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Edition 5 **2015**

Directors' Cut
Board Effectiveness

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Sharpening your edge

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Methodology

Deloitte interviewed 50 Chairs and CEOs of ASX 200 companies on the issues, challenges and opportunities faced by Australian boards and executives.

Participants were invited to respond to questions about rule-making in the private sector following on from the fourth *Building the Lucky Country Report – Get out of your own way: unleashing productivity*.

The interviews were conducted between April and July 2015. This report incorporates the participants' qualitative comments and the quantitative results of the survey questions.

All information provided by the participants is confidential and reported only in aggregate form. The names of the individual participants and their companies are not disclosed.

Where appropriate, Deloitte has used interviewee quotes to support the report's findings and opinions. The views expressed in this report do not necessarily reflect the views of the individual Chairs and CEOs interviewed unless otherwise stated. Where applicable, Deloitte's views are reflected at the bottom of each page.

We make no representation or warranty about the accuracy of the information, or about how closely the information gathered will reflect actual board performance or effectiveness.

Due to rounding, responses to the questions covered in this report may not add up to 100%. Not all respondents answered every question.

For brevity, the term CEO also includes Managing Directors.

Executive summary

"Regulation can tie you up from making decisions. Companies can make a choice as to the degree of adoption of internal policies - you don't need to spend a lot of time on this."

This is the opinion of one of the 50 Chairs and CEOs from leading Australian companies who we interviewed for this edition of the *Directors' Cut*. It indicates how some of the country's business leaders feel about what they perceive as an increase in regulation that impinges on both directors and companies. How they cope with the added pressure and how their businesses make headway in a more onerous environment are at the heart of this report.

We asked the Chairs and CEOs how they find the time to deal with these issues and how it affects their approach to growth.

Key findings

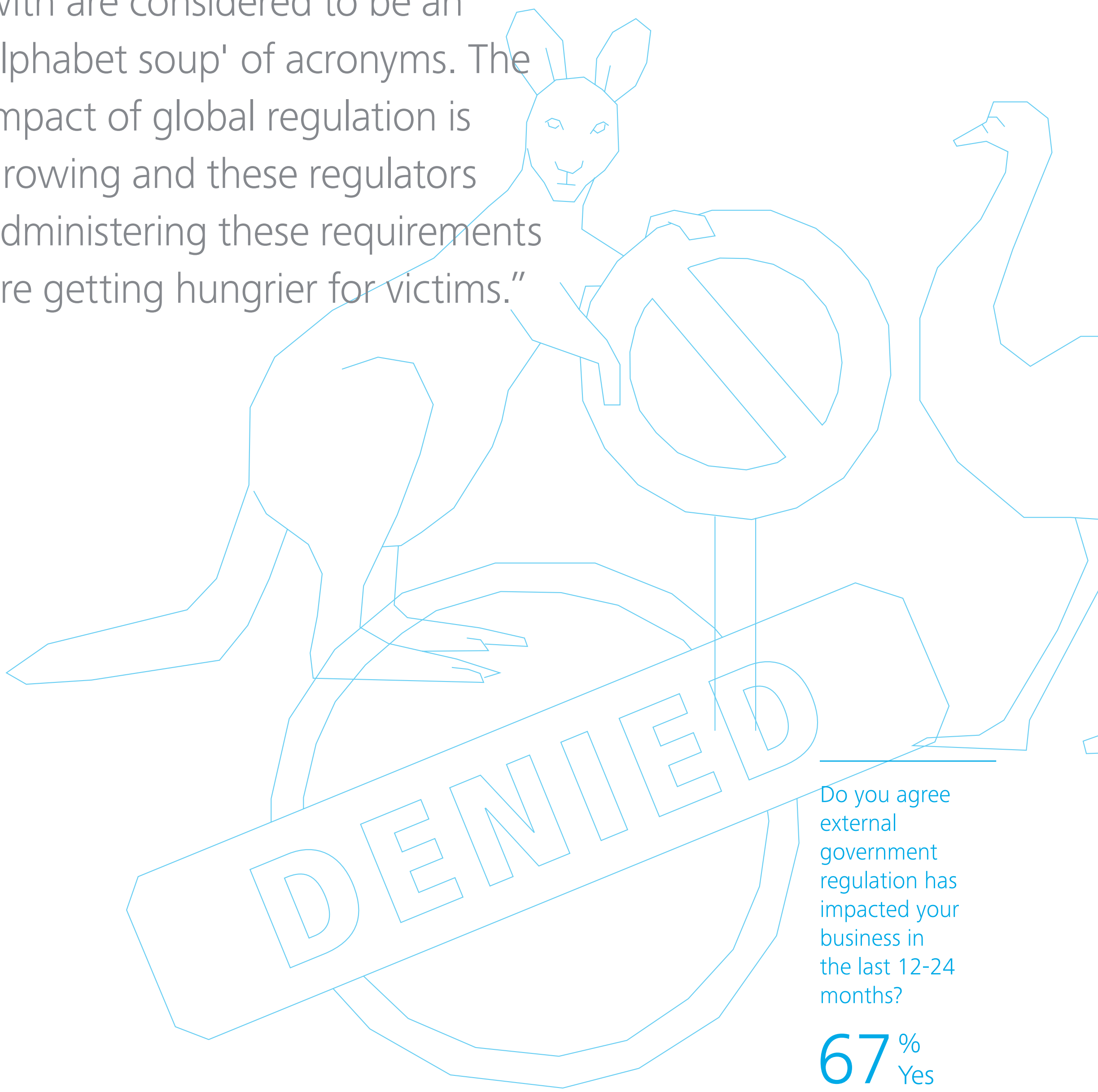
- Sixty-seven percent of CEOs and Chairs say regulation is increasing. One CEO says the government is using regulation to force social change, which is driving up compliance costs.
- Similarly, 65% of respondents believe that corporates are wrapped up in red tape. Companies want to reduce risk and often see their own new rules as the best tool to do so but by cutting or simplifying the rules, we can unleash productivity.
- Sixty percent of Chairs agree that boards do make time to deal with strategic issues, but comment that regulation requires a lot of attention.

Key findings continued

- There is strong agreement among CEOs and Chairs (89%) that their companies have a consistent approach to risk across their business.
- Generally, CEOs are willing to look overseas to achieve their business objectives as Australia is seen as inflexible. Despite this, there is acknowledgement that Australia's regulatory environment does create relatively low sovereign risk and a stable political situation.
- CEOs and Chairs view shareholder activism as a positive development, as long as it represents all shareholders, not just special-interest groups.
- Overall proxy advisory firms are often viewed negatively, with a belief that they can have too much power and that this power will only continue to grow.
- Interestingly, 68% of respondents believe that compliance is not the culprit for the lack of innovation. Cultural issues and politics are seen as key factors.

Our fourth *Building the Lucky Country* report shows that there is a tendency to focus on government red tape as a drag on productivity. This has been substantiated through the interviews we carried out for this report. In fact, the dollars locked up by businesses in complying with self-imposed red tape are double those associated with government regulations. CEOs and Chairs acknowledge in this report that while external regulation is an issue, it isn't a burning platform.
The real issue is corporate red tape.

"The regulations we need to comply with are considered to be an 'alphabet soup' of acronyms. The impact of global regulation is growing and these regulators administering these requirements are getting hungrier for victims."



Do you agree external government regulation has impacted your business in the last 12-24 months?

67 % Yes

33 % No

Impact of government regulations

The majority of CEOs and Chairs (67%) said regulation was increasing. One CEO said the government was using regulation to force social change, which was driving up compliance costs.

"There is an enormous amount of regulation around reporting, diversity and safety, and these just keep getting added to with very little going away," one CEO commented.

One Chair added, "I particularly take offence to prescriptive governance that is irrational and not well founded."

Chairs in particular thought the amount of regulation had increased, with one saying that governments just added new rules without removing old ones, and no one government than any other was better in this area.

A number of both CEOs and Chairs believed that the government was now looking to use regulation to raise revenue, which respondents thought was incredibly inefficient.

While acknowledging that compliance had grown, one CEO pointed out that it was a mechanical function and just something management had to deal with.

Several Chairs warned that boards needed to ensure regulation didn't overtake their meetings. The feeling was that more responsibility needed to be given to the audit and risk committees.

There was a feeling that increased scrutiny of directors was turning some talented business people off taking a board role. In addition, the regulatory environment around employment generally was making it difficult for companies to be agile.

Chairs noted that government regulations often came too late or after an issue had been fixed, and in most cases the best recourse was through common law rather than extra regulations.

There was the feeling among CEOs that while governments talked about simplification, they were increasing the number of regulations and there was a lack of harmonisation, particularly around retail and financial services legislation. "There's no harmonisation of regulatory data across the country, or the globe, which makes things difficult," one Chair commented.

Nevertheless, at least one CEO felt it was necessary to tightly regulate the financial services industry.

"As a global business, if you focus on regulation then you will get nowhere."

Deloitte's perspective: Governments can do a lot to streamline our regulatory environment and reduce the cost of governing our economy. Boards, meanwhile, should not lose sight of addressing the more strategic issues of the organisation, rather than being overwhelmed by compliance issues.

Dealing with 'regulation arbitrage'

Just over half of the CEOs and Chairs who responded to this question believed Australia suffers from regulation arbitrage.

CEOs in particular were willing to look elsewhere to achieve their business objectives as Australia was seen as inflexible, with complex approval processes for construction projects, high costs and powerful unions.

One CEO said his company was forced to go to the US for one project as it took months to get approval in Australia and the construction costs were too high. In contrast, he described the process in the US as 'super-fast'.

"The mindset of regulators is also critical – empowering private enterprise [US] versus adversarial [Australia]," the CEO said.

Some Asian countries, such as Singapore and Hong Kong, were seen to be welcoming and cooperative in trying to help Australian companies operate in their geographies, contrasting strongly with Australian governments' interaction with these businesses.

In fact, both a CEO and a Chair predicted that Australia's equity markets and associated services would move to Singapore and that would just be the start as the competition from Asia increased.

Sixty-three percent of Chairs and CEOs said their boards had clear priorities about doing business in Asia.

The Australian regulatory environment might be stringent but it did create relatively low sovereign risk and a stable political environment. "One of the few benefits of operating in the Australian economy is the stability from a political, legal and economical perspective," one Chair said. "That is what compensates for the fact that we put up with bureaucracy."

Even so, one CEO said that some overseas companies considered Australia too 'risky' and as a result, it was losing access to scale and technology.

Regulation arbitrage was not restricted to looking offshore for benefits as domestically-focused companies that got no advantage from moving overseas instead shopped around in Australia to find the state that least hinders their business.

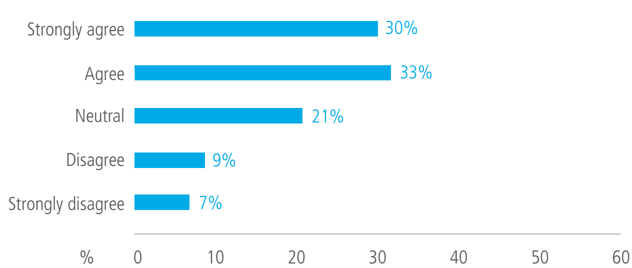
"All the regulation has created a semi-industry of smart professionals who work with business to identify the opportunities and risks of these regulations and how to work around them," one Chair said.

Do you think we suffer from 'regulation arbitrage' in Australia?

53 % Yes

47 % No

Does your board have clear priorities for either entering Asian markets or establishing and growing businesses there?



Deloitte's perspective: Taking a long, hard look at the rules that individual organisations operate within will reduce the cost and complexity of doing business in Australia. While Australia's regulatory environment may be stringent, it does have low sovereign risk and a stable political environment that balance the risks.

Cutting the red tape

The majority of respondents (65%) complained of more corporate red tape, with one Chair commenting, "you have to take a machete to it on a regular basis as it can be a monster problem."

There was a concern that with all the red tape, the board could lose sight of the risks that were important, another Chair said.

Several CEOs said external pressures were creating a response of more internal red tape, resulting in an increase in internal bureaucracy.

Chairs acknowledged that internal regulation had been partly driven by their risk committees asking for more information as they were more aware of their liabilities as directors.

One CEO said self-regulation was becoming more prolific, more advanced and more complex. "Unfortunately to attract capital these days you need to have transparent self-regulation," the CEO said. Another added that there was generally not much return on this self-regulation.

Nevertheless, others said companies could choose what internal policies and controls were adopted and normalised and that it was not necessary to spend a lot of time on these issues.

One Chair said the yardstick should be how any initiative, process or cost contributed to cash flow, customer satisfaction and employee satisfaction. If it did not satisfy at least one of those criteria, it should be cut.

"Governments think they will get the right result by putting legislation in place, but this doesn't really solve any issues. It's best to rely on the judgement of the board," one CEO said. "Regulation and disclosure produce the same sort of problems."

Do you agree there has been an increase in red tape and rule-making in the private sector?

65% Yes

35% No

"It is a problem. We've just appointed someone to get rid of the red tape."

Deloitte's perspective: CEOs and Chairs believe external regulation is an issue, but it isn't a burning platform. They agree that the real issue is corporate red tape. Public and private sectors can therefore benefit from a new approach. The biggest opportunity to unleashing productivity is for business to slash its own red tape.

Making time to focus on strategic issues

Over half of the respondents (60%) believed boards did make time to deal with strategic issues. A number of Chairs in particular said that boards made time to deal with strategic issues, with government regulation being a factor, but not an excuse.

The majority of those interviewed believed that regulation definitely required a lot of attention.

The degree of focus on true strategic issues depended on the business. For some boards, particularly in financial services, regulation has had a significant impact.

"So many specialists are used – risk, external audit, internal audit – that no one has a complete view of how all the risks come together," one Chair said.

Boards were sometimes more worried about risk aversion and brand protection rather than growth.

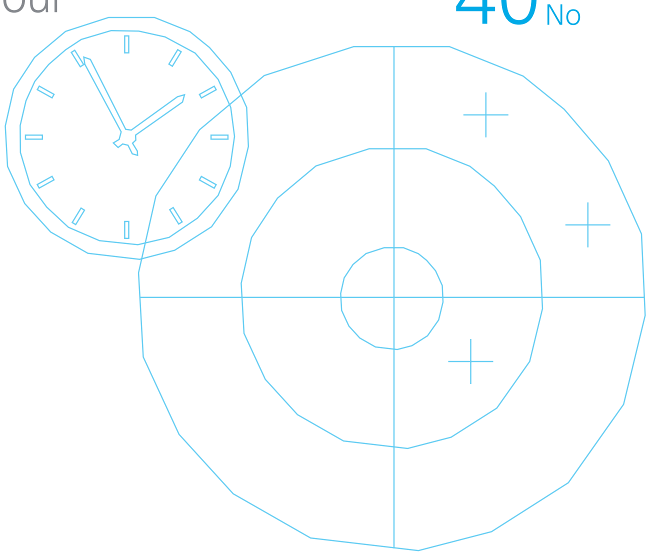
"There is no doubt compliance distracts from the focus on strategy," another Chair added.

With the increase in regulation of your board, does your board have time to focus on the true strategic issues of the business?

60% Yes

40% No

"We spend less time than we should on strategy and more time than we should on regulation in our business today versus our business tomorrow."



Deloitte's perspective: Good boards do not see regulation as an excuse for inaction or to create more rules. A board's responsibility is to ensure compliance happens as well as to facilitate strategic execution.

Sizing up the risks

The increased scrutiny has reduced the risk appetites of many companies.

"There is an element of over-governance," one CEO said. "The board has taken a risk-averse view and management are reporting to it."

"We are more risk-averse, given the environment," another Chair said.

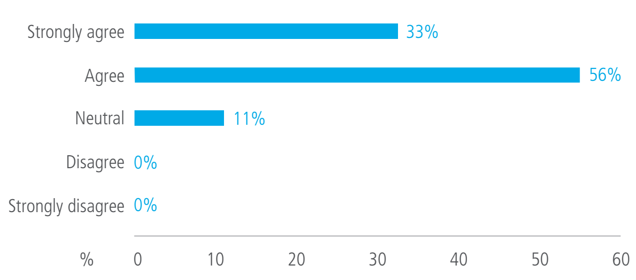
Nevertheless, CEOs and Chairs generally agreed that their companies had a consistent approach to risk across the business.

"You can find a sensible balance by having a board who challenge each other and have someone to drive strategy, someone to be the voice of risk, someone to be financially conservative with regard to spending and budget," one Chair said.

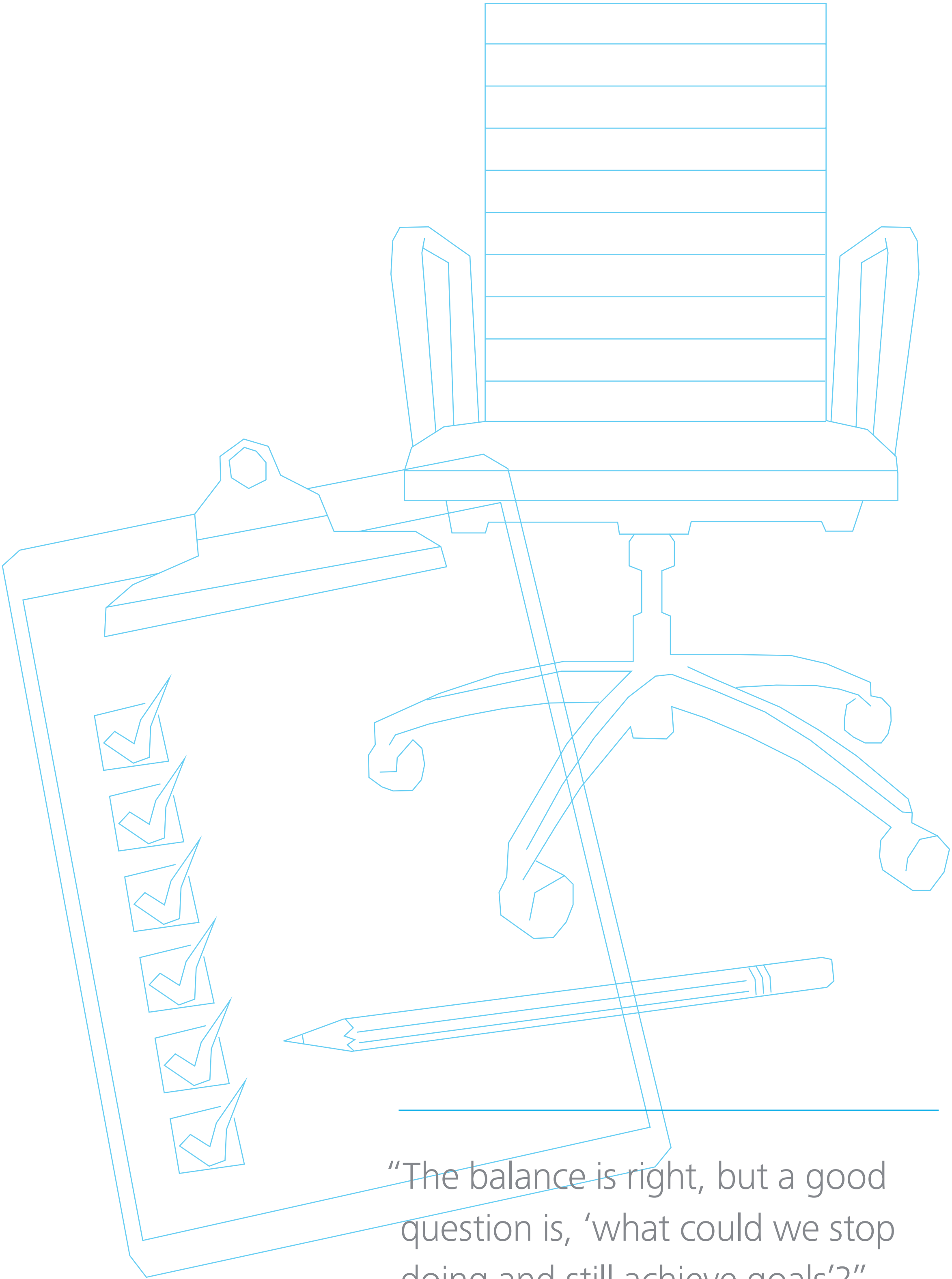
One CEO commented that a very good reason for boards to focus on risk was to avoid the stigma of becoming high-profile failures.

A Chair noted that "self-regulation is a key focus for boards as this is the area where there is most risk for a specific business".

As an organisation we have a consistent view on our risk appetite across the business and between management and the board.



Deloitte's perspective: If companies can drive new approaches to risk, rules and regulation, and increase productivity, this will more than compensate for our ageing population and pressured commodity prices.



"The balance is right, but a good question is, 'what could we stop doing and still achieve goals'?"

Shareholder activism gathers strength

Rather than seeing shareholder activism as as a negative, the CEOs and Chairs generally viewed it as a positive development, as long as it represented all shareholders, not just special-interest groups.

The views were based on the assumption that shareholders had the right to be informed, that activism made directors more diligent as it held them to account and that it could provide a viewpoint that might lead to better business results.

Activism forced directors to become better prepared and had the added impetus of waking up sleepy boards. There was an expectation that activism would become more common.

“Many of the shareholder activist groups are driving a focus on environmental, social and governance factors,” one Chair said. “This is a shift in the previous focus on remuneration and the uncapped bonuses of the executives.”

Another Chair noted that shareholder activists didn’t cause problems if companies communicated the logic behind their policies. Poor corporate governance could lead to greater activism, but there would always be an element that focused on the negative and that was inevitable, the Chair said.

Nevertheless, being held accountable by external parties was considered an important part of the business environment.

"It is not a bad trend, it just needs to be sensible and focused on the right issues.”

Deloitte's perspective: Shareholder activism makes directors prepare better. All shareholders benefit through improved governance and better business results.

Proxy advisors make their mark

Overall, there is a negative view of proxy advisory firms and a belief that they often have too much power and this will only continue to grow.

It takes time and effort to engage with these firms. One Chair said he personally visited them three times a year and was confident he could influence their thinking.

One CEO, however, was scathing in his criticism of proxy advisory firms, saying they can be self-serving and had little engagement with the company.

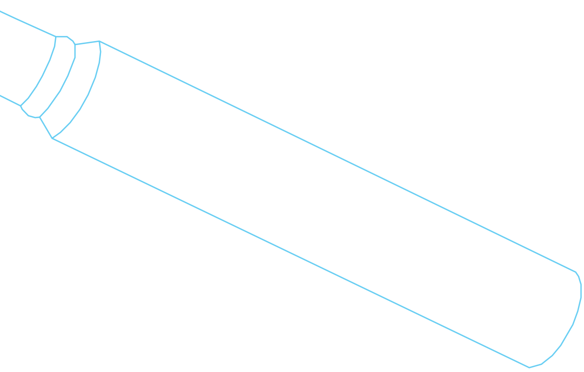
"Proxy advisors have a vested interest in making the issue more about remuneration," the CEO said. "They add zero value."

Another Chair said the firms hunted in packs, and boards had no choice but to take their recommendations into account. "Given their presence, it is the role of boards to be diligent with communications," the Chair said.

"The ability for boards to engage with proxy advisors will lead to a change – not yet – but in the future," another said.

It was generally agreed that boards needed to engage with these firms, which could be a positive experience. However, it was possible they could focus on the wrong areas, such as remuneration.

"They tend to give superficial recommendations and not overly compelling responses."



Deloitte's perspective: Proxy advisors continue to play an increasing role in governance. Boards need to proactively engage with proxy advisors to ensure concerns on all sides are understood.

Compliance versus innovation

More than half of the respondents (68%) believed compliance was not stifling innovation. The remaining CEOs and Chairs believed tighter rules affected the development of new ideas.

Lack of innovation was seen as a cultural issue in business in Australia, with little national pride in or encouragement for our world-beating achievements. "Innovation can't be stifled by compliance if you have the right culture," one Chair said.

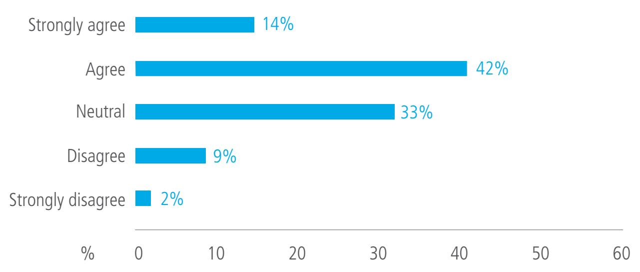
Another Chair blamed performance reporting and politics. "What hurts innovation more than regulation is the public visibility of performance and the politics that goes along with that visibility. Generally, innovation takes time and, in a market where your performance is so public, it hinders innovation."

A CEO added: "The biggest issue in Australia is the inflexible workforce regulation and unionism that affects this."

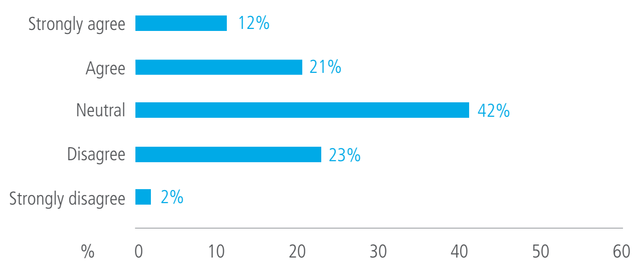
On the separate question of an effective innovation program, over half of the CEOs and Chairs agreed their organisation had such a program. Fifty-six percent of respondents believed that a significant proportion of their current revenue was derived from recent innovation.

Those companies with innovation ingrained in their culture agreed that they needed to work within the regulatory environment.

Our organisation has an effective innovation program in place.



A significant proportion of revenue is derived from recent innovation.



Deloitte's perspective: The abundance of internal rules, procedures and requirements that businesses impose on themselves is hampering innovation and creativity.

By removing unnecessary rules and regulations, the right incentives can enable both businesses and individuals to unleash the productivity and innovation needed to drive growth.

"The fear of failure and lack of effective collaborative behaviour are restricting innovation," one Chair said. "Businesses need to want to leave a legacy rather than simply have a personal gain."

Is compliance stifling innovation?

32% Yes

68% No

On the agenda

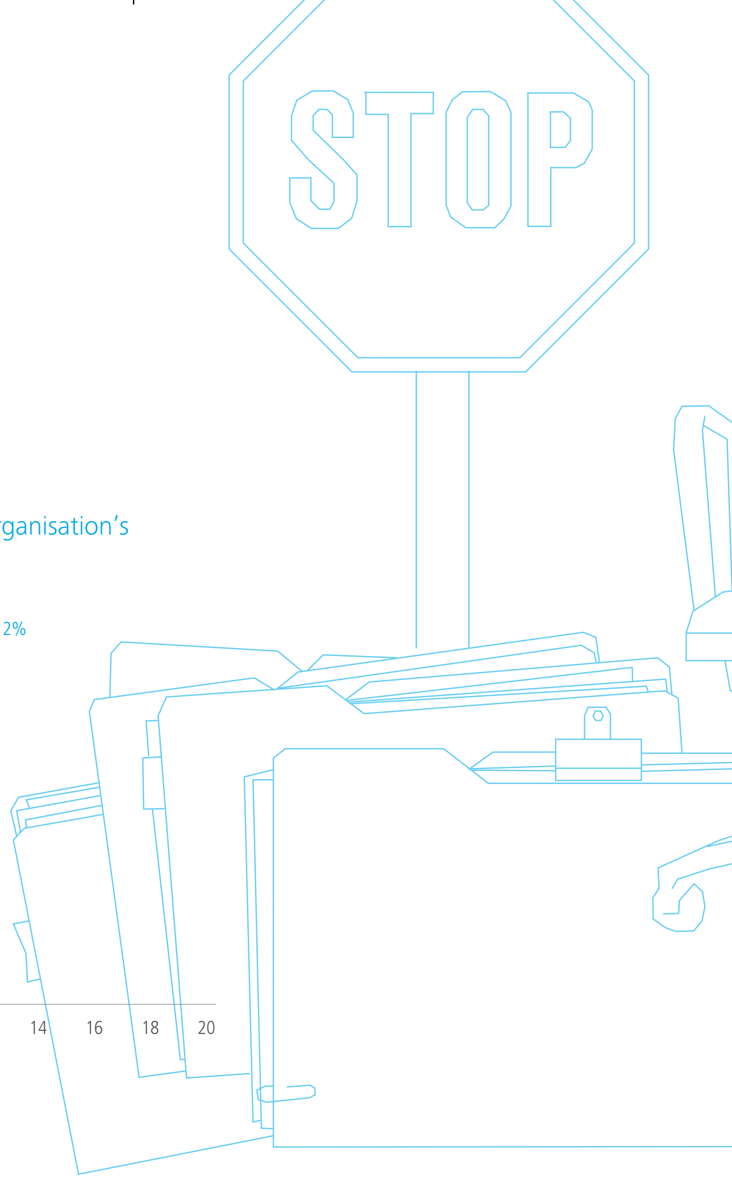
Top issues in the past year

The top issues in the past 12 months have been government policy and regulation, economic and political uncertainty, and market volatility. Added to this, it has been a volatile year as the uncertain economic environment has made achieving growth more of a challenge.

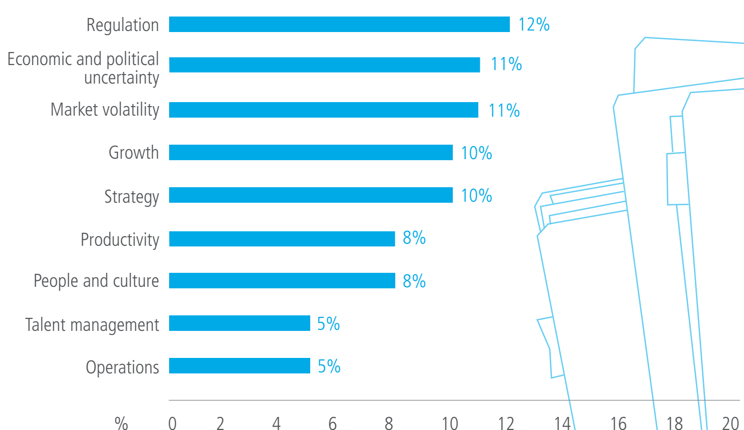
This report has focused on the changeable nature of the regulatory framework for business and the increasing burden this has placed on companies. Dealing with government regulations is normally part of the day-to-day operations of a company and is rarely noted. However, the burden of complying with government policy and regulation stood out as a significant issue in this survey.

Productivity and growth, which had been the top two concerns in the previous *Directors' Cut* report in 2013, fell to fifth and sixth place. This time market uncertainty also appeared as an issue.

The elevation of concern about the global economic and political environment to second place highlighted the concerns over the debt crisis in Greece and its knock-on effects in Europe, turmoil in the Middle East and slowing economic growth in China which have dramatically cut Australia's export income.



What have been the top three issues on your organisation's agenda over the past 12 months?



Top issues in the next 12–24 months

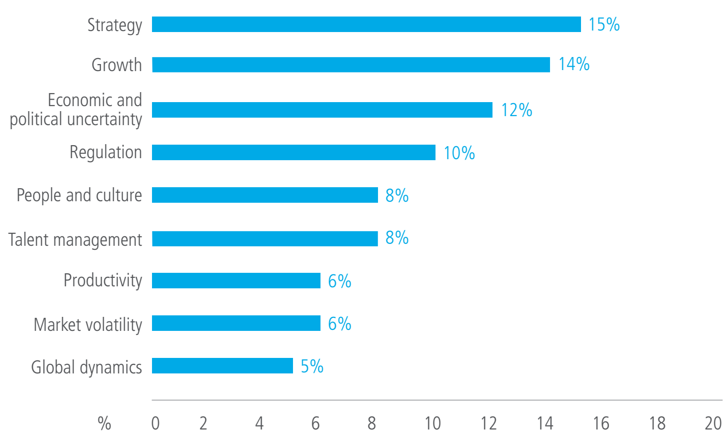
Strategy, growth and continued economic and political uncertainty emerged as the leading concerns for the coming 12–24 months, followed by regulation. This showed the focus remained on maintaining results in the short term while trying to take a strategic approach to the longer term to avoid being caught out by sudden changes in the business environment.

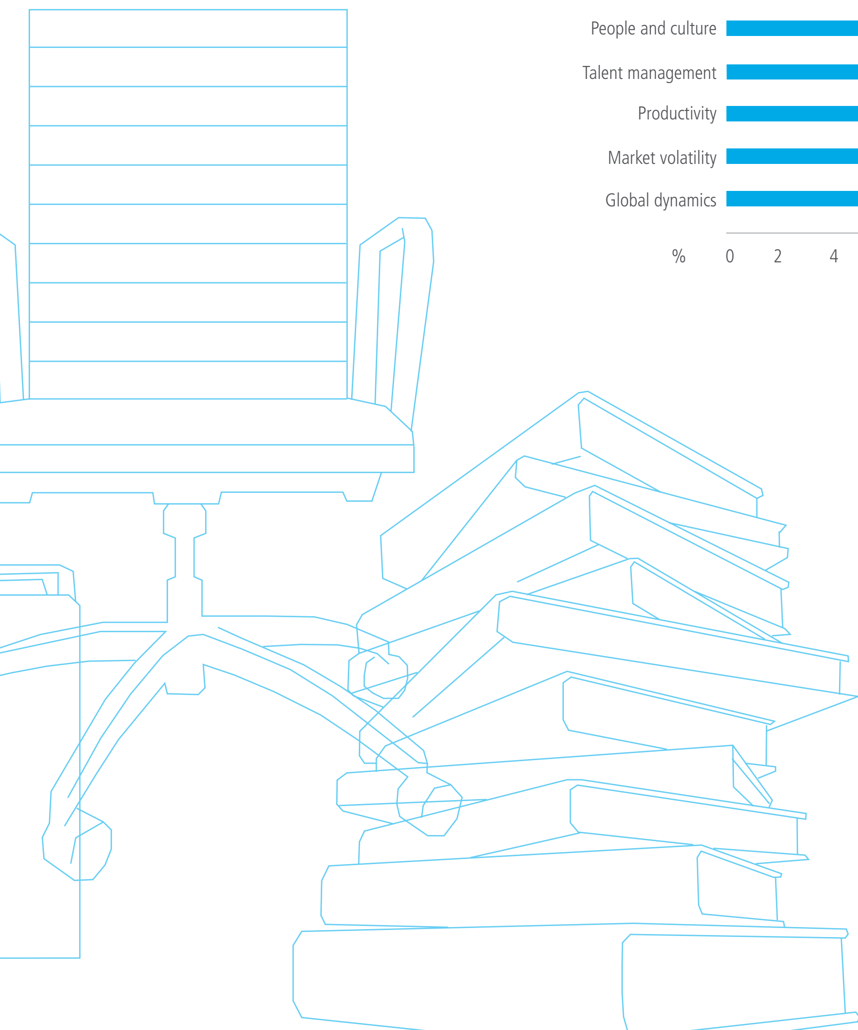
The worldwide hunt for investments that would produce decent returns was a dominant concern for a number of companies, given the low interest rate environment globally. This overtook more micro issues such as executive remuneration and shareholder confidence.

Export-orientated companies would benefit if the value of the Australian dollar remained low, though importers and those with a domestic focus may find it harder to find pockets of growth.

The survey also showed that dealing with increased regulation and red tape would remain a focus.

What are the top three issues on your organisation's agenda in the next 12-24 months?

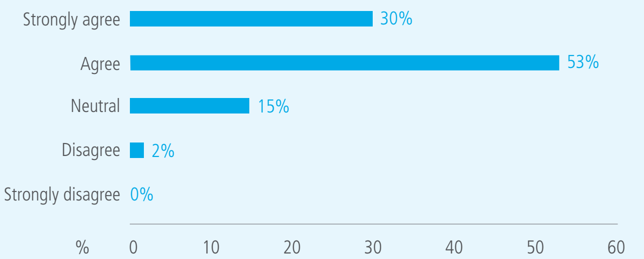




More insights: survey results in detail

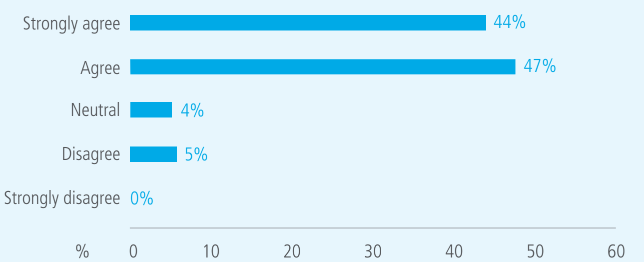
The research for this edition of the *Directors' Cut* comprised a quantitative survey and in-depth, face-to-face interviews with Chairs and CEOs at ASX 200 companies.

Q1 The board adds significant value to the development of corporate strategy.



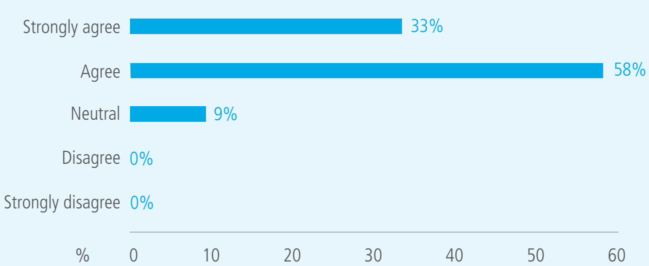
Boards were still seen as valuable in setting strategy, with little disagreement from either Chairs or CEOs. Overall, 83% of CEOs and Chairs thought the board added depth to the formation of company strategy, with 15% sitting on the fence.

Q2 The board allocates time on its agenda to consider strategic risk.



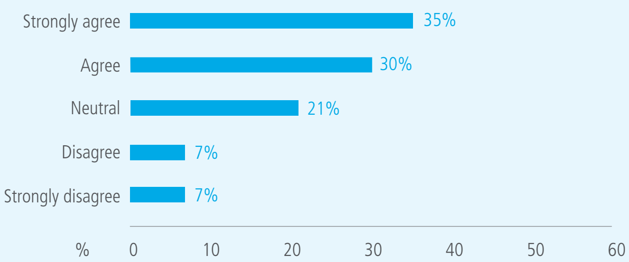
An overwhelming majority of CEOs and Chairs believed the board spent enough of its time thinking about strategy, with only a small number sitting on the fence or disagreeing.

Q3 The board is actively monitoring the execution of strategy.



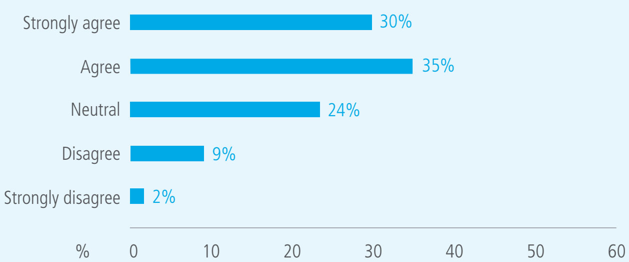
Chairs and CEOs agreed that the board was watching where the company was going and is actively monitoring its course.

Q4 The business model for the organisation has changed in the past few years.



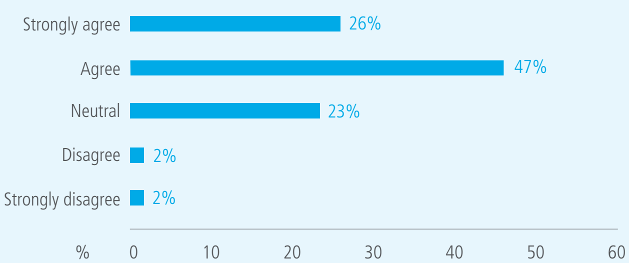
The one constant in any business was change. That meant that to remain relevant and profitable, companies generally had to adapt and move with the times. More than half (65%) of the respondents said their business models had done just that. While 14% said there had been no changes.

Q5 Digitisation has significantly impacted the way the organisation does business.



The impact of digital technology has been profound and widespread, and most companies now had a digital strategy. The majority of respondents agreed the latest technology had a significant impact on their businesses, although 11% either disagreed, or strongly disagreed and 24% remained neutral on the issue.

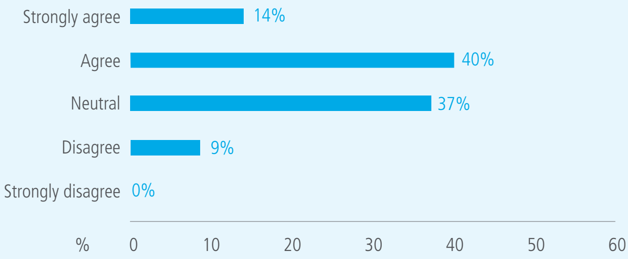
Q6 We understand the elevated cyber risk that comes from our enhanced use of technology.



Information security was one of the most pressing issues and cyber attacks were increasing. On the issue of cyber security and the dangers lurking in the ether, 73% of respondents said they were either aware or very aware of the risks associated with doing more business digitally.

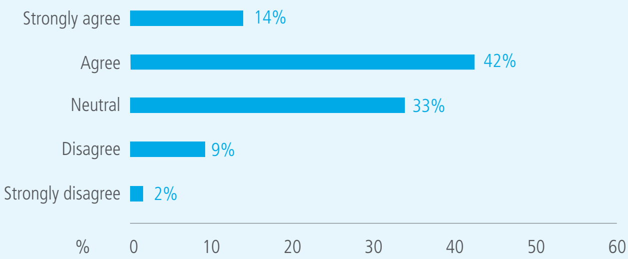
More insights: survey results in detail

Q7 As a board we understand how well we are managing cyber risk as an organisation.



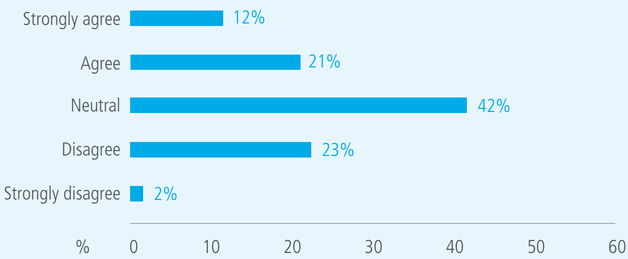
When financial losses, intellectual property theft, reputational damage, fraud and legal exposure are all at risk, it was necessary for information security to get the full attention of company executives. So it was surprising that 37% were neutral on the question of how well cyber risks were being managed. But for the most part, 54% were confident they understood the risks.

Q8 Our organisation has an effective innovation program in place.



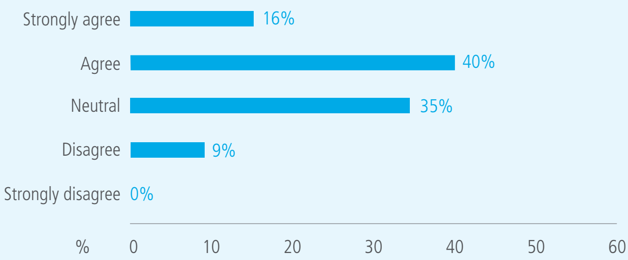
Adapting to an ever-changing world means developing and embracing new ideas, products and processes, but that can't happen unless it is encouraged and supported. In large firms, innovation tended to come in increments to avoid upsetting shareholders. Even so, there needed to be mechanisms to achieve that. Fifty-six percent of the Chairs and CEOs believed that was the case in their companies but, surprisingly, 33% were non-committal about the issue.

Q9 A significant proportion of revenue is derived from recent innovation.



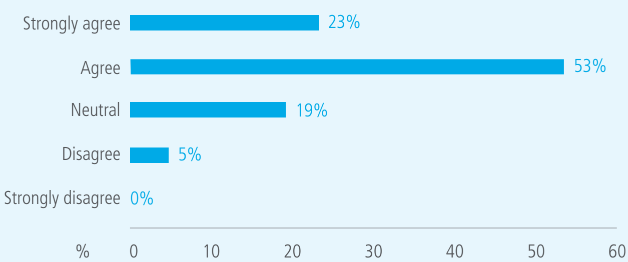
Close to one-third (33%) of the Chairs and CEOs said their companies had derived a good chunk of revenue from new ideas, products and processes they had recently adopted. A sizeable 42% were neutral and 25% said there had been no gains.

Q10 The organisation is seen as a leading developer of talent.



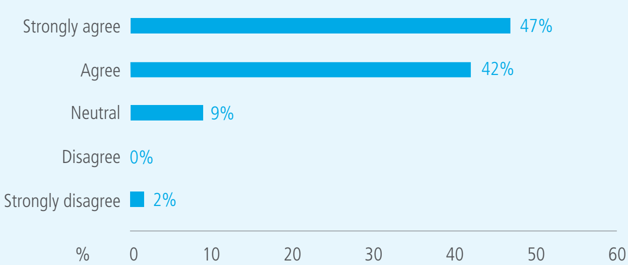
A company is only ever as good as the people it employs, so choosing the right people and developing their talent is crucial. Over half (56%) of the Chairs and CEOs said they were confident about their company's ability to nurture talented people, while 35% had a neutral view about it.

Q11 The organisation has an effective senior management succession plan.



Leadership is critical, and ensuring the right succession plans are in place is crucial to the continued existence of the company. The issue was recognised as a priority by 76% of Chairs and CEOs. A concern was that those who admitted their companies didn't have proper succession plans were all Chairs.

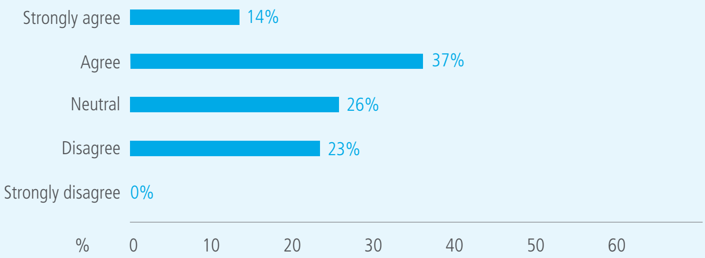
Q12 The balance of power between the CEO and chair is appropriate.



Clashes between CEOs and Chairs can be part and parcel of executive life but most of the CEOs and Chairs interviewed for this survey (89%) thought the balance of power was just about right.

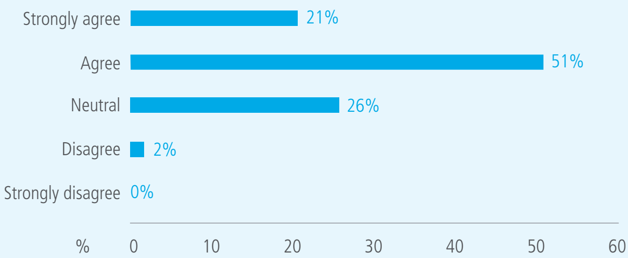
More insights: survey results in detail

Q13 Our board has made innovation and disruption a focus of the entire board.



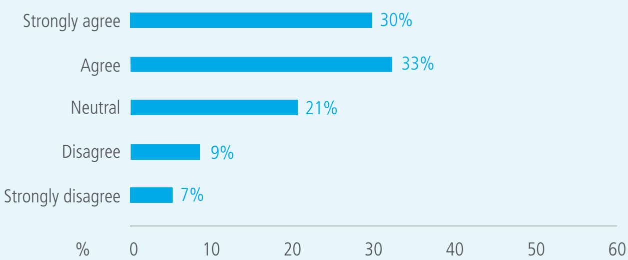
Innovations and disruptive ideas are seen largely as the province of nimble start-ups but 51% of Chairs and CEOs of these larger companies thought their boards were doing a good job of promoting change.

Q14 The organisation uses robust analytics to revisit and refine strategy.



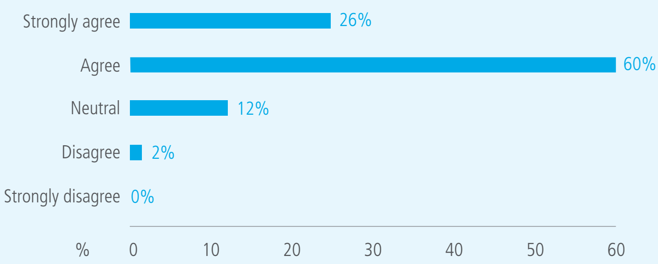
Data is playing a larger role in everything from the formation of strategy to the day-to-day running of companies, and using it to chart a course in today's economic environment is becoming increasingly common. Seventy-two percent of the respondents interviewed said their company strategy was formed using robust analytics, though 26% were unmoved on the issue.

Q15 Does your board have clear priorities for either entering Asian markets or establishing and growing businesses there?



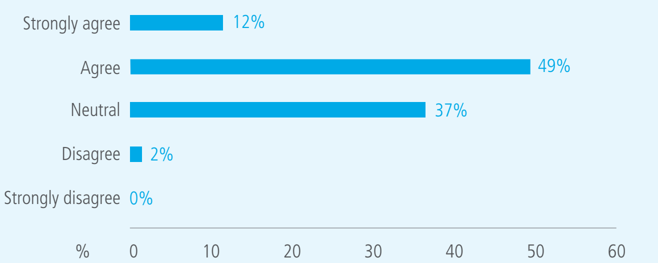
As any expansion into Asia essentially is a strategy issue that is dealt with at board level, it's not surprising that 63% of Chairs and CEOs were dealing with the issue. Sixteen percent of Chairs and CEOs said their organisation had no intention of going to Asia, which might account for those companies that are purely domestic.

Q16 The organisation has a clear customer strategy and execution plan.



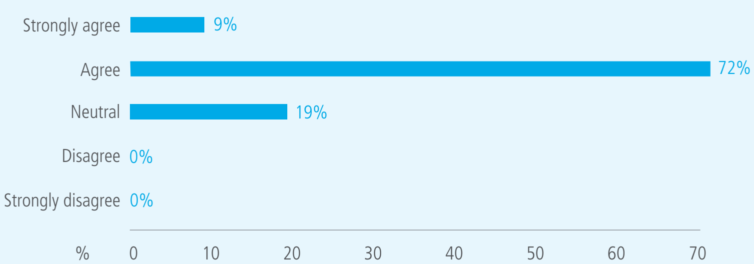
Customers are at the heart of every enterprise and having a clear strategy to service those customers and win more is essential to making profits. That's why 86% of Chairs and CEOs said their companies had suitable strategies.

Q17 The organisation is adapting appropriately to the changing needs of customers across digital, social and physical channels.



The growing influence of digital technology means companies must interact more often through social media channels as well as have more traditional options available to customers. Over 60% of Chairs and CEOs thought their companies were doing enough.

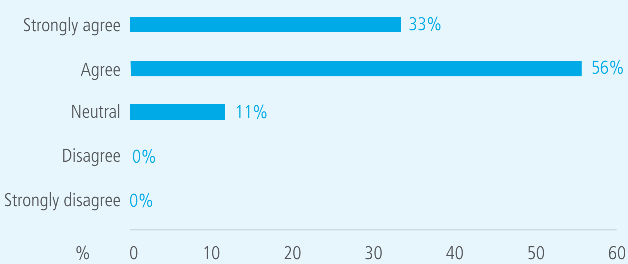
Q18 The organisation is well prepared for significant reputational risk events.



Planning for the worst is taking up a significant amount of time and energy, with nearly 81% of Chairs and CEOs saying they were confident their organisations were well prepared to handle an event that might cause a big hit to their reputations.

More insights: survey results in detail

Q19 As an organisation we have a consistent view on our risk appetite across the business and between management and the board



There appears to be strong alignment on risk appetite views between boards and executive management teams but generally the appetite for risk is low. Is board members' low appetite for personal risk overly influencing low corporate risk appetite?

The way ahead

- Regulations are necessary but should never get in the way of innovation or ensuring growth and productivity are maximised. Too much focus on the regulations can stymie the decision-making process.
- Good boards do not see regulation as an excuse for inaction or to create more rules.
- Organisations may encourage rules that focus on what must go right, not what could go wrong. It's not just about training people in what to do; it's about training people in what to stop doing.
- The biggest opportunity lies in business slashing its own red tape, which puts a brake on creativity and innovation.
- Shareholders have the right to be informed and directors have to be accountable, which should encourage more diligence.
- New approaches to risk, rules and regulations can create innovative approaches to increasing the effectiveness of a company's workforce.
- Companies need to work out effective and efficient processes, rather than let regulation take over and the demands and costs of internal functions escalate.

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