the prevalence of non-GAAP [generally accepted accounting principles] financial measures. If accounting is aligned with economics, then why are non-GAAP metrics necessary?"* Mr. Schroeder explained, *"I view non-GAAP measures as an edge to investors that helps provide a three-dimensional model for viewing financial statements. It's just another tool in my toolbox. Many of the non-GAAP financial measures that companies disclose are built on the foundation of their GAAP reporting."*

Turning toward future standard-setting activities, Mr. Schroeder and members discussed areas where the FASB might consider changes, such as accounting for intangibles, goodwill amortization, segment reporting, and disclosure simplification. Mr. Schroeder was sympathetic to members who suggested that on the heels of major changes to revenue recognition and lease accounting, the FASB might consider slowing the pace of change in the near future.

The impact of digitalization on internal audit

Mr. Singer explained that with access to new technologies and an emphasis from management on adding value, the orientation and mandate of the internal audit function is changing at many companies: *"It's important for internal audit to evaluate their purpose and challenge it – they need to ask themselves what they can do to provide the company with the most value."* For example, Mr. Singer suggested that members challenge their internal audit teams to reallocate resources to achieving particular purposes rather than simply checking boxes. Mr. Singer mentioned Sarbanes-Oxley (SOX) testing as an example of work that should be completed by management to free up internal audit to work on projects of value to the business units. One member said, *"One of my companies with a large internal audit function employs this practice – SOX testing is done by management."* Another disagreed with this approach, stating, *"This is backwards from our current model. Our internal audit team spends 50% of their time on SOX testing."*

Some internal audit teams are adopting new technologies to improve efficiency and effectiveness. Mr. Singer noted, *"Data analytics has been around for a long time, but internal audit faces a number of challenges when trying to incorporate this tool into its planning and risk assessment processes. Getting the data is an issue because systems don't talk to each other, and staff doesn't know what to do with the data once it is analyzed because they are not sure what problem they were trying to address in the first place."* Many members do not think that their internal auditors are taking full advantage of analytics. One said, *"I hear about data analytics, but I am not sure how our team is using it."* Mr. Singer also mentioned that some internal audit functions are using robotic process automation (RPA) to improve efficiency and reduce time and cost. He explained, *"RPA allows for software robots to perform the up-front, heavy lifting for tasks – think anything manual and repetitive – allowing … internal audit to focus on analysis and freeing them up for operational risk auditing."*

Major changes to the internal audit function will require new staffing strategies. Mr. Singer was of the opinion that an optimal internal audit function should *"have no more than 20% career auditors and be 80% rotational to bring in business acumen to the function and push internal audit knowledge back out into the business units."* Many members agreed and noted that they would also prefer a chief audit executive (CAE) to come from a business unit as opposed to rising up the audit ranks. One said, *"When I look at the universe of companies I have worked with over the years, the best internal audit functions were those headed by credible leaders with experience in change management, not career auditors."*

Members agreed with Mr. Singer that an effective relationship between the audit committee chair and the CAE is essential. One said, *"We meet regularly and also to go through the [internal audit] mandate, which I find to be a very useful tool for understanding priorities."* Another added, *"We provide an annual performance evaluation, and that is an opportunity to help the CAE understand where they are doing great and where they have performance gaps and may need education."* One member noted the importance of the audit committee going to bat for the CAE and their team: *"At least once a year there will be budget pressures, and my CAE will come to me and say, 'I can't do my job if you cut any more of my resources.' This is when you must show support and talk to your CFO. Also, many CEOs don't value the function. You need to make the CEO set the tone at the top and show the importance of internal audit. Be sure they have a seat at the table."*

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About this document

The West 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.

Meeting participants

- Vanessa Chang, Transocean
- Rich Dozer, Swift Transportation
- Burl East, Excel Trust
- Earl Fry, Hawaiian Holdings
- Mohan Gyani, Blackhawk Network Holdings
- Leslie Heisz, Edwards Lifesciences
- Ed Lamb, Real Industry
- Lou Lavigne, Depomed, Novocure, and Zynga
- Cathy Lego, Lam Research
- Sara Grootwassink Lewis, PS Business Parks, Sun Life Financial, and Weyerhaeuser
- Stan Meresman, Palo Alto Networks and Snap
- Roger Molvar, PacWest Bancorp
- Dick Poladian, Occidental Petroleum and Public Storage
- Peter Taylor, Edison International
- Joe Tesoriero, Smart & Final Stores

EY was represented during all or part of the meeting by the following:

- Mark Borowski, Americas Program Mercury Implementation Leader
- Lee Dutra, San Francisco Office Managing Partner, West Region
- Kay Matthews, Vice Chair and West Region Managing Partner
- Todd Moody, West Region Managing Partner of Markets and Accounts