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Directors' Alert 2018:
Linkages to Success

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Directors' Alert 2018: Linkages to Success

Protecting the reputation of the organization is among the most important and challenging responsibilities of the board. This is especially the case right now, when reputation risks have never been more numerous or more threatening.

Reputation risks are usually generated and accompanied by other risks, such as culture, cyber, and third-party risks. If serious enough, a risk of any type can create significant reputational risk, particularly if it goes unchecked. For this reason, boards and management teams are increasingly seeking ways to identify and manage sources of reputation risk.

Protecting reputation is critical, but leaders are also responsible for enhancing this asset, which is among a company's most valuable. Taking steps to enhance an organization's reputation requires the board to take a more proactive position than if the goal is merely to protect it.

This edition of *Directors' Alert* directs your attention to some of the most powerful levers the board can pull to enhance and protect reputation. Specifically, we focus on the board's oversight of three critical areas: strategy and risk appetite, CEO succession and organizational culture, and digital innovation.

Oversight of strategy and risk appetite are at the heart of a board's responsibilities; this is particularly true in the current environment, where it is essential to take risks to create value while also avoiding risks that erode value. The board's role in CEO succession may be the most powerful lever it has to influence culture, and culture stands among the primary components of organizational reputation. Digital innovation drives growth in many organizations but holds risks that must be overseen by boards that may be

unfamiliar with recent innovation; when it comes to digital, boards need to update their knowledge and capabilities continuously.

Each of these levers links to reputation, either enhancing it or placing it at risk. We expect these matters to appear on boardroom agendas across the globe in 2018, and we hope this publication serves as an alert not only to the importance of these links, but to effective ways of approaching them as a board and with management.

As in past editions of *Directors' Alert*, we interviewed Deloitte global business leaders on each topic. These practitioners work closely with boards and senior executives in many of the world's leading organizations. We also spoke with directors of leading organizations around the globe regarding the related challenges and opportunities they face in their boardrooms today. These contributors provide valuable insights as well as a balancing perspective, and we thank them for both.

Each article includes a short list of questions directors can use to begin exploring these issues in the boardroom and with management. We also identify specific actions boards can take to employ these levers and work with management more effectively in the context of their oversight roles.

Dan Konigsburg
Senior Managing Director
Deloitte Global Center for Corporate Governance

Michael Rossen
Managing Director
Deloitte Global Center for Corporate Governance

The missing link in CEO succession planning:
Organizational culture

A number of recent high-profile incidents that could be described as failures or breakdowns in organizational culture have resulted in the sudden need for a new CEO. Other cases of CEO succession have signaled sharp changes in direction for the organizational culture. Both situations underscore the need not only for ongoing board oversight of CEO succession planning and organizational culture, but also for strong linkage between the two.

To be prepared for both sudden and planned CEO transitions, a board must understand the organization's cultural needs. While dramatic culture failures make news, it's more common for organizations to neglect needed changes to their cultures or find themselves outpaced by more agile competitors. Such "slow-motion culture failures" call for a more purposeful reset of the culture before it's too late, and effective CEO succession is often the best means of achieving that reset.

The CEO, more than any other executive role, determines how culture plays out in the organization. Some of the most effective CEOs think of themselves as the "chief culture officers." Yet when the board is consumed with either sudden CEO succession or long-range succession planning, it is easy to overlook the importance of cultural considerations in CEO selection. A CEO candidate's past performance, industry experience, and stature in the business community will likely loom larger than the cultural needs of the organization. But neglecting those cultural needs increases the chance of a poor fit, missed opportunities, and even disaster, with potentially significant negative reputational impacts. By the same token, fulfilling those cultural needs increases the chances of CEO success, and preserves and enhances reputation.
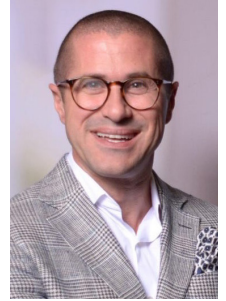
At most organizations, the succession process needs to fully consider the relationship between the CEO, other members of the C-suite, and culture, and must do so well before a new CEO is needed.

Connecting CEOs and culture

Research reveals that enterprise performance and value are clearly linked to solid senior leadership and strong CEO pipelines.

- Survey results show an average equity premium of up to 15 percent for organizations with perceived effective leadership and discounts of as low as 19 percent for organizations perceived to have ineffective leadership.[1]

- A study of the world's 2,500 largest public companies shows that companies that scramble to find replacements for departing CEOs forgo an average of $1.8 billion in shareholder value.[2]

- Research has shown that 80 percent of analysts typically put an equity premium on companies that are perceived to have a strong CEO pipeline.[3]

- A survey of 7,000 executives in 130 countries found that 82 percent of respondents believe that "culture is a potential competitive advantage." The connection between culture and performance was seen as "important" by 87 percent of respondents, with 54 percent seeing it as "very important."[4]

Anthony Abbatiello
Digital Leader
Human Capital
Deloitte Consulting LLP

Jeff Rosenthal
Managing Director
Deloitte Leadership Consulting
Human Capital
Deloitte US

At most organizations, the succession process needs to fully consider the relationship between the CEO, other members of the C-suite, and culture, and must do so well before a new CEO is needed.

Rooting succession in culture

Organizational culture can be defined as the system of shared beliefs, values, and ways of working within an organization. It is ultimately the board's responsibility to ensure that the organizational culture prompts people to perform in ways that serve the organization's mission and purpose and achieve its goals. Fulfilling this responsibility begins with board consensus on what the desired culture looks like; otherwise, there is little hope of defining the qualities needed in the CEO who will be asked to instill or maintain that culture. Consensus is also important because if a board disagrees too much on the desired cultural aspects, they could be tempted to minimize those criteria.

Boards realize that organizational culture—in the sense of "how things get done around here"—is not determined solely by formal value statements and manifestos, although they are useful in defining the desired culture. They understand that culture emanates largely from the C-suite leaders' values and priorities as reflected in their daily interactions and activities and in the individuals and behaviors they reward and promote. That is where culture is realized and how culture plays out. In essence, a CEO can embody the desired culture of the organization as the strongest agent for changing or reinforcing that culture.

The board must first agree on the culture the organization needs to maintain or pursue its strategy and achieve its goals. Strategy and goals must fit the organization's purpose, which can be hard to keep in focus during times of rapid change. Many boards are wrestling with organizational identity crises as technologies transform entire industries as well as customer behavior, business models, and enterprises. Are we a media company or an entertainment company? An entertainment company or a tech company? A tech company or a manufacturer? A manufacturer or a distributor? A distributor or a payments facilitator or a bank?

With organizational identities in such flux, it takes dedication and decisiveness for a board to figure out its near-term leadership needs, let alone those in the more distant future. Yet, that is the board's responsibility. The board must grasp the organization's purpose and mission—its most foundational and enduring reason for being— while also constantly looking ahead. Too often boards believe that criteria for the next CEO will remain the same as current CEO criteria, and fail to develop a clear enough picture of both the culture needed for continued success and of the CEO needed to foster that culture.

For example, many boards now believe that their organizations need more innovative strategies and, by extension, more innovative cultures to fulfill their missions.[5] Many want to build a culture of innovation, but most have difficulty agreeing on what that means and how to move beyond "the way we have always done it." They know the organization needs to evolve to compete in today's environment, but few have defined what a culture of innovation would look like in their own organizations. They will say they want to drive new ideas or they want new products and business models, but they haven't defined the thinking, behavior, activities, and events to drive their innovation. They haven't defined the culture.

Boards need to arrive at that definition before embarking on the CEO selection process. Doing so might start with asking management:

- What innovations are being considered for our business?

- What are we seeing in the industry?

• What time are we allocating to generating new ideas that will lead to new sources of revenue?

• How are we evaluating new ideas?

• How are we developing and prototyping new products, services, and business models?

• How much money are we allocating to developing new ideas and methods?

The board can validate the responses based on experience and appropriate input from advisers in considering what kind of culture promotes its objectives and what kind of leader promotes that kind of culture.

Once it has agreed on a definition, the board can turn to developing a culture for the future. It may be a continuation of the current culture, a slight departure, or a total transformation. It may support more risk taking or become more risk-averse. It may need to become more innovative, more customer-focused, more cost-conscious, more global, or more local. Whatever the need, it will be the CEO who is most responsible for establishing the culture on an operational level.

Expanding the focus in CEO succession

Defining the organization's cultural needs in succession planning should expand the focus on candidate criteria from performance, experience, and personality to include specific leadership capabilities. Boards are becoming much more intentional about how CEOs lead from a cultural standpoint.

This expanded focus should be based on continuous monitoring of organizational culture and its effectiveness, discussing culture as a board and with management, and gauging and deciding which leadership attributes the organization needs. These often include the ability to harness technology, to pivot to new courses of action, to build consensus and emotional connection, and

Seeing succession through a cultural lens

Once a board decides what culture—or cultural changes—the organization needs to drive performance, the task turns to defining the CEO's characteristics and whether a candidate possesses them.[6] In general, a candidate for CEO should be able to:

• **Fit the desired culture and model desired behavior.** Through their daily communication and behavior, leaders exert tremendous influence over the culture of their organizations. That culture works in conjunction with policies, structures, and governance to shape how employees work. The board must understand and assess how the executive leads from a cultural standpoint, then consider a candidate's ability to succeed in that role.

• **Understand his or her fit with the culture and drive positive change.** Leaders who understand their own fit with the existing culture can lead more effectively by knowing when to leverage existing ways of working and when to call for change. This self-awareness informs an intentional approach to daily decisions and actions that shape the culture.

• **Connect with hearts and minds to create common purpose.** To sustain an effective culture, leaders must connect with employees emotionally to create shared purpose and enhance motivation. While always important, this is particularly relevant to millennials.

Routinely, CEO candidates are assessed on past performance using financial and market share metrics. Cultural criteria are harder to measure but equally crucial in preserving or enhancing the health of the organization.

to develop and implement global strategies. At times, the need for such leadership attributes can outweigh the need for a candidate with the exact skills the board would like to see.

Of course, boards can and do disagree about culture and the characteristics they value in a CEO. But smart boards recognize and resolve those disagreements well in advance of selecting the next CEO, and they are taking steps to enhance their CEO selection process in itself and as it relates to organizational culture.

Cultivating culturally competent CEOs

Approaches to CEO succession planning appear to correlate with the maturity of the industry and the age and size of the company. Large, well-established companies in mature industries, such as consumer products and banking, often tend to their senior executive pipelines more diligently than smaller companies in newer industries, such as digital technologies. Yet company size and industry hardly guarantee sound practices in this area; despite significant regulatory requirements for public companies to build executive pipelines, an alarming number remain exposed in terms of their senior executive succession practices.

Those that do the best job have adopted the following basic practices for infusing cultural considerations into the CEO succession process, and are poised to move to the next level:

Raise the board's cultural awareness. In assessing the organization's current environment, culture assessments and monitoring tools are basic necessities. The same can be said of assurance reports that ascertain whether employees have been trained properly and understand policies and procedures. While valuable, culture assessments typically measure employee satisfaction, and training conveys knowledge but cannot control behavior.

↪ Moving to the next level: To understand culture, the board needs visibility into what is really happening in the organization. Human resources or external advisers can use confidential interviews, focus groups, and data analytics to discover where policies and procedures are working well, causing frustration, or failing to deliver the intended results. The board must be advised on how management communications and behaviors are shaping the culture and whether that culture is supporting the defined strategy, risk management policy, and goals.

Sustain board engagement in the succession process. It is far more common now than it was even five years ago for boards to discuss CEO succession and cultural considerations at the same time. For example, there has been a move to shift the conversation from who could replace the CEO to what leadership qualities the organization needs and how to locate them when the time comes. Boards also now seek a consensus view of those qualities and characteristics.

↪ Moving to the next level: Boards that actively monitor the leadership pipeline well typically treat succession planning as an ongoing practice. It is on the agenda regularly, regardless of the CEO's tenure or performance. These boards are candid and courageous in discussing future needs, potential candidates, executive development, and needed adjustments, whether as a full board or in a board-level committee such as the governance and nomination committee or a similar body.

Broaden CEO candidate criteria. It's natural, and easy, for a board to focus on CEO candidates' financial and operational performance. Discerning boards look to how that performance was achieved, which can indicate the potential interplay of CEO, culture, and performance. For example, the characteristics needed to achieve growth through acquisitions and divestitures differ from those

CEO as chief culture officer

One CEO we worked with recently said he believes deeply in the importance of culture and considers himself the "chief culture officer" of the organization. In the final months before retiring from his CEO role, he wanted to ensure that the culture of the organization continued to be a top priority. A man of action, he asked the board to institute a cultural audit of the CEO-elect one year into his or her tenure, and then each subsequent year, to allow the board to track the pulse of the organization's culture and make real-time changes if needed.

The board has agreed to this course of action. In this situation, the CEO not only believes in the importance of culture, but has been able to influence the board to maintain culture as a priority even beyond his own tenure.

needed to achieve organic growth. Those needed in a challenging market differ from those needed on a clear playing field, just as those needed to steer a company through a turnaround differ from those needed to lead a major expansion. Looking to characteristics such as personality type, leadership style, and cross-cultural experience enriches comparisons of potential candidates.

Moving to the next level: Look beyond performance to characteristics such as agility, creativity, and ethical outlook. Predictive benchmarks can now identify personality types in useful ways, indicating how one is likely to lead others, involve others in decisions, consider risks, and deal with change. A window on change management, ethics, and other dimensions of leadership helps a board identify culturally relevant characteristics. This data, coupled with the board's consensus on the needed culture, can help in identifying the best candidates.

Oversee internal talent development. The internal leadership pipeline can and should be developed and managed using a proactive approach. Companies that have strong leadership pipelines and formal leadership growth initiatives have 30 percent greater net revenue per

employee, are five times more likely to anticipate and respond to change effectively, and are 10 times more likely to be effective at identifying and developing leadership than those lacking such advantages.[7] Given the board's responsibility for CEO succession and the advantage internal candidates have in not only understanding the culture but also being known quantities, the board should support a robust internal senior executive development program.

Moving to the next level: The most effective programs follow a 3-E model, which stresses expertise, experience, and exposure. Expertise comprises the skills, capabilities, and functional knowledge leaders need. Experience focuses on broadening candidates' knowledge of the company through rotational assignments and special projects—at a minimum. To take that further, place candidates in highly ambiguous, conflict-ridden situations so they can develop coping abilities. Exposure might mean sending candidates on overseas assignments to adapt to different markets, methods, customs, and perspectives; increase their knowledge; and test their ability to function in a cross-cultural environment.

Support the CEO before, during, and after the transition. Boards often consider CEO succession complete when the new executive is installed. Many boards also over-delegate the shaping of the culture to the CEO, expecting that one individual to change it singlehandedly. Given high CEO turnover, it's essential to support the CEO in any culture change initiatives. The board must also gauge appropriate time frames for culture change, which can be longer than expected.

Moving to the next level: The board should help the CEO manage time, talent, and key relationships and provide clear, constructive feedback to a new CEO in the beginning and throughout his or her tenure. For an executive team tasked with culture change, it is important to establish a formal program that employs a performance-management approach by setting

goals, encouraging certain actions, reinforcing the right behavior, and enabling candid conversations at all levels. This brings the often lofty idea of "culture" down to an operational level, pushing needed change into daily routines.

In closing

Boards have many priorities, but virtually nothing stands higher than the decision on who leads the organization. Although the CEO is only one person among many, he or she exercises influence over the entire organization and, often, well beyond it.

The value boards clearly place on the CEO role does not always translate to robust succession planning. This is particularly true when it comes to the impact of the CEO on culture, and poor cultural fit is often at the root of a failed CEO selection.

Boards have many priorities, but virtually nothing stands higher than the decision on who leads the organization.

In a very real sense, CEO succession is a risk oversight responsibility. First-rate succession planning helps avoid expensive and embarrassing breakdowns in culture while also positioning the organization to execute its strategy and achieve its goals. Proper oversight of the CEO succession process and the organizational culture helps minimize reputation risk while providing ample opportunity to enhance the organization's image among investors, potential alliance partners, and CEO candidates themselves.

Questions for directors to ask

What do we see as the relationship between our organizational culture and performance—operationally, financially, and otherwise? What levers do we intentionally employ to influence the culture? How effectively do we employ them?

How do we currently manage CEO succession planning? To what extent do we consider cultural matters in that process? How can we better align culture with CEO succession?

Have we agreed on the desired organizational culture and the characteristics of the CEO we need to instill or maintain that culture? If not, how can we do so?

How do we monitor the culture and its characteristics and effectiveness? What can we do to better understand what's happening in our organization?

What is the condition of our leadership pipeline? How can we incorporate the 3-E model into our internal development efforts? How can we identify and cultivate external candidates with the ability to lead from a cultural standpoint?

If a sudden need arises, how prepared are we for immediate succession in the form of an acting CEO, and are we ready for the subsequent search and transition?

How do we currently support a new CEO, particularly in managing time and relevant talent and relationships? What can we do to ease the transition into new responsibilities?

Q&A with Ilene Gordon

Ilene Gordon is executive chairman of Ingredion Incorporated, a leading global producer of nature-based ingredient solutions for food, beverage, brewing and industrial customers. She was chairman, president and CEO of Ingredion from 2009 through 2017. Ms. Gordon joined Ingredion from Rio Tinto Alcan Packaging, where she was president and CEO of Alcan Packaging. She spent 17 years in executive roles at the Packaging Corporation of America, a division of Tenneco Inc., and began her career at the Boston Consulting Group based in Boston, London and Chicago. Ms. Gordon is a member of the boards of Lockheed Martin and International Paper.

What would you say are some of the leading board-level practices for CEO succession?

Boards at high-performing companies tend to cultivate well-suited candidates internally. Robust development plans are typically established for internal candidates based on their history, strengths, and needs for improvement over specific time frames. I use a "three and three" rule of thumb—look three years ahead and have three internal candidates. While specifics can vary, this approach frames the board's choices about the company and its next chapter.

In general, I believe internal candidates are preferable. However, sometimes changes in culture or strategy are warranted, even in high-performing companies. Then an external candidate is usually preferable, unless you have an internal "outlier"-type of candidate who won't be bound by past customs and approaches. Having a set CEO retirement age, while not necessarily a best practice, helps frame the board's planning horizon.

What tends to work well in cultivating internal candidates?

Most boards go through an annual succession planning process for all executive leadership positions. Typically, the HR/talent management function works with executive management to prepare a report for the board. There can be a dedicated board-level committee for succession, but when it comes to CEO succession, the entire board will need to be involved as it's a full board responsibility. At Ingredion, we have three candidate categories: ready now, ready in one to three years, and ready in four to six years. This pipeline helps the board to identify development activities to prepare the not-yet-ready candidates. Depending on the candidates, the needed development might include on-the-job training or outside talent development, such as helping the candidate find a position on an outside public board to gain governance experience.

What does the board consider when it comes to linking the kind of culture the organization needs and the next leader's qualifications?

The board and management are responsible for strategy, which sets the stage for everything from business objectives and KPIs to talent management and development. Strategy and culture go hand in hand. Much depends on how the company has been performing, as measured by shareholder value. If it's been performing well, the board will likely seek internal candidates. But if the company faces challenges, such as industry changes, they may look externally. When I joined Ingredion in 2009, the company, known as Corn Products at the time, wanted to grow amid changing food trends. The board knew the organization needed to pivot and sought someone from outside the industry. So, what's happening in the industry and how the company is performing dictate whether you need a culture change. It's really driven by strategy, which determines how you are going to win in an industry.

How did that play out in your joining the company as CEO?

The board had identified a need for innovation focused on customer recipes—ways of creating value for customers along specialty, rather than commodity, lines—as a key success factor going forward. The board had to gauge whether an internal or external person would be better suited to drive that change. To their credit, the board decided that food or agricultural industry experience was not as important as having someone who understands how to create value for customers in a challenging environment. My background was in the packaging industry, which had undergone changing requirements for success and a need to create innovative solutions for customers. The board felt I could learn the agricultural parts of the business from my team at the company, and that proved true. For example, when I joined, the company had more than 25 percent of its revenue from high fructose corn syrup (HFCS), primarily to the beverage industry, and we've brought that number to under 10 percent in terms of HFCS sales to the beverage industry. That was driven by moving the focus from sweeteners to healthy food trends and helping customers by developing new healthy products, such as gluten-free, non-GMO, or digestive-health related products, quickly. That was all based on strategy.

Are boards using personality profiles and similar tools or external consultants in assessing candidates?

Sometimes boards will have an external consultant, using his or her own tools, assess a candidate. They may evaluate past experience, where the candidate has been successful or less than successful, usually based on hours spent with internal and external candidates. Rather than assessing "personality," I believe it's key to assess candidates' temperaments. What do they get excited about? Are they optimistic in their outlook? Can they deal with multiple constituents, or do they find that frustrating? Successful CEOs thrive on people challenging their thought processes and decisions, and someone who finds that annoying will probably find leading a team of senior executives quite difficult.

What can boards do to assist a new CEO in the transition to the new position?

My successor joined us through an acquisition, and he and I have worked together for seven years. The board appointed me executive chairman, and is keeping me on to assist in his transition until this coming July. It's essential to have someone available and accountable to help the next CEO make the transition and navigate issues during that period. The transition time frame should be more than three months and less than a year, but it varies by company. When I came to Ingredion from the outside, the board decided it would be best to have the outgoing chairman and CEO completely retire, but to make him available to me for eight months as a consultant. So, my predecessor and I never overlapped as employees, but he was available as a consultant from when I joined until the end of that year. It's also important for the departing CEO to move out of the building on the last day. Some move to another floor, but that can create confusion as people continue to see them on a daily basis. Moving out of the building sends a clearer message.

What else works well during the transition?

When Ingredion's CEO-elect was announced, he was immediately appointed to the board. Having the CEO-elect join the board right away involves the person in decisions as they're becoming familiar with their new role and responsibilities, and that has worked well at Ingredion. He was included in all board correspondence, reports, and meetings, right from his appointment as CEO. Of course, you can have only one CEO, and you need clarity in the organization regarding the CEO and CEO-elect roles and who is making decisions at any given time. Then on the day of transition the roles clearly shift. I was also involved in CEO transition on another board, and you realize that each company has different needs. But in an orderly transition, the CEO is in alignment with the board on strategy and responsibilities.

What helps a new CEO coming in from the outside to understand the organizational culture?

In my case, coming in as an outsider, I held one-on-one interviews with the board members to have them alert me to the dos and don'ts of the company and familiarize me with the past. The board was very good about this and about encouraging me to drive change. When I interviewed my management team, I always asked, "What are three things I should keep the same and what are three things I should change?" This helped me identify what remained, as well as what they believed needed to change. Even though various people will have different perspectives, general themes emerge. It's also useful for the board to have an executive session, first with the CEO, then without the CEO, and then to give the CEO feedback. As I was onboarding, I would sit with the board and give them my view of the situation and then leave the room. They would have their own discussion and the lead director—since I was also chairman—would give me feedback on things they believe would help me run the company better.

Any final thoughts?

The board is very much accountable for strategy, CEO succession, and reputation—and they are all intertwined. If you look at surveys of the most admired companies, you'll see that organizations with boards that pay close attention to those areas tend to do well in those surveys, which I believe are indicative of reputation. The board is accountable for that and for monitoring all factors that could affect strategy, culture, and reputation. They all have a strong impact on shareholder value, which is the board's ultimate responsibility.

Exercising oversight of
digital innovation
How boards can keep pace

Organizations are both transforming themselves with digital innovation and being transformed by it. Apart from the financial benefits, organizations with reputations for successful digital innovation often garner strong followings among customers while becoming magnets for technological talent.

At many organizations, however, board oversight of digital innovation has not kept pace with technology. One major reason is the tendency of boards and senior executives to retain attitudes and methods from the pre-digital age. Many still apply largely irrelevant practices, such as overly detailed business cases, in overseeing digital innovation.

Successful digital innovation hinges on new modes of thinking and acting. Yet many board members and executives still think of it in terms of the long time frames and huge sums associated with IT transformations, where it would not be unheard of to have spent $200 million and still be in Year Two of the project. A massive business case precedes such investments, and lingering technological uncertainty may cause sleepless nights.

Many oversight practices from the past simply don't apply to digital initiatives. The ability to "think digitally" is a success factor for boards and executive teams, who must now exercise oversight in ways that reflect current modes of innovation and general business challenges. While some boards and executive teams get it, many do not.

Think digitally

Thinking digitally involves a shift from a traditional perspective suited to capital investments in physical structures and products to one more suited to initiatives that are virtual and experimental.

Here are four major differences between traditional and digital thinking:

- **Digital transforms activities.** Digitalizing a process is not a matter of performing the same activity in a new medium. It goes deeper than filing sales reports on mobile devices or enabling web-based customer onboarding by exploring the development of new value streams, business models, and communities via digital technology. Many organizations are so slow to capitalize on the possibilities that their customers outpace them and begin doing business with companies better able to meet their demands.

- **Innovation is rapid and continual.** In another example of holdover from large-scale capital projects, many leaders think a digital project ends when it is launched. In practice, most digital offerings undergo continual evolution. Although they have a beginning and a middle, and certainly a point of becoming operational, development doesn't stop there. Users' needs, competitors' responses, and regulators' requirements continue to evolve, demanding further innovation.

- **Mobilization is unprecedented.** The hyperconnectivity engendered by digital transformation translates to the capacity to mobilize groups of people. Whether it's Twitter providing a platform that ignites political movements, open-source software creating communities of developers, or multiuser platforms linking gamers worldwide, we can now mobilize people with shared interests at an unprecedented speed and scale. Yet most organizations still think in terms of networked ecosystems and how to digitize what they've always done; instead, they need to define where they want to be and how digital technologies can help them get there.

Peter Williams
Chief Edge Officer
Centre for the Edge
Deloitte Australia

Many oversight practices from the past simply don't apply to digital initiatives.

The ability to "think digitally" is a success factor for boards and executive teams, who must now exercise oversight in ways that reflect current modes of innovation and general business challenges.

- **Late adopters and laggards die off.** Most organizations use digital technologies to make their current activities faster, easier, and cheaper—a useful, but not transformative, goal. A few aim to truly transform their businesses or, perhaps, entire industries or aspects of modern life. Too many leadership teams neglect to set goals and fail to act until it is too late, only to find they have been outpaced by competitors who can provide higher quality at a lower cost or they have been rendered obsolete by completely new business models.

Truly transformative opportunities open up for leaders who think in terms of business models rather than products. Their organizations move early and quickly. They learn by doing and understand what's at stake. They place multiple, relatively small bets related to their value proposition, customer needs, and available resources while recognizing that these are all in constant flux.

How should the executive team manage digital opportunities and how can the board oversee the organization's path to innovation? There are no hard-and-fast rules, but some approaches are proving more effective than others.

Digital oversight

Digital oversight does not require board members to stare at their smartphones or dashboards for real-time assurance. Although most companies find it beneficial to digitalize current processes for monitoring assurance and reporting, it is important to focus on the board's broader oversight of innovation and organizational initiatives.

This shift does not require boards to jettison time-honored approaches to approving and overseeing capital-intensive projects, which will continue for most organizations, and some of those practices can be adapted. Yet boards need to embrace an attitude that enables effective oversight of digital innovation, which many find difficult. The benefits are clear, however. A board that understands digital transformation, including its risks, can often better oversee capital-intensive initiatives or suggest alternatives to those projects. Several shifts in perspective must precede a change in practices.

Free your mind

Most organizations have yet to scratch the surface of digital potential. Waiting too long is often the most common, and arguably worst, mistake. Waiting for perfect data, waiting for the next release, waiting until initiative X or Y is complete, waiting for next year or the next budget or the next CEO—all of these postponements take a toll. Although no organization can be a pioneer on every front, board members need to welcome and support digital innovation to succeed.

Those most in touch with recent trends, the so-called digital natives, tend to be significantly younger than the average board member and are often millennials born after the widespread adoption of the Internet. They tend to accept as fact certain tenets that require other board members to undergo deliberate shifts in perspective to assimilate.

Understand that exponential change is the goal. Deloitte calls developments that create such change exponentials: innovations that create rapid, significant leaps in performance relative to cost. Exponentials result from exploring a broad range of possibilities rather than striving for incremental improvements in current performance.

Think about new business models rather than new products. Consider how the organization can establish platforms that enable people to work faster and receive better feedback in collaboration

with a broader range of individuals and entities. Many organizations avoid open-source platforms, but those platforms often accelerate development.

Zoom out and zoom in. Encourage management to zoom out and imagine customers' needs, competitors' moves, and your organization's configuration and offerings five, 10, or even 20 years in the future. Then zoom in to the next six to 12 months to identify high-impact initiatives that can be used to test assumptions, blaze trails, and generate near-term revenue. "Zooming" should be an iterative process that supports ongoing innovation.

Deepen your understanding of digital innovation. Digital innovation is inherently iterative. You identify what you want to do, launch a prototype, find people willing to use it and provide feedback, improve that prototype, and begin again. This concept is at the core of agile development methods.[8] Walls between developers, users, engineers, and marketers are being torn down. "Devops" teams, which combine development and operations professionals, can now produce iterations with amazing speed. Boards need to think about oversight accordingly and guide management in useful directions as innovation progresses. Without a shift in mindset, attempts to "go digital" often falter. Board members may see the promise of digital technologies and know that competitive threats demand a strong response, but they often don't know how.

Practice the practices

Although a change in mindset usually comes first, changes in practices can lead to, and certainly reinforce, new attitudes. Boards and management teams may want to consider the following eight changes in practices to foster a more meaningful evolution of their approach to overseeing digital innovation.

Provide needed direction and leadership. If the board lacks a "digital champion" or knowledgeable director, the chairman should be proactive in driving

A negative case in point: How not to do it

A materials handling company we worked with was concerned about being outperformed by more digitally advanced competitors. We said, "Give us six months and a budget and we'll launch a new model for ordering and tracking. We'll do this in several successive iterations, learn what's working and what isn't, and take it from there."

So far, so good.

We then told the client that rather than preparing a detailed business case, we would conduct pilot projects and weekly reflection sessions. Instead of an elaborate, time-consuming process for making decisions, we would work in the open using an online project management tool so they would have full transparency.

Again, so far so good.

After a couple of months, the company just wouldn't green-light the project. Why? Because they could not shake off their usual documentation and approach to making decisions. It was a true example of leaders who grasped digital innovation intellectually, understood the possibilities, and seemed ready to commit before reverting to long-standing habits.

Once the needed shift in mindset occurs, the need for detailed upfront business cases diminishes, although it does not disappear entirely. Similarly, when boards shift to a new perspective they can move toward more fluid practices for overseeing digital innovation.

the board's exposure to digital innovation and working methods. If the organization lacks digital capabilities, the board should consider establishing a committee focused on these matters. Even if innovation is well established in the organization, the board still needs to provide oversight. Boards should certainly consider qualifications in digital technologies and experience in digital innovation when selecting new members. It is simply too important not to. To make digital innovation a priority, place it at the top of the board agenda multiple times each year.

Get out and about. Boards that visit Silicon Valley for formal tours of tech companies tend to get the Disneyland version of digital innovation. It's exciting, but they return to headquarters without a clear idea of what to do next. It's good practice for boards to visit a noncompetitive peer, a critical supplier, a customer, or any other innovative company willing to share its methods. Visits to innovation hubs or R&D labs at universities is another option, as are discussions with startups that are breaking new ground.

Get down in the digital trenches. Ask to attend a few working sessions of devops or agile teams operating either in your own company or at a customer, supplier, or noncompetitive peer. These teams usually track and report progress using online tools or sticky notes. They visually map the customer journey, the development process, who's doing what, and what's been accomplished. Often they can show working prototypes and discuss how they are setting priorities. Most use weekly sessions to consider what has gone right and what has gone wrong, which may trigger new best practices. Be open and nonjudgmental about this working style and learn how it all comes together. If this seems time-consuming, consider it the alternative to a pilgrimage to Silicon Valley.

Lose the business case, then make it. Business cases tend to take a blue-sky approach based on favorable assumptions. That's because they are largely based on positive market research

rather than experience. Digital technology lends itself to rapid prototyping and testing, actual user feedback, and successive iterations. After a few rounds of small experiments, a development team usually can define uses, users, costs, and pricing more accurately than any upfront business case could. The results of these tests can be used to compile a more accurate and persuasive business case based on far better data.

Seek the minimum viable transformation. Instead of large-scale business model transformation, target the minimal viable transformation. This is akin to the minimal viable product concept digital entrepreneurs employ to test a hypothesis and understand user needs. A new business model comes from answers to questions about how the company makes money, its modes of delivery, whether it needs to enlist outside skills, and how its processes are organized. Small changes to these elements enable a company to test hypotheses about how users, costs, pricing, and other variables will respond. True digital transformation usually comes about through changes to business models, not to products.

Look to the edges. We use the concept of an "edge" to define an area of the business that can become a catalyst for change: an unmet need, a new way to deliver value, or a rapidly emerging opportunity. An edge has the potential to expand to the point where it may replace the core business. The board should encourage management to identify edges before competitors or new market entrants do, establish teams to innovate along the edges, and scale accordingly. This aligns with the zoom out/zoom in and minimal viable transformation concepts. Edges define where to look, and they may be the true genesis point for new competitors who seem to "come from nowhere."

Oversee the risks. This type of incremental approach to transformative change can actually limit risk. It recognizes that some of the greatest

A positive case in point:
How to do it

A wholesaler of property and casualty insurance selling its products through brokers saw its market share plummet by 40 percent over three years. Management and the board realized dramatic steps were needed, and quickly. They also realized that those steps would cause channel conflict and potentially upend their broker-based business model.

To meet the client's need to have a workable business model in four months, it was decided that everything would be done using cloud-based platforms and that the CEO would manage the internal politics and channel conflict.

Instead of constructing a business case based on X customers in Y months at Z revenue per customer, the innovation team took a design-oriented approach. The goal was to take a new business model to market quickly and learn how customers responded to it. The team designed three models and considered what customers bought, when and how they bought it, the purchase drivers, and pricing. They also considered the company's market segmentation. Within four months a model had been selected and was operational, and it has succeeded in the three years since.

The team mapped what worked, what didn't, and how obstacles were overcome to provide a blueprint for future initiatives and establish a new way of innovating. Work was done in a large room to facilitate collaboration among various contributors, which included a sales data management company, a cloud company, a design company, an ad agency, and internal personnel.

The team walked the board through that room and showed them how the process worked and how the customer journey map on the wall guided every decision and activity. Leaders demonstrated how the team used sticky notes and rough drawings to organize tasks and the board immersed themselves in this process and learned how it worked. Board members also attended the team's weekly reflection sessions, where they discussed what had been accomplished, what they were seeing, what went right and wrong, and what remained to be done.

This company was truly open to changing its business model, and the brokers ultimately benefited because the marginal cost of using this channel was so low. What the board saw was an initiative developed based on back-of-the-envelope calculations rather than an overly detailed business case. The team understood that the model would work if they could scale it, so their objective was to develop a working model, test and gain acceptance among users, and then build it out further.

risks in our hyperconnected, increasingly virtual world stem from isolation, legacy thinking, and inaction. Oversight of digital initiatives and the associated risks requires an approach that is in some ways tighter but in other ways looser than what was used in the past. For example, it is important to set specific goals but stay open about how to reach them. If it takes alliances with emerging companies to reach your objectives, so be it, but first identify and manage the risks within the parameters established by the board and management. If multiple initiatives are needed, formulate and test hypotheses so the organization pursues only viable opportunities. To obtain different results you need to do things differently, but you must also identify and manage the accompanying risks.

Change the conversation, expectations, and metrics. Management may need encouragement to pursue new opportunities in new ways, particularly when performance is strong. As stewards of long-term value, the board should urge management to zoom out and zoom in. As an overseer of risk, the board should help management gauge which opportunities to pursue and which safeguards to employ. As a monitor of performance, the board should set expectations regarding measures such as number of initiatives, successes and failures, returns, and time frames. And as the overseer of strategy, the board should assist management in areas such as talent, external resources, competitive developments, and needed investments.

In closing

The proliferation and evolution of technologies requires the boards of companies far outside the high-tech industry to understand digital innovation and use it to their advantage.

The term "digital" goes well beyond traditional IT, and proficiency in legacy IT systems and practices does not necessarily translate to the digital world. Most organizations need to focus more broadly on opportunities for business model

The presence of board-level digital skills and meaningful digital oversight practices sends a strong message that the organization supports innovation, enhances the company's reputation, and works to position itself to manage the risks of digital innovation.

transformation, increased agility, and ways to capitalize on customer behavior. This requires an understanding of the importance of design, a willingness to empower those people on the front lines, and an ability to establish platforms and use experimentation to spur ongoing innovation.

Boards can certainly tap internal and external digital expertise, but most can benefit from a director who can distill the views of specialists and help the board translate that knowledge into the advice and oversight management requires. The presence of board-level digital skills and meaningful digital oversight practices sends a strong message that the organization supports innovation, enhances the company's reputation, and works to position itself to manage the risks of digital innovation. Downside risks are managed aggressively by taking an iterative approach to multiple innovations, seeing what customers want, adjusting accordingly, and supporting the initiatives that work. Digital transformation of business models has proven extremely successful in retail, publishing, entertainment, advertising, financial services, and other industry sectors. It has also boosted efficiency and effectiveness in areas such as inventory control, logistics, transportation, supply-chain management, facilities management, customer service, and financial management.

Digital innovation is still a new area rife with uncertainty, well outside the comfort zone of many board members and management executives. As in the case of any potentially disruptive technology, it may be wisest to take an exploratory approach to understanding what you're dealing with, where it is going, and where it can take you.

Questions for directors to ask

What is our organization's digital strategy? Where can digital technologies yield new opportunities and competitive advantage?

How often do our digital innovations result in incremental improvements rather than transformation? How can we leverage digital technologies to develop new, transformative business models?

To what extent are the board and company mired in innovation methods oriented toward long-range, capital-intensive projects? How can we learn new about new methods of innovation?

Where are the "edges" in our business—areas with the potential for exponential growth? Which edges could provide opportunities for competitors with new digital business models? How can we pre-empt or deflect those competitors?

How open are we to possibilities and transformation? How can we become more open to tactics such as open-source platforms and alliances with new market entrants? What do we need to do to manage the associated risks?

What oversight mechanisms should we have in place when management undertakes digital initiatives? Do we have the resources on the board to develop and adopt those methods? What internal and external resources might help us accelerate our learning process?

What digital experiences do our customers and employees expect, and what are we doing to deliver those experiences?

Q&A with Tse Hau Yin, Aloysius

Tse Hau Yin, Aloysius, is an independent non-executive director of CNOOC Limited, Sinofert Holdings Limited, SJM Holdings Limited, China Telecom Corporation Limited, and China Huarong Asset Management Co., Ltd., all of which are listed on the main board of the Stock Exchange of Hong Kong Limited. He is also a member of the International Advisory Council of the People's Municipal Government of Wuhan. Mr. Tse is a fellow of the Institute of Chartered Accountants in England and Wales and the Hong Kong Institute of Certified Public Accountants (HKICPA), and a past president and former member of the audit committee of the HKICPA.

How would you characterize boards' general understanding of digital innovation?

In certain industries, such as banking, financial services, technology, and telecommunications, boards have a good knowledge of digital innovation. Of course, digital innovation will be very useful in other industries, such as real estate, retail, travel, and logistics. The opportunities are there if the understanding is there. But boards at most companies still need to have more understanding of this area.

Overall, apart from financial services and technology companies, most boards are not yet at the point where they are incorporating digital into their strategies or changing their business models. Their limited understanding usually relates to a lack of awareness and a traditional "old economy" thought process among directors, although in some cases they have the awareness but lack the skills to address the issue.

Can you tell us more about the limitations around boards' skills?

In Hong Kong, there are not enough experts in digital technology to equip boards with the knowledge they need in this area. These experts are in extremely high demand and the excess demand makes hiring in-house specialists difficult and expensive, leaving external support as the only viable option. This makes adding digital innovation skills to the board, through a change in composition, quite challenging.

I believe the next stage will be to develop more technology specialist positions at the management level rather than to diversify boards with technology specialists. These in-house technology experts can then advise the board on digital matters. Changes at the board level will take more time, and few companies have human resources strategies to address this issue.

How do you advise boards to overcome these problems?

Boards need to educate themselves, make use of outside experts, and develop buy-in, at both the board and management levels, for the strategic and operational changes that will be needed in the near term and further into the future. This way, the board can start to understand the issue and then help the organization move on to adaptation. Whenever possible, including a director with a strong background in IT, digital technology, or digital innovation on the board would be a major advantage.

What do you see as the number one risk for companies regarding digital innovation?

Definitely the risks posed by mass layoffs due to certain jobs no longer being needed. This can arise in various industries, for example in manufacturing due to industrial robots and in business services due to robotic process automation. Such layoffs can create reputational risk in places like Hong Kong, where the business culture tends to encourage long-term employment and discourage mass layoffs. Management's instinct is typically to redeploy employees to new jobs, but those new positions may not fit them properly unless they have been trained for them.

Given the magnitude of the changes, if many companies were to undergo significant layoffs simultaneously, it would be useful to have government policy and education strategies to temper the effects. Also, the resulting reputational risk could, in fact, be lower if many companies make this transition at the same time. The manner in which management handles layoffs is also important, for example when employees are given assistance in transitioning to new positions or external opportunities. In addition, the younger generation sees new working arrangements as positive because they provide flexibility, mobility, and work-life balance, which younger people tend to value more highly than lifetime employment.

What other risks do you see in digital innovation?

Most other risks are more in the future, and relate to issues such as the increased responsibility of developers of artificial intelligence (AI) for its performance in collaboration with the consumer (e.g., the safety of driverless cars). A further example is the effectiveness and validity of assumptions used in algorithms behind certain AI applications. Thus, in industries such as retail, investing, or wealth management, AI could be biased or manipulated by being programmed to make particular choices for consumers or to reinforce a particular viewpoint.

One present risk is in social media, where monitoring by companies is now a mainstream practice to address reputational risk and potential changes in customer and market sentiment. Companies are now using social media proactively when managing communications with their stakeholders, rather than just reactively.

What local issues do you see in digital innovation in Hong Kong?

The Hong Kong Monetary Authority has organized seminars on this topic but, in general, I see Hong Kong being behind other markets, especially Mainland China, in dealing with digital innovation. In Mainland China, companies are able to leapfrog technological developments more easily. For example, mobile payment systems and apps development in Mainland China are well ahead of those in Hong Kong.

While Mainland Chinese state-owned enterprises face challenges in adapting, they benefit from government support. Also, businesses in Mainland China are less constrained by the longer traditions associated with family companies in Hong Kong. Hong Kong faces a challenge in learning to adapt quickly and effectively, and might look to Mainland China for examples of ways to do that.

Overall, are you more optimistic or pessimistic in terms of the impact of digital innovation on companies?

Optimistic. Companies understand they have to adapt in order to compete; they are doing so and will continue to do so. The contributions that digital technologies bring to companies will generate greater efficiency but also brand-new experiences and power for customers.

To initiate change and keep pace with change, boards need to focus more on risks and issues related to digital innovation and deal with them as part of their standard agenda. Boards themselves will also have to embrace technology if they are to remain relevant in this rapidly changing world.

Are boards now meeting more with management on strategic digital decisions affecting the organization?

Boards have certainly become more aware of the impact of digital innovation on the future operational and financial well-being of their companies. They are, therefore, devoting more effort and resources to understanding their companies' IT initiatives and are meeting with management to assess and prioritize them. As the new digital economy progresses, boards have to be constantly updated by, and collaborate with, company management to ensure that they are not left behind in this new industrial revolution.

Strengthening the link between strategy and risk appetite:
How the board can lead the way

Board responsibility for overseeing risk and the strategy developed by management will not be the headline for 2018; over the past few years, boards have worked steadily to enhance their oversight of both. They have obtained better risk information, strengthened organizational risk governance, and, in some cases, supported the appointment of chief risk officers or formed board-level risk committees. They have also done more to understand and challenge the strategy put forth by management and to encourage management to develop and model strategic alternatives when needed.

Yet risks and challenges continue to multiply and evolve, and management must continually revise strategies in pursuit of organizational goals. These same forces are driving boards to move their oversight of risk to the next level of maturity.

One way boards are enhancing their risk oversight practices is by clarifying—and formally approving—the organization's risk appetite. This is the aggregate level of risk management is willing to take in pursuit of its strategy. As a first step, boards must also understand and sign off on management's strategy.

Directors realize it is their role to oversee both risk appetite and strategy, but conversations linking the two are usually informal, if they happen at all. Moreover, the board's understanding of risks, especially nonfinancial risks, is often more intuitive than explicit. Formally articulating the organization's risk appetite and linking it to strategy will help management and the board acknowledge the risks, and the related opportunities, the organization faces in pursuing a strategy. That, in turn, positions them to determine whether the organization is taking the right risks, whether it is assuming too much or too little risk, and whether to consider alternative strategies for reaching its goals.

Risk management and strategic decisions have a profound impact on reputation. When the board is confident that risks are not only well managed but appropriate to the strategy, it protects the organization's reputation. When an organization takes too much risk and creates needless exposure, or takes too little and underperforms, the media, investors, and other stakeholders eventually ask the same question: "Where was the board when this was happening?"

Forging the missing link

Since the global financial crisis, boards have intensified their focus on risk oversight. Yet it is only recently that most organizations, particularly those outside the financial services industry, started formally defining their risk appetite. This process usually begins with fairly basic measures, such as developing risk statements for principal risks, usually of a financial nature. In this process, management considers exposures to certain markets, levels of credit for counterparties, country risk, concentrations of risk, and other measures. This enables the board and management to discuss the levels of risk they are prepared to take and how they define risk.

This is a good start, but it leaves aside two issues: the aggregate level of risk that the organization has taken on, and the ability to track exposures. While a risk appetite statement defines the aggregate level of risk, management must be able to track levels of exposure against the risk appetite statement and risk tolerances (see sidebar on page 30). Linking risk appetite and strategy clarifies the level of risk associated with a strategy. It also enables discussions of whether alternative strategies would present more attractive risk/return tradeoffs, given the organization's risk appetite.

Tim Archer
Strategic Risk Leader
Deloitte Northwest Europe

Formally articulating the organization's risk appetite and linking it to strategy will help management and the board acknowledge the risks, and the related opportunities, the organization faces in pursuing a strategy.

Important risk concepts include the following.[9]

- **Risk capacity** defines the maximum level of risk the organization could absorb. For example, even if this were to be a large number, or were applied to a large-scale acquisition, as it could be for major global companies, few leadership teams would want to operate close to risk capacity.

- **Risk appetite** defines the level of aggregate risk leadership is willing to take, or how close to maximum risk capacity the organization will venture, in pursuit of its strategy. In considering strategy and risk appetite, management and the board must weigh a variety of options for reaching strategic goals.

- **Risk tolerances,** or risk limits, designate the degree of risk the organization is willing to take in specific businesses and functions. If those thresholds are approached or breached, it's time to reconsider the strategy, risk management tactics, or both.

- **Risk profile** refers to total risk exposures aggregated across risk categories. However, risks are generally too variable, unquantifiable, and overlapping for precise aggregation; summing the exposures is likely to provide only directional information on the overall risk position. Nevertheless, a risk profile can be developed by assessing exposures, concentration of risk, correlations across risk types, and likely scenarios.

In summary, risk capacity is the largest amount of risk the organization could can absorb, risk appetite designates how near to capacity management will operate, risk tolerance is how much risk management will accept in a specific area before taking action, and risk profile represents actual aggregate exposure at a given time.

Conversations about risk appetite can become complicated when nonfinancial risks are considered. For example, most organizations have a low appetite for health and safety, cyber, legal, or reputational risks. Calculations to translate those risks into financial terms, such as legal settlements, fines, or lost market capitalization, would be highly uncertain at best. Risks associated with many value-creating activities driven by strategic choices cannot be quantified in a risk appetite statement the way credit or currency risk can be quantified. In these cases, the risk should be acknowledged in the discussion of strategy and perhaps in the risk appetite statement.

Strategic planning activities, strategy statements, and board and management discussions of strategy have also grown more robust in the past few years. In developing their strategies, organizations use more internal and external data, especially in the area of artificial intelligence. They may explicitly consider a wider range of strategic options and conduct more intensive modeling of potential outcomes. Strategic planning, treasury, and risk management functions now have the chance to come together to develop strategy more holistically.

That said, a good number of companies still view public statements about strategy and risk mainly as narratives to be deployed in the marketplace. While understandable, and useful to an extent, fuller depictions of strategy and risk and greater transparency—internally and externally—will generally serve an organization better.

A sample risk appetite statement

Management develops and defines both the strategy and the risk appetite while the board, as part of its oversight role, approves (and provides constructive critique of) the strategy and risk appetite. Risk appetite can be defined in various ways, and there is no single standard or set of guidelines. For that reason, organizations will vary widely in their efforts to develop and communicate their risk appetite. Given this, a formal risk appetite statement, in written form, can be quite useful.

A risk appetite statement may be for internal use only or also for public disclosure. When an organization has disclosed principal risks to the marketplace, those risks clearly must be considered in the risk appetite statement.

Very few organizations have published a formal risk appetite statement; among those that have is Anglo American plc, a UK-based global mining company, in its 2016 annual report.

In its annual report, this organization considers its principal risks and defines an appetite standard for each one. It defines a principal risk "as a risk or combination of risks that would threaten the business model, future performance, solvency or liquidity of Anglo American."[10] That is the leading edge of risk appetite statements— not only internally clear, but shared with investors and other external stakeholders. Furthermore, this shows that the practice of defining risk appetite has spread to non-banks.

The company's risk appetite statement, as set forth in the 2016 annual report, states:

We define risk appetite as 'the nature and extent of risk [the company] is willing to accept in relation to the pursuit of its objectives.' We look at risk appetite from the context of severity of the consequences should the risk materialise, any relevant internal or external factors influencing the risk, and the status of management actions to mitigate the risk. A scale is used to help determine the limit of appetite for each risk, recognising that risk appetite will change over time.

If a risk exceeds appetite, it will threaten the achievement of objectives and may require a change to strategy. Risks that are approaching the limit of [corporate's] risk appetite may require management actions to be accelerated or enhanced in order to ensure the risks remain within appetite levels.[11]

A brief section titled "How does risk relate to our strategic elements?" explicitly links risk and strategy in a readily available public statement. This gives investors and other external stakeholders high-level visibility into risks to the strategy and the steps management has taken to address them.

Risk appetite statements need careful wording to achieve an effective cascade of risk guidance downward and risk information upward in the organization. An enterprise-wide public statement, like the one cited above, represents the starting point of a more specific hierarchy of risk appetite statements, measures, and tolerances for the organization and its businesses and functions.

The initial step for most boards is simply to have in-depth discussions with management regarding strategy, risk, and risk capacity, appetite, and tolerances.

Why now?

As important as it has always been for the board and management to understand the interplay of strategy and risk appetite, it has become essential during the past few years. Here's why:

- **Strategies have become more dynamic.** Given that ongoing disruption and innovation define the new reality—to say nothing of developments such as the extended enterprise and evolving regulations—strategies have become more varied, adaptive, and subject to change.

- **Risks have become more varied and unpredictable.** Apart from those associated with any given strategy, risks arising from new technologies, competitors, customer behavior, and business models have increased. Depending on the organization and its industry, any of these risks could undermine successful implementation of the strategy.

- **Risk information has improved dramatically.** Until recently, many risks, and particularly nonfinancial risks, were difficult to identify, measure, and monitor. Now data-driven technologies provide a wider and more accurate view of risk. This enhances the board's ability to obtain risk assurance and oversee risk management.

- **Stakeholders' expectations have risen.** Investors, regulators, communities, and media grasp recent developments, and they expect boards to do more than rubber-stamp management's strategy and accept management's word that risks are controlled. In financial services, some regulators have even cited adherence to a risk appetite as an imperative, although they have not all defined what it is.[12]

Linking strategy and risk appetite enhances the transparency, rationality, and quality of both strategic and risk management decisions and oversight. A risk appetite statement makes risk more explicit and measurable, and thus more manageable.

Many organizations struggle to articulate risks rigorously enough for their own needs, let alone those of external parties, and many fail to link risk appetite specifically to strategy. Yet doing so does not need to be complicated. The initial step for most boards is simply to have in-depth discussions with management regarding strategy, risk, and risk capacity, appetite, and tolerances. Boards can benefit from having members with broad experience who are thoughtful, ask good questions, and can challenge management. They can also benefit from the expertise of external risk professionals who can bring industry knowledge to conversations and act as devil's advocate regarding risks and underlying assumptions. These discussions should encompass a holistic view of the organization's purpose and mission, business model, past and projected performance, and opportunities to create value. This enables the board to advise management in developing the risk appetite, as opposed to simply signing off on it.

Strengthening the link

The following are processes boards are adopting to better link strategy to risk appetite and to enhance their oversight of strategy and risk.

Ask management to articulate measures of risk. Risk-aware boards are asking management to define risk capacity, appetite, tolerances, and profile. This usually requires adopting a framework for developing those concepts and values and sets the stage for discussions of risks that fit into the framework and those that do not. These boards will ask management to quantify risk concepts in terms of potential impact on capital, cash, assets, market share, revenue, market capitalization, organizational value, or credit ratings. For certain risk events, it is important to estimate financial impact over an extended period.

Challenge management on the risks to, and of, strategies. The board must challenge management to discuss strategy and risk in tandem. Boards should ask about the effects of strategic decisions on risk capacity, appetite, and profile. Request scenarios in which two or three risks occur and management's proposed response. Clarify the rationale driving the explicit or implicit risk/return tradeoff and choices underlying a strategy, as well as the range of strategic options and the risks those options pose.

Make risk appetite a living thing. In many organizations, the internal audit function periodically reports on point-specific issues or failures deemed to be of importance to the board. These arise in diverse areas, such as finance, procurement, logistics, health and safety, and IT, leaving directors without a clear view of the larger picture. Those presenting to boards must provide context and answer questions about exposures, significance, needs, remediation costs, and likely outcomes. One useful method is to have the teams managing those areas conduct risk assessments against their risk tolerances, which roll up to risk appetite. Those assessments can be validated by functions like compliance, safety, and internal audit to link risk appetite with specific processes, yielding a clearer picture of risk across the organization.

Update reporting media. Most board members have or can be provided with devices to enable

Today, maintaining the status quo presents risks.

visual reporting. Risk visualization tools can highlight specific risks in the asset base, by asset or by geography, pinpointing high and low risk and enabling click-through to further detail. Bubble charts on two-by-two matrices depicting risk impact and likelihood are giving way to methods that can drill down to gross exposure, value deployed to address the risk, company reliance on the value at risk, and the effectiveness of controls. This type of reporting enables a dynamic view of exposures and their sources, as well as risk management effectiveness. This makes risk reporting a dynamic process that keeps leaders truly informed.

Get people in the same room. Do not settle for siloed risk reporting or overly technical reports. Confirm the board understands the interplay of strategy and risk appetite and how management's decisions can generate risks. Gaining that understanding may require presentations from various functions and units to the full board or the board committee responsible for overseeing risk (e.g., audit committee, risk committee, etc.). Boards need to understand the impact that initiatives such as new products or ventures, IT installations, cross-border expansions, mergers and acquisitions, and third-party alliances have on risk appetite. They also should understand the risks and impact of not pursuing a new strategy. Today, maintaining the status quo presents risks.

Request a review of strategic planning and risk management. A good number of internal audit functions are already reviewing their organizations' strategic planning and risk management processes.[13] These are not reviews of strategic planning and risk management decisions and outcomes, but an assessment of the integrity of the processes that underlie them. A strategic planning review might cover data used and sources; internal and external parties consulted; assumptions; and model integrity.

A risk management review might include risk data, identification, assessment, and monitoring procedures; decision-making and escalation policies; risk training; and governance. The review should consider external data and, potentially, tap outside experts to enrich the process and resulting perspectives. Internal audit personnel should also assess and advise on how the strategic planning and risk management processes inform one another and how they can be linked more tightly.

In closing

We are seeing greater board engagement and challenge when it comes to organizational strategy and risk oversight than we did when organizations were emerging from the global financial crisis. Yet many boards still need to better understand the interplay of strategy and risk, and do more to foster that understanding across the executive team. Linking discussions of strategy and risk appetite, both of which the board must approve, is an excellent way to create that understanding. As

the ultimate steward of value and overseer of risk, the board must grasp the relationship between strategy and risk and assist management not only in gaining that understanding but in putting it to practical use. Of course, different boards will take different approaches as to how vigorously their non-executives will challenge and intervene.

The table is set for even more robust board engagement with management regarding strategy and risk appetite. Directors now receive substantial information before each meeting, operational managers present their views of their specific areas, and many boards conduct site visits. When boards become aware of an issue, directors seek to learn more and, if necessary, ascertain whether management is addressing the issue and whether the CEO is the right person for the role. Framing oversight efforts in this context enables directors to actively engage management in optimizing strategy within the risk parameters the organization has set.

Questions for directors to ask

How would we rate our maturity, as a board and as an organization, on linking strategy and risk appetite? How often do we consider and discuss strategy and risk appetite in tandem? How deliberate and explicit is our approach to this discussion?

What efforts have we made to quantify the dimensions of risk capacity, appetite, tolerance, and profile? Where do we need to do a better job?

What has been our approach to less quantifiable dimensions of risk, such as cyber, environmental, and reputational risk? How do we measure and monitor those risks? How can we incorporate them into calculations of risk capacity and risk appetite?

As a board, how can we bolster our approach to risk oversight? What can we do to drive greater awareness of the risks to our strategy throughout the organization? Do we consider what our industry peers and industry analysts see as risks?

How do we know management is taking enough of the right risks? Could we be taking more risk to increase returns in the bounds of our current risk appetite and risk management capabilities?

What is the state of our risk identification, assessment, monitoring, and reporting capabilities? Are we using data analytics, artificial intelligence, risk sensing, and data visualization tools to their full advantage? Are we, as a board, satisfied with the level and quality of risk information we are receiving?

Are we sufficiently challenging our strategy, our approach to risk, the alignment of the two, and any underlying assumptions?

Do we clearly understand the risk implications of management's strategies and the alternatives from strategic and risk management perspectives? How complete and candid are the conversations we have with management in this regard? How can we make them more robust?

Q&A with Dr. Andreas Gottschling

Dr. Andreas Gottschling is a member of the board of directors of Credit Suisse Group AG, where he serves on the risk committee; he also serves on the UK subsidiary board of Credit Suisse International. Previously he served as chief risk officer and member of the management board of Erste Group Bank in Vienna, and, before that, as the global head of risk analytics and operational risk at Deutsche Bank in London and Frankfurt.

How has the board's role in overseeing risk in the financial services industry changed over the past several years?

Its changed significantly because the maturity of large financial services firms is now quite different relative to before the global financial crisis. Today, a financial services board must include people with specific technical know-how in areas such as derivatives, market risk, compliance and financial instruments accounting, as well as the traditional areas of strategy and governance. Before the crisis, boards were often comprised of industry captains with great experience in the latter two areas but nowadays the technical detail prescribed by banking regulation in risk governance is far greater. My own involvement in risk committees and boards has been driven in part by the need of those bodies for additional technical expertise.

Are you seeing risk appetite statements at the business unit level?

Yes. The overall risk appetite level is set at the top of the house and is then cascaded down, reflecting the business and corporate setup for the risk taking. This leads to quantitative limits for risk positions as well as possibly qualitative limitations (for example, thematic exclusions at the business unit level). This also means that a multinational company, having to comply with a myriad of regulations in many jurisdictions, has quite a lot of aspects to consider for the individual business unit's risk appetite.

How might those regulatory issues affect risk appetite?

Many risk measures are statistical in nature. That means in spite of getting it right on average, an outlier can, and therefore eventually will happen, causing the sudden need for capital or funding. For example, transfers of resources between regulated legal entities can be slow—even within the same country. When one adds the cross-border aspect, the possibility of a delay in proper funding in response to a stressful scenario further increases. That should be covered in the discussions leading up to the risk appetite statement or one may end up with a statement that reflects one's view on risk governance at the group level but does not serve well to control the type and magnitude of events at a country or legal entity level.

How have risk appetite statements changed?

Risk appetite statements are evolving beyond, "We have an overall measure of risk and like to keep it below level X." Recognizing the diversity of risks and their threats, now it's more often a detailed statement outlining how much of a given risk one is willing to take in specific areas. While increased granularity appears satisfying to some, one should understand the assumptions underlying these statements as well as the measures employed. For illustration of the latter pitfall, take the approach of limiting market risk by use of Value at Risk (VaR). VaR uses information about the positions but also about current and recent market developments. Hence, when a change in VaR occurs, one needs to first ask whether it comes from a change of position or a change in the market environment. As both change frequently, the question of whether the board is comfortable with an observed change in the market risk profile can become difficult to answer. As VaR constitutes only one of the derived measures commonly found in a risk appetite statement, these discussions can often be quite intricate. Therefore, many directors appreciate risk appetite discussions in a down-to-earth style. These discussions should include questions such as: "How much money are we willing to lose, and how often?" The answers are often hidden in extensive data tables without specific focus.

How would you describe the board's role in overseeing strategy?

In recent times, if a bank's strategy came under public scrutiny, analysis would more often than not indicate that the board had failed to sufficiently challenge management on whether strategy and resources were aligned. For example, organizations that failed to adapt their business models in a timely fashion to the post-crisis regulatory capital requirements have struggled. Whether this is based on management's misreading of the writing on the wall or an unwillingness to change their business models, it usually comes down to lack of oversight by the board. Similarly, if management proposes a strategy and the board cannot determine whether it is beyond the bank's resources, then a rude awakening is only a matter of time. Robust questions must be asked about strategy, particularly when management is implicitly placing large bets or perceiving something very differently from the rest of the market. Oversight is not just hoping that management gets it right.

How, if at all, has the board's role in overseeing strategy changed over the past several years?

There is much more tying-together of risk and strategy. Previously, strategy discussions could be quite lofty, such as wanting to "become a global leader in…," or very broad, with the focus on an aspirational financial result. Management would try to reach these goals, and if things looked too aspirational by mid-term, maybe change the business mix and lean to riskier components of the business to make up the shortfall. These changes in risk profile would often go unnoticed by the board. Today, the board cannot give overly broad direction and hope for the best. Instead, they must examine the resource and risk implications, review potential downsides as they develop, and monitor the associated risk profile in light of the strategy to verify that it remains within risk tolerances. Regulators spend a lot of time with management and boards to determine whether checks and balances exist and whether the right questions are being asked in this context.

What kind of risk reports are boards seeing?

Many banks used to have risk reports with hundreds of pages, and thousands of facts, but no information. Board members have the right to information in a format they can understand. In some instances, board risk reports used to present either a management narrative or bewildering arrays of tables; neither should be acceptable now. Granularity and various levels of aggregation for various purposes have to be geared to the questions that matter at the board level. One needs information that's timely and just granular enough so one can answer the questions one is mandated to focus on. In the quest for information rather than overwhelming factual data, many risk reports have dropped from triple digit pages to lower double digits, and have become more visual. If one feels the information is too granular, one should have management aggregate it to the preferred level. If it's too aggregated, one should have them break it down further. One needs information commensurate with the oversight one is conducting.

Do you feel boards are providing enough challenge to management?

From what I've seen, I do feel there is sufficient challenge in our environment. But a good chairman is key. They have to set the tone in terms of robustness, keep the discussions focused, and must recognize when and to what extent a separate interaction is needed. Also, the institutional memory of what has been tried but failed and for what reason, as well as cutting short the search for ideal solutions when they don't exist, are greatly aided by long-serving board members. The large personal liability one assumes as part of the mandate also helps to serve as a reminder of some dictums to work with: "trust—but verify," and "confidence builds through challenge."

We've talked about quantitative risk, but how do boards evaluate qualitative risks?

There are many such risks, including the risk of governance or compliance failures, technical break downs, or conduct issues—and these risks can be critical. It is quite common to use scenarios, heat maps, benchmarking, and inferences based on the past, but a lot of residual uncertainty remains in this area. Nevertheless, while it may be impossible to assess that uncertainty accurately beforehand, evaluations can be improved upon over time with improved processes and controls. But even in a highly automated world, some risks, such as conduct, will remain, because they are rooted in human behavior when facing a skewed incentive mix. Another risk, which is tricky to assess, is cyber risk, but one can safely infer that it will increase with increasing exposure to system vulnerabilities through relentless automation. Hence, I would expect the topic of assessing qualitative risks to continue to take up a lot of discussion.

And finally, how do you think about strategy and risk appetite in the context of reputation?

One has to consider various aspects of reputation. Originally, problematic counterparties created reputational risk. In the financial crisis, certain products, such as subprime loans and structured products, created additional reputational risk. Now reputational risk appears in new and unexpected spaces such as the many dimensions of sustainability impacted by business decisions. One can choose to limit one's involvement in certain businesses, industries, or nations, but the best hedge from a reputational standpoint would be to avoid exposure to sources of reputational risk entirely. Unfortunately, this may be problematic from a risk diversification standpoint or even infeasible in case of public interests. As it's hardly ever black-and-white, the possibility of a reputational impact arising from a business decision can never be discarded. Hence, this subject takes up considerable time for management and boards. The key thing is to try and assess what can go wrong, and then decide whether to leave it alone or, if not, how to most prudently go about mitigating the risk.

How boards can protect— and enhance—reputation

This is an exciting time to serve on a board. Although the risks to organizations perhaps have never been greater, the opportunities to make a positive impact—both for the organization and for society at large—have never been greater, either.

This publication has looked at reputation and the board's role in protecting and enhancing it. An organization's reputation is among its most valuable assets, and risks to reputation are increasing steadily. In today's hyper-connected world, information—whether positive or negative—travels at warp speed. Both the board and management must do all they can to stay ahead of threats to reputation.

Currently, boards are not only looking for ways to protect reputation but also for ways to enhance it. They realize that enhancing reputation is itself a protective measure: the more trust stakeholders have in the organization and its brands, the more resilient its reputation will be. An organization with a resilient reputation can better withstand reputation-impacting events, and control the conversation more effectively when those events occur.

While reputational sensing and assessment tools within the organization are essential, so is leadership from the board. That leadership is occurring. For example, boards are now asking whether management is taking enough of the right risks in the right areas to achieve strategic goals. They are asking whether the culture supports achievement of strategic goals, and whether the CEO is promoting the desired culture. They are asking whether the organization is cultivating a reputation as an innovator or as a laggard—the disruptor or the disrupted.

The answers to these questions make a difference when it comes to enhancing reputation but also in attracting (and retaining) talent, business partners, and investors.

Most leadership teams—boards and management—need to look at reputation proactively through scenario playing and wargaming. They need to develop greater strategic flexibility to be able to pivot as quickly as risks and opportunities evolve. They need to monitor closely and tie risks to reputation and the organization's ability to respond to reputation-impacting events. They need detailed digital strategies that enable them to invest at the right levels in initiatives that will support their strategic goals.

Forward-thinking boards are working to ensure that their oversight efforts keep pace with these needs. This process starts with board awareness of all the elements critical to success, including strategy, risk, leadership, culture, innovation, and reputation. It continues with robust engagement with management and flows through to management's plans and initiatives.

In addition to continually updating their oversight efforts, boards must harness technologies to support those efforts. These may include analytical, data visualization, artificial intelligence, or other technologies that increase the board's— and management's—awareness of strategic options and outcomes, risks, and culture and conduct in the organization.

As long as directors keep abreast of emerging methods and technologies and remain vigorously engaged in their oversight responsibilities, the path forward shines bright.

Chuck Saia
CEO
Deloitte Risk and
Financial Advisory

Endnotes

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Resources

Want to dig deeper? We selected the following Deloitte publications related to our 2018 Directors' Alert topics to assist you in identifying potential risks and opportunities facing your organization.

Strengthening the link between strategy and risk appetite: How the board can lead the way

- Are you in?: Conduct it's everyone's responsibility (Deloitte Australia)

- Risk appetite frameworks: How to spot the genuine article (Deloitte Australia)

- Effective third party risk management: Exploring strategies to improve contract management (Deloitte Canada)

- CFO Survey Herbst 2017: Ausblick Mittelstand: Steigende Zinsen, stärkerer Aufschwung? (Deloitte Germany) article in German

- Risikomanagement Benchmarkstudie 2017: Status Quo des Ausgestaltungsgrads gemäß der Anforderungen (Deloitte Germany) article in German

- The future of compliance 2017 (Deloitte Germany) article in German

- Evolution or irrelevance: Internal audit at a crossroads: Deloitte's global chief audit executive survey (Deloitte Global)

- Global risk management survey, 10th edition (Deloitte Global)

- New risk in a time of uncertainty and change (Deloitte Global)

- Risk Powers Performance: Integrity Risk Appetite: A key pillar in the strategy of financial institutions (Deloitte Netherlands)

- Unlocking the value of corporate values: How ethics powers performance (Deloitte Netherlands)

- Governance in focus: On the board agenda 2018 (Deloitte UK)

- Putting victims at the heart of a crisis response (Deloitte UK)

- Risk appetite: Is your exposure where you want it? (Deloitte UK)

- Too complex to manage?: Global bank governance in a structurally reformed world (Deloitte UK)

- Corporate development strategy: Thriving in your business ecosystem (Deloitte US)

- On the board's agenda | US: Framing strategic risk in the boardroom (Deloitte US)

- Risk appetite in the financial services industry: A requisite for risk management today (Deloitte US)

The missing link in CEO succession planning: Organizational culture

- Outcomes over optics: Building inclusive organizations (Deloitte Canada)

- On the board's agenda: Would you recognize the warning signs of a toxic culture? (Deloitte Global)

- The leadership premium: How companies win the confidence of investors (Deloitte Global)

- Women in the boardroom: A global perspective (Deloitte Global)

- El Plan de Sucesión y el Consejo de Administración (Deloitte Mexico) article in Spanish

- Plan de sucesión (Deloitte Mexico) article in Spanish

- Board impact: Thinking differently about boards (Deloitte UK)

- Too complex to manage?: Global bank governance in a structurally reformed world (Deloitte UK)

- Governance in focus: On the board agenda – the 2018 reporting season (Deloitte UK)

- Can CEOs be un-disruptable? Why today's best leaders are flexible, not steadfast (Deloitte US)

- Missing pieces report: 2016 board diversity census of women and minorities on Fortune 500 boards (Deloitte US)

- Rewriting the rules for the digital age: 2017 Deloitte Global Human Capital Trends (Deloitte US)

- The culture or the leader?: An organizational view of the chicken or the egg question (Deloitte US)

Exercising oversight of digital innovation: How boards can keep pace

- Data driven marketing: How efficient and personalized customer dialog will work in future? (Deloitte Germany)

- Boosting digital banking performance & revolutionizing customer journeys through FinTechs (Deloitte Luxembourg)

- Deloitte Digital Series: Artificial Intelligence (Deloitte Luxembourg)

- Disruption: A new way to generate alpha (Deloitte Luxembourg)

- Impact of digital transformation on Banking Operating Models (Deloitte Luxembourg)

- Mobile innovation: From predictions to reality (Deloitte Luxembourg)

- Smart buildings: How IoT technology aims to add value for commercial real estate companies (Deloitte Luxembourg)

- swissVR Monitor: February 2017 (Deloitte Switzerland)

- Too complex to manage? Global bank governance in a structurally reformed world (Deloitte UK)

- Approaching disruption: Charting a course for new growth and performance at the edge and beyond (Deloitte US)

- Automation is here to stay...but what about your workforce?: Preparing your organization for the new worker ecosystem (Deloitte US)

- On the board's agenda | US: Board oversight of algorithmic risk (Deloitte US)

- On the board's agenda | US: Managing brand risk in an age of social media (Deloitte US)

- On the board's agenda | US: The role of the board in an age of exponential change (Deloitte US)

- On the board's agenda | US: Winning with digital: What boards need to know about digital transformation (Deloitte US)

- Patterns of Disruption: Anticipating disruptive strategies in a world of unicorns, black swans, and exponentials (Deloitte US)

Contacts

Global

Dan Konigsburg
dkonigsburg@deloitte.com

Michael Rossen
mrossen@deloitte.com

North America

Canada

Jonathan Goodman
jwgoodman@deloitte.ca

Duncan Sinclair
dlsinclair@deloitte.ca

United States

Maureen Bujno
mbujno@deloitte.com

Deborah DeHaas
ddehaas@deloitte.com

Debbie McCormack
dmccormack@deloitte.com

Latin and South America

Argentina

Maria Mercedes Domenech
mdomenech@deloitte.com

Brazil

Camila Araujo
camilaaraujo@deloitte.com

Gustavo Lucena
gustavolucena@deloitte.com

Chile

Fernando Gaziano Perales
fpgaziano@deloitte.com

Arturo Platt
aplatt@deloitte.com

Colombia and Peru

Maria Cristina Pineros
mpineros@deloitte.com

Costa Rica

Mauricio Solano
msolano@deloitte.com

Guatemala

Maria de Collier
mecollier@deloitte.com

Mexico

Daniel Aguinaga
daguinaga@deloittemx.com

Trinidad and Tobago

Rikhi Rampersad
rrampersad@deloitte.com

Asia Pacific

Australia

Richard Deutsch
rdeutsch@deloitte.com.au

China

David Lung
dalung@deloitte.com.cn

Hong Kong

Hugh Gozzard
huggozzard@deloitte.com.hk

Eric Tong
ertong@deloitte.com.hk

India

Abhay Gupte
agupte@deloitte.com

Indonesia

Antonius Augusta
aaugusta@deloitte.com

Jose Sabater
josabater@deloitte.com

Japan

Masahiko Kitazume
masahiko.kitazume@tohmatsu.co.jp

Masahiko Sugiyama
masahiko.sugiyama@tohmatsu.co.jp

Korea

Jun Cheol Kim
junckim@deloitte.com

Malaysia

Cheryl Khor
ckhor@deloitte.com

New Zealand

Andrew Burgess
aburgess@deloitte.co.nz

Peter Gulliver
pegulliver@deloitte.co.nz

Singapore

David Chew
dchew@deloitte.com

Ernest Kan
ekan@deloitte.com

Gek Choo Seah
gseah@deloitte.com

Taiwan

Christina Tseng
christitseng@deloitte.com.tw

Thailand

Subhasakdi Krishnamra
skrishnamra@deloitte.com

Vietnam

Trung Nguyen
trungnguyen@deloitte.com

Nguyen Vu Duc
nguyenvu@deloitte.com

Europe, Middle East and Africa

Belgium

Rik Neckebroeck
rneckebroeck@deloitte.com

CIS

Oleg Shvyrkov
oshvyrkov@deloitte.ru

Cyprus

Panicos Papamichael
ppapamichael@deloitte.com

Czech Republic

Jan Spacil
jspacil@deloittece.com

Denmark

Martin Faarborg
mfaarborg@deloitte.dk

Henrik Kjelgaard
hkjelgaard@deloitte.com

Finland

Merja Itaniemi
merja.itaniemi@deloitte.fi

France

Carol Lambert
clambert@deloitte.fr

Germany

Claus Buhleier
cbuhleier@deloitte.de

Ghana

Joe Ohemeng
johemeng@deloitte.com.gh

Greece

Alithia Diakatos
adiakatos@deloitte.gr

George Trivizas
gtrivizas@deloitte.gr

Hungary

Gabor Molnar
gmolnar@deloittece.com

Ireland

Colm McDonnell
cmcdonnell@deloitte.ie

Israel

Irena Ben-Yakar
ibenyakar@deloitte.co.il

Italy

Ciro di Carluccio
cdicarluccio@deloitte.it

Kenya

Julie Nyangaya
julnyangaya@deloitte.co.ke

Lithuania

Saulius Bakas
sbakas@deloittece.com

Luxembourg

Laurent Berliner
lberliner@deloitte.lu

Justin Griffiths
jugriffiths@deloitte.lu

Middle East

Hani Khoury
hakhoury@deloitte.com

Hossam Samy
hsamy@deloitte.com

Morocco

Hicham Belemqadem
hbelemqadem@deloitte.com

Netherlands

Wim Eysink
weysink@deloitte.nl

Caroline Zegers
czegers@deloitte.nl

Nigeria

Tony Olukoju
aolukoju@deloitte.com.ng

Norway

Endre Fosen
efosen@deloitte.no

Helene Raa Bamrud
hbamrud@deloitte.no

Poland

Halina Franczak
hfranczak@deloittece.com

Dorota Snarska-Kuman
dsnarskakuman@deloittece.com

Portugal

João Costa da Silva
joaolsilva@deloitte.pt

Romania

Andrei Burz-Pinzaru
aburzpinzaru@deloittece.com

South Africa

Johan Erasmus
jerasmus@deloitte.co.za

Nina le Riche
nleriche@deloitte.co.za

Spain

Juan Antonio Bordas
jbordas@deloitte.es

Sweden

Bjorn Mikkelsen
bjmikkelsen@deloitte.se

Switzerland

Thierry Aubertin
thaubertin@deloitte.ch

Fabien Bryois
fbryois@deloitte.ch

Lisa Watson
lwatson@deloitte.ch

Turkey

Itir Sogancilar
isogancilar@deloitte.com

United Kingdom

Tracy Gordon
trgordon@deloitte.co.uk

William Touche
wtouche@deloitte.co.uk

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